

The Risks of Product Mis-selling

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Thank you for inviting me here this afternoon. I'm aware that I may be the only regulator speaking at this conference, so while my technical knowledge on risk management will pale in comparison to the numerous experts gathered here, I do hope to throw some useful light on some of the issues discussed today from a regulatory perspective.

Today I wish to talk about the risks of mis-selling financial products and what the SFC is doing to promote higher standards amongst those intermediaries who provide investment advice.

Investment advisory industry overview

The investment advisory industry is a growth industry and a profitable one. How so?

Investing trends

In the past, Hong Kong investors mainly invested in property, shares and foreign currency. However, stock market volatility and the low interest rate environment have encouraged many investors to seek better returns in a wider range of financial products. These include the traditional unit trusts and mutual funds, hedge funds and other collective investment schemes, structured products as well as investment-linked insurance policies (ILAS).

Demographics

In terms of demographics, the Government predicts that 25% of Hong Kong's population will be aged over 65 years by the year 2031. Higher life expectancy and an aging population will increase dependency on working persons. In this way, more and more couples are looking to systematically plan for their retirement rather than rely on children for financial support. They have a nest egg which they wish to preserve and grow.

Over time, however, financial products have become more complex, cutting across traditional boundaries between securities investment, banking and insurance. A competitive market like Hong Kong fosters greater innovation, choice and value-added for investors. Innovation is the key and this is reflected in the wide range of both authorised and unauthorised financial products available to investors. There are now over 2,600 SFC-authorized collective investment schemes (including 14 authorised retail hedge funds) and over 190 investment linked insurance products (ILAS).

Equally significant is that as the market becomes more sophisticated, and therefore more unforgiving to the average retail investor, more and more investors rely on investment advisers or IAs to guide them through the complex range of financial products, to find those that are reasonably suitable and appropriate for them.

Risks arise when IAs, due to various reasons, are unable to provide professional and objective investment advice to their clients. Once investors lose confidence in their IA, the danger is that they lose confidence in the market and this would be detrimental to all market participants.

Regulatory landscape

In Hong Kong, three groups of IAs provide financial advisory services to the public: (1) SFC licensed investment advisers (2) banks (3) insurance intermediaries.

The SFC directly supervises SFC-licensed IAs only, whereas the HKMA is the frontline regulator for registered institutions (i.e. banks) that are IAs. However, both SFC licensed IAs and banks are subject to the same SFC regulatory requirements [(i.e. Code of Conduct and the Internal Control Guidelines) and the relevant laws under the Securities and Futures Ordinance (the “SFO”)].

Insurance intermediaries, on the other hand, are regulated under a separate regime governed by the Insurance Companies Ordinance and is administered by the Insurance Authority and two self-regulatory organisations (SROs).

The SFC’s role in addressing fraud and mis-selling

Theme inspection

In February 2005, the SFC published a report regarding a theme inspection on a good mix of 15 SFC-licensed investment advisory firms - roughly 10% of the total number of firms that we licensed at that time. We focused on looking at the selling practices of IAs and assessing their compliance with the relevant rules and regulations.

A number of deficiencies were detected. In particular:

- Insufficient Know-Your-Client information collected
- Inadequate due diligence on products
- Lack of proper basis for the investment recommendation
- The explanation given to the client was not sufficient to enable the client to make an informed decision on the investment

Some examples of unsuitable recommendations found were:

- A teacher who worked in Hong Kong for 26 years was advised by an IA to put a proportion of his salary into an unauthorised fund with a promise of a potential return of 16%. He was also advised to gear up by 4 times. In the end, he lost all his savings (GBP 95,000).
- It was reported in 2005 that a woman, aged 86, had most of her savings switched into high-risk single country funds by bank staff. Apparently there were 58 switches made to her savings within 8 months. (We passed the case to HKMA).
- Some distributors do not perform proper product due diligence. In one case, the distributor produced misleading marketing materials stating that the unauthorised fund was suitable for conservative investors with low risk-tolerance. In reality, the offering memorandum described these funds as speculative investment designed only for sophisticated and experienced investors.

Most of the problematic regulatory issues identified could have been avoided if IAs had strictly observed the standards that are already set out in the existing codes and guidelines. One of the primary objectives of the SFC report was to remind IAs to follow these requirements very closely.

We reminded IAs in no uncertain terms that we would carry out another theme inspection in a year's time and if there were no improvement, other options would be considered.

Consumer Council Survey

The Hong Kong Consumer Council also carried out a survey that was published earlier this year to assess the level of service and advice by investment advisers at 33 financial institutions. The survey was conducted by people posing as potential customers with differing backgrounds (i.e. age, family and economic status) and a total of 58 visits were made. In the Consumer Council's own words, the results were "quite an eye-opener". The survey highlighted a number of areas of concern including:

- (i) Lack of disclosure of license or qualifications of the IAs in some cases. This is essential as some products can only be sold by persons licensed to carry out regulated activities.
- (ii) In some cases, detailed information of remuneration was lacking. Some IAs simply indicated to potential clients that their advice is free without disclosing that they get incentives in the form of commission rebate for recommending specific products. This can be potentially misleading to consumers.
- (iii) In other cases, IAs only highlighted the benefits of a proposed investment, and neglected to mention the risks involved.
- (iv) Some IAs appeared to be only interested in pushing products of their own company without due regard to the status and financial objectives of their customers. This results in inappropriate advice being provided to customers.

The common examples given were of investment products being sold to elderly consumers with overly long maturity terms, lock-in periods or even no guaranteed returns.

- For instance, in one case, a 63-year old in retirement was recommended to purchase an ILAS product that required annual payment of US\$80,000 for 3 years and then he had to wait 9 years (till the age of 72 years) before receiving a stable monthly return of US\$1,295 over the next 25 years.
- In another case, a retiree aged 65 years was asked to take out an insurance savings plan for his grandson that will run for the next 16 years.

These practices are clearly unacceptable.

IAs have a duty to act in the clients' best interests

This broad but fundamental duty can be broken up into various principles that are set out in the SFC's Code and Guidelines:

1. Know your client – Collect and record sufficient information of the client's financial situation, investment experience, and investment objectives. If the investment adviser maintains an ongoing relationship with the client, the client's profile should be updated periodically.
2. Product due diligence - Ensure that all material aspects of a product are understood before recommending the product to the client. This duty is more onerous when it is an unauthorised product.
3. Reasonable recommendation - Make recommendations that are reasonably suitable given the client's specific circumstances. Document the basis of recommendation and how the recommended investments would match the client's investment objectives and risk profile.
4. Help the client make informed decisions - Give the client a proper explanation of the basis of the investment recommendation, as well as the nature and extent of the risks. The consequences of early encashment should be clearly explained. It is not enough to hand over a product brochure and treat it as self-explanatory for the client.
5. Competency - Employ competent staff and provide appropriate training.

Thus, the overriding principle is to act with due skill, care and diligence in the client's best interest. And in this, we expect senior management to take responsibility and to play a greater role in ensuring that proper standards of conduct and compliance are adhered to.

Our findings have shown that some IAs have still some ways to go to comply with these duties.

Action Plan

To address the risks of product mis-selling, the following initiatives have been or will be implemented:

- (1) Currently, the SFC is conducting a second round inspection on IA activities.
- (2) Where there is clear evidence of breaches of the rules and regulations, we have taken and will continue to take the necessary enforcement action.
- (3) The SFC will provide more detailed guidance on existing regulatory requirements concerning the duties and obligations of IAs to their clients.

At the international level, the SFC is an active participant on IOSCO which is the industry standards setting body for the securities market. One of the hot topics currently being discussed by international regulators is the issue of appropriate disclosure and ways to address intermediary conflicts of interest.

- (4) Finally, the SFC will continue its efforts to help investors know their rights, responsibilities and risks when seeking advice from IAs. We will continue to educate investors through different channels via the media, workshops, publications and our comprehensive online investor education portal - "InvestEd".

However, regulation alone will not help those investors who rush into investments without first understanding the product, the risks, the fees and obligations. We will be seeking to improve investors' awareness in this regard.

Conclusion

The SFC has the statutory duty to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry. Towards these objectives, we will do all we can to help ensure that that financial products in Hong Kong are not being mis-sold and that investors are being provided with better service, and appropriate advice from their advisers.

Thank you.