Circular

SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

HONG KONG MONETARY AUTHORITY
香港金融管理局

18 April 2024

Joint circular to intermediaries

Findings of concurrent SFC-HKMA thematic review of the distribution of non-exchange traded investment products

1. During a concurrent thematic review[1] of the distribution of non-exchange traded investment products by intermediaries, the Securities and Futures Commission ("SFC") and the Hong Kong Monetary Authority ("HKMA") identified some issues on intermediaries' practices in performing product due diligence ("PDD") and suitability assessment, providing information to clients and ensuring investment products are in the best interests of the clients. The intermediaries concerned were required to undertake remedial action to address the issues identified.

<u>Key observations</u>

2. Many intermediaries would assign risk rating to investment products as part of PDD for matching with client's risk tolerance level, either calculated using their internal risk-scoring mechanisms or based on the nature of underlying investments. The regulators noted that some intermediaries had overlooked certain key features and risk factors in their PDD assessment methodologies which could directly or indirectly impact the risk return profiles and growth prospect of the investment products. In some cases, intermediaries did not consider during the assessments the pay-out and characteristics of a leveraged structured forward contract, credit events relating to the product issuers, heightened market and industry risks, or adverse economic and political environments.

3. These intermediaries could run the risk of making inappropriate recommendations to clients if the risk return profiles of the products were not adequately assessed and accurately reflected in the product risk ratings used for the suitability assessment. Under such circumstances, the ability of intermediaries to fully inform clients the nature and extent of risks of the products would also be adversely affected. The risk would be further aggravated if the investment products, such as structured products, have leverage features which could amplify potential losses.

4. Structured products were the most prevalent type of non-exchange traded investment products sold by intermediaries. Among the structured products, accumulators and decumulators were the most popular products sold.[2] Accumulators and decumulators are derivative products associated with significant investment risks. Investors typically risk a loss up to the notional amount of the contracts, and could only achieve positive returns if the price of the underlying asset moves within the defined range between the strike price and the knock-out price that was set to limit the maximum amount of profit. The loss could be unlimited in some cases, for example, where the investors of decumulators have to bear the loss when the price of the underlying asset goes up.

[1] See the Joint circular to intermediaries on Concurrent SFC-HKMA thematic review of the distribution of non-exchange traded investment products issued on 1 March 2022.
[2] See the SFC-HKMA Joint Survey on the Sale of Non-exchange Traded Investment Products 2022.

5. Clients would not be able to understand the characteristics of accumulators and decumulators should the intermediaries merely hand over the product literature to the client, ask the client to read them, or read them to the client without any explanation. In one case, a salesperson was unable to explain why investors could buy shares at a price lower than the market price with an accumulator contract. He could only read out the value of its “discount” compared to market price, its knock-out clauses and potential losses from the relevant term sheet. It is therefore imperative for intermediaries to develop thorough understanding of structured products during PDD and provide adequate training to staff to ensure that they are fully conversant with the characteristics, nature and extent of risks of the products recommended to clients.

6. Intermediaries are reminded to exercise due skill, care and diligence in selecting investment products for different risk categories of clients and arrive at an assessment of the products taking into account information that is appropriate and reasonably available for a fair and balanced assessment. Failure to do so could severely inhibit intermediaries’ ability in helping clients to make an informed investment decision.

7. The regulators also wish to remind all intermediaries of their obligations to, among other things –

   (i) give due consideration to all the relevant circumstances specific to a client when assessing the suitability of a product to the client; and

   (ii) disclose all relevant transaction related information, and ensure that information provided and any representations made are accurate and not misleading.

8. The observations from the concurrent thematic review on licensed corporations are set out in Annex 1 and those on registered institutions in Annex 2. Intermediaries are expected to review their policies and procedures to address any issues relevant to their firms with a view to improving compliance, having regard to relevant annexes.

9. Should you have any questions regarding the contents of this circular, please contact Ms Nicole Cheung on 2231 1492 or your case officer at the Intermediaries Supervision Department of the SFC or Ms Eloise Pun at the Banking Conduct Department of the HKMA on 2878 1903.

Intermediaries Supervision Department
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Enclosure

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