Annex 1

Key observations by the Securities and Futures Commission

1. This annex shares key observations from the thematic review of the distribution of non-exchange traded investment products conducted by the Securities and Futures Commission ("SFC") on licensed corporations ("LCs"). The thematic review covered selected LCs' policies, procedures, systems and controls, as well as management supervision of the distribution of structured products (including accumulators and decumulators), corporate bonds and funds.

A. Product due diligence ("PDD")

2. PDD involves intermediaries developing of a thorough understanding of the investment products based on their review of relevant product information that is appropriate and reasonably available, and identifying the key terms and features of investment products which delineate respective characteristics, nature and extent of risks. Where relevant, it should also take into account market and industry risks, economic and political environments, regulatory restrictions and any other factors directly or indirectly impacting the risk return profiles and growth prospects of the investment products.

(a) Lack of proper verification work and management supervision

3. LCs commonly set out in their policies and procedures a list of factors to be considered as part of their due diligence work when selecting investment products for clients. We noted instances where LCs' senior management failed to make appropriate enquiries or verification on the investment products, and approved them for offering to clients despite omissions and errors during PDD.

SFC's observations
(i) Some LCs' senior management approved substandard PDD documentation which had obvious omissions or contained inaccurate analyses on investment products without verifying respective work. For example, they misdescribed an accumulator as a coupon-bearing instrument, misdescribed the bid/ask price of a Chapter 37 Bond[1] as being determined on an exchange, misstated bonds ranked *pari passu* with other unsecured unsubordinated debts of the issuers as "senior secured", or misidentified a secured bond as being collateralised by real estate properties of the issuer instead of capital stocks of its subsidiary guarantors with no material operations.

[1] Being bond offered for subscription and listed under Chapter 37 of The Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("Chapter 37 Bond"), which was not traded on an exchange.

4. LCs failing to afford sufficient review of the investment products for identifying key terms and features, including special features, would not be able to duly assess the characteristics, nature and extent of risks of each investment product offered to clients.

SFC's observations
(i) Some LCs did not identify for their clients the special features of bonds, such as variable coupons, bondholder's put option to demand issuer repurchasing on a specific date, loss absorption or multiple credit support structures. Failure to identify and adequately assess these special features which could fundamentally alter the risks and pay-out of the bonds would adversely affect the LCs in helping clients to make an informed investment decision.

5. LCs had sometimes overlooked qualitative factors such as heightened market and industry risks, as well as adverse economic and political environments that could also impact the risk return profiles and growth prospect of the investment products.

SFC's observations
(i) An LC having required its staff during PDD to consider the credit risks of product issuers with reference to their credit rating and credit default swap price did not provide guidance on respective criteria of approval. (ii) Where high-yield bonds could be more sensitive to economic downturns compared to investment-grade bonds when default risk increases, some LCs selected high-yield bonds for clients merely because of their discounted price and yield advantage over higher-quality bonds, or an issuer exhibited a better prospect of recovery relative to its peers in the industry. However, when credit events and adverse news were severely affecting the market or industry, the LCs did not assess the risks of bonds arising from the commonly deteriorating credit quality across the industry. Nor was there sufficient analysis to support why the high-yield bonds would be considered suitable for clients looking to make bond investments.

(b) <u>Inconsistent assessment on product risks</u>

6. Many LCs had assigned risk rating to investment products for matching with the client's risk tolerance level, either calculated using their internal risk-scoring mechanisms or based on the nature of underlying investments. Where staff were allowed to exercise discretion in adjusting the calculated risk-scores or deviate from the LC's risk assessment methodology, inadequate guidance in this respect would result in inconsistent assessment.

SFC's observations
(i) An LC assigned product risk ratings to funds primarily based on the nature of underlying assets (e.g. equity funds, high-yield bond funds or investment grade bond funds), their redemption frequency, lock-in period and authorisation status. It further required its staff to consider generally the level of risk of underlying investments, concentration, their use of derivatives and leverage in their assignment of product risk ratings. However, no guidance was provided to staff on how the risk rating should be adjusted in light of these factors. (ii) An LC classified funds into high, medium or low risks, but it did not provide guidance to staff on the respective criterion of determination. It was unable to explain the rationale underlying its staff's assessment for classifying a high-yield bond fund not authorised by the SFC as low risk, as compared to other investment-grade bond funds classified as medium risk.

(c) Failure to adequately consider the nature and extent of risks of structured products

7. When structured products, particularly accumulators and decumulators, remained the most prevalent type of products sold by LCs[2], some LCs were not able to demonstrate a good grasp of the terms and features, characteristics of each structured product sold to clients. Some LCs might have underestimated potential losses. LCs failing to thoroughly understand the nature and extent of risks of structured products could severely inhibit their abilities in helping clients with various objectives and horizons to make an informed investment decision.

8. For instance, accumulators incorporate a series of option contracts giving investors the right to buy the underlying asset at a predetermined strike price that is often set at a discount to the prevailing market price. While investors selling the put option could incur a loss throughout the contract tenor and up to the maximum notional amount, their positive return could only be fully achieved when the price of the underlying asset moves narrowly between the strike price and a knock-out price that was set to limit the maximum amount of investors' profit. Therefore, accumulators would not offer good value to investors during a volatile market, or for investors looking to maximise their gain from any sharp price changes.

SFC's observations
(i) A staff member of an LC who had been selling accumulators to clients was unable to illustrate any understanding that the "discount" in fact represented the premium received by clients from selling a (series of) put option. Neither was he able to explain the deeper the "discount", the greater the risks. This also led to concerns on whether the staff member could properly explain to clients the characteristics, nature and extent of risks of an accumulator by merely reading

[2] See the SFC-HKMA Joint Survey on the Sale of Non-exchange Traded Investment Products 2022.

out from a term sheet the quantum of its potential return, its knock-out clause and the maximum loss from the investment.

(ii) An LC assigned product risk rating to structured products based on the nature of their underlying asset. It had classified an equity-linked fixed coupon note as high risk, and a foreign exchange target redemption forward contract ("FX-TARF")[3] as medium risk. However, the terms and features, pay-out and characteristics of the FX-TARF were akin to accumulators and/or decumulators and investors could incur unlimited losses under the contract. It also contained a leverage feature which would have multiplied any amount of loss significantly. The LC's assessment of the FX-TARF being generally suitable for clients willing to accept a moderate level of investment risks despite the heightened volatility from the currency pair, and describing its potential maximum loss as non-principal protected, were clearly inadequate and insufficient to reflect the nature and extent of risks of the structured product.

(d) Insufficient ongoing PDD

9. Some LCs maintained a list of approved investment products they could distribute to clients, but they did not have procedures in place to ensure that PDD was conducted on a continuous basis or at intervals proportionate to the nature, features and risks of investment products to ascertain whether the products remain suitable for their clients.

SFC's observations
(i) An LC did not review its previous PDD work when selling investment products to clients in instances where a bond issuer had defaulted repayment on its other bonds, or when the investment manager of a fund was changed. (ii) An LC implemented a new product risk-scoring mechanism only to assess new products but not its existing products. When the existing products remained on the firm's product shelf, and a certain portion would be adjusted to a higher risk rating if assessed under the new mechanism, failure to assess its existing products would hinder the LC's suitability assessment when the products it sold to clients were risk-rated with different methodologies producing varying results. (iii) When assigning product risk ratings, some LCs gave significant weighting to the period-to-date return and/or volatility of an investment product, or those of its underlying investment. However, these LCs did not subject a product to review when its return deteriorated, or when volatility heightened during the product tenor. They have failed to ensure that their understanding on the

[3] The FX-TARF was a structured forward contract involving a series of forward transactions. The investor's potential gain was limited by a target profit, but there was no ceiling on potential losses as the investor in unfavourable situation would remain obliged to exchange currencies at the predetermined rates according to a regular schedule during the tenor of the contract. As the FX-TARF also contained a leverage feature, varying notional amounts might be involved magnifying the investor's risks associated with the contract.

product remained relevant for subsequent suitability assessment, particularly whether the product risk rating continued to reflect the product's risk return profile during changing conditions.

(iv) When the price of a bond dropped beyond a percentage threshold set by an LC for triggering ongoing PDD, its review only focused on the general analysis on market outlook and industry performance, without reassessing the credit quality of the issuer who had been subject to several downgrading actions by credit reference agencies over time. The ongoing PDD work performed was insufficient to illustrate, for instance, in what aspects the specific bond remained suitable for its clients.

B. Suitability assessment

10. Suitability assessment is a risk-based process that involves intermediaries matching of investment products with the personal circumstances and risk tolerance of clients. While many LCs relied on the matching of the product risk rating with their assessment result on a client's risk profile as their primary consideration, they are reminded to take into account all the relevant circumstances specific to a client, including the client's financial situation, investment experience, objectives, horizon and concentration risk, when assessing the suitability of a product to the client.

(a) Inadequate risk profiling of clients

11. There were different ways for LCs to assess a client's attitude towards risk for the purpose of suitability assessments. Where a risk profiling questionnaire ("RPQ") was used and risk-scores were assigned to the client's answers to support an assessment, some LCs had overlooked whether the design of the RPQ questions and its underlying scoring mechanism could produce skewed results towards high risk tolerance.

SFC's observations
(i) An RPQ used by an LC did not seek to understand from its clients their tolerance of the risk of capital loss. It had instead assigned significant weighting on the client's investment experience, where the maximum scores assigned to multiple questions relating to the client's investment experiences would have qualified one as having high risk tolerance. The RPQ would hence produce skewed results on experienced investors; and the LC was unable to justify the disproportionate correlation of one attribute with the client's risk tolerance.

(b) Inadequate consideration of clients' concentration risk

12. Some LCs did not provide clear guidance to staff on the types and categories of investment products that would add to a client's concentration level, nor the nature of assets (e.g. investible, liquid or otherwise) that form the bases of consideration. It calls

into question as to whether an assessment of the client's concentration risk had been properly and consistently performed.

SFC's observations
(i) Some LCs relied on their staff to assess a client's concentration risk by assessing whether the client's investments in the same type of product had exceeded a predetermined concentration threshold. However, it was noted that staff had taken different interpretation as to products falling within the same type. Where some staff considered it to include all products within an asset class (e.g. funds), some differentiated them between authorised and unauthorised funds, and some others narrowly differentiated them between fund managers or product issuers. (ii) Where the information about a client's net worth obtained during account opening may not provide accuracy when used in concentration assessment (e.g. the band range being representative of the client's net worth was set too wide as answer options on the account opening form), the LC arbitrarily used the maximum value in the band range as the value for the assessment. The LC did not make further enquiry about an appropriate reference to be used. If the mid-point or minimum value in the band range was used, the transaction would be assessed as overly concentrated by the LC.

13. LCs which only focused on the concentration risk of a transaction but neglected information available to them, including the client's investments in the account, would not be able to properly assess the overall impact of the transaction on the client's portfolio.

SFC's observations
(i) The staff of an LC assessed a client's concentration based on a value of the client's net worth that was 10 times greater than the LC's record about the client. The LC was unable to demonstrate any clarification made by its staff with the client, nor could the LC ascertain whether the value was representative of the client's net worth. (ii) An LC did not consider a client's aggregated exposure on high-risk products, arising from all equity-linked structured products it sold to the client over a short period of time when assessing the client's concentration risk. (iii) When assessing a client's concentration risk, some LCs did not consider the client's exposures on an issuer arising from the client's holding of high-yield bonds and shares of the issuer, which in aggregate accounted for a very significant portion of the client's portfolio maintained with the LCs respectively.

14. Many LCs had set concentration thresholds on their clients in respect of the maximum proportion of a client's net worth and/or investment portfolio that may be invested in high-risk products. While exceeding a particular concentration level may be acceptable so long as the outcome is commensurate with the overall risk profile of the investment portfolio and the client's other circumstances, some LCs could not justify the set threshold or any exception.

SFC's observations
(i) An LC allowed clients of a moderate risk tolerance level to invest up to 80% of the client's portfolio in investment products classified by the LC as high risk, but the LC could not justify such determination as being commensurate with the clients' portfolios or the circumstances of all such clients. (ii) An LC allowed its clients during risk profiling to indicate any value between 0% and 50%, or "over 50%" as their acceptable level of concentration. Where clients had indicated to accept a concentration level of over 50%, the LC did not otherwise assess a client's concentration in high-risk investment products. Neither could it justify in what aspects would an unlimited level of concentration be considered suitable for these clients. Further, clients would be asked to risk-accept a transaction should it exceed the client's acceptable level of concentration previously indicated. We were concerned about the LC's practice to solely rely on a risk acceptance statement made by clients for discharging its suitability obligations.

C. Information for clients

15. LCs are reminded to deliver all relevant transaction related information[4] to a client when distributing investment products to the client, prior to or at the point of entering into the transaction. They should act to ensure that any representations made and information provided to the client are accurate and not misleading.

16. Some common deficiencies noted in this respect are highlighted below –

SFC's observations
(i) Many LCs receiving trailer fees from fund managers indirectly through their execution brokers did not disclose the maximum percentage of such monetary benefits receivable per year and per fund on a transaction basis.[5]

[4] In accordance with paragraph 8.3A of the Code of Conduct Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct").
[5] In accordance with the expected standards set out in the answer to question 2 of the Frequently Asked Questions on the Code of Conduct issued on 16 November 2017, and the answer to question 1 of the Frequently Asked Questions on the Code of Conduct issued on 15 June 2018, respectively.

(ii) An LC inaccurately represented itself as being independent when it had in fact received fees and commissions for distributing investment products. Other LCs often did not disclose their affiliation with product issuers, the fact that they were not independent or the bases for such determination.[6]

(iii) Many LCs explained to clients the risks and consequences of being treated as a Professional Investor ("PI") with the use of a proforma notice setting out all provisions under paragraph 15.4 and/or paragraph 15.5 of the Code of Conduct the LC could disapply when dealing with PIs. However, the LCs in practice did not disapply the provisions when dealing with clients qualified as PIs. This practice might cause confusion to clients as to whether the Code of Conduct requirements are disapplied by the LCs.

[6] In accordance with paragraph 10.2 and Schedule 9 of the Code of Conduct.