

## **Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers**

### *Executive Summary*

Following on from the thematic inspections carried out on licensed investment advisers (“IAs”) in 2004<sup>1</sup>, the Securities and Futures Commission (“the SFC”) conducted a second round of on-site inspections on ten selected IAs in 2006 to assess their selling practices and compliance with the relevant regulatory standards.

The inspection findings revealed that a similar range of issues and deficiencies noted amongst the 15 firms during the first round of thematic inspections also exist in the other 10 firms selected for this second round.

The recent inspection findings include:

- Insufficient knowledge of clients;
- No proper due diligence on the products sold;
- Lack of justification to illustrate suitability of advice;
- Ineffective management supervision;
- Poor documentation; and
- Non-compliance with licensing requirements.

The SFC will take regulatory actions against those who committed serious breach of the law, rules and code. Investigation has already commenced on the more serious deficiencies and breaches noted in this second round of theme inspections.

Moreover, to further enhance the compliance of meeting the code of conduct requirements, the SFC issued guidance in the form of questions and answers<sup>2</sup> on 8 May 2007 and we will continue to monitor and inspect IAs to assess their level of compliance with the relevant regulatory requirements.

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<sup>1</sup> The first round of thematic inspections on licensed investment advisers was conducted in 2004, resulting in the issuance of the “Report on selling practices of licensed investment advisers” in February 2005. Appendix 1 contains a summary of the 2005 report.

<sup>2</sup> The guidance aims to assist the licensed and registered persons who are engaged in financial planning and wealth management business activities relating to provision of investment advice, making of recommendations and/or solicitation meet the suitability obligations under paragraph 5.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

## **I. Introduction**

### ***Profile of the inspected firms***

1. In this round of theme inspections, we inspected ten IAs with various sizes of operations. The profile of these selected firms can be summarised as follows:
  - Size of clientele: from about 100 to 2,000 clients;
  - Number of licensed individuals: from 2 to over 100;
  - Amount of shareholders' fund: from less than HK\$1 million to about HK\$11 million.

This small sample is not necessarily representative of the IA industry in general.

### ***Objective of the inspections***

2. The objective of the theme inspections is to assess the current selling practices adopted by IAs and to review whether any improvement has been made since the issue of the last report.

## **II. Existing regulatory requirements**

3. As a recap, the expected standard of conduct for investment advisers is set out in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code") which requires investment advisers to:
  - Act in the best interests of their clients;
  - Avoid conflicts of interest as far as possible;
  - Know their clients before giving any advice;
  - Exercise due care when giving advice;
  - Give suitable advice to their clients; and
  - Employ competent staff and other resources and procedures for ensuring compliance with relevant laws, rules and codes.
4. Investment advisers are also governed by the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission ("Guidelines"). Under the Guidelines, investment advisers should implement special procedures, which may include:
  - Adequate research work and preparation and retention of relevant documentation; and

- Documenting the rationale underlying an investment advice or recommendation.
5. Both the Code and the Guidelines apply to all licensed corporations and registered institutions and there are significant differences that exist in the organizational structure as well as the nature and scope of the business activities conducted by them. As a result, the Code only sets out high-level principles and the Guidelines only suggest control techniques and procedures. Individual firms have to consider their own circumstances when developing their own systems and controls for meeting our expectations.

### **III. Common issues identified during the inspections**

#### ***Overall results of the inspections***

6. In general, our findings indicate that a similar range of issues and deficiencies noted during the first round of thematic inspections also exist in some of the IAs inspected during this second round. In particular, some of these IAs were found lacking in the one or more of following areas:
- Knowing your clients
  - Product due diligence
  - Ensuring suitability of investment advice
  - Ineffective management supervision
  - Maintaining documentation
  - Licensing requirements

Investigation has commenced on some of the more serious breaches of SFC rules and regulations identified in this round of theme inspections.

#### ***Knowing your clients***

7. Knowing your client is one of the fundamental steps that must be taken before any investment adviser is capable of giving suitable advice. Our inspections revealed that there was room for improvement in this area for most of them.
8. The observations during the inspections below illustrate that not all IAs may have attached enough importance to knowing their clients before providing investment services to their clients. For instance:
- A number of IAs did not obtain information from their clients about their financial situation, investment experience or investment objectives before providing investment advice.

- A member of the sales staff was found to have allowed his client to select *all* the available investment objectives in the client's profile form, which includes a wide and conflicting range of investment objectives from "capital preservation" to "aggressive growth". Moreover, this client also selected "Others (please describe)" as one of his investment objectives but did not offer any further description. According to the firm's internal policies and procedures, advice to clients should be subject to review by senior management but in this case it appears that illogical information has not been spotted and followed up.
  - A client indicated in his client profile form that he aimed to grow his investment aggressively but only accepted average risk. However, the responsible sales staff did not follow up on this inconsistency with the client.
9. It is only possible for an IA to give appropriate investment advice to their clients if they know something about their clients' background etc. Understandably, some clients may decline to provide some key information and IAs should develop an appropriate policy for handling this kind of situation. Even if a client does not fully disclose his personal circumstances (for example financial situation) to an IA, this would not stop the IA from making an assessment of the client's attitude towards risk, his expectations and so on. If an IA is unable to make that assessment, the IA should, as a minimum, explain to the client the inherent limitations of the advice as a result of the lack of information. Furthermore, the IA should explain to the client the assumptions he made in relation to the advice given.

### *Product due diligence*

10. An IA must thoroughly understand the structure, nature, return and risk profile of a product, as well as the background of its service providers, before recommending that product to its clients. This is important at the time when a firm considers a product for the first time as well as on an ongoing basis. For example, an IA should conduct a timely review using relevant market and financial information of the products presently recommended by them and assess the propriety of continuing to recommend such products.
11. In the following case, the IA failed to spot some serious inconsistencies between the offering documents and marketing materials<sup>3</sup> of some non-SFC authorized collective investment schemes it sold:

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<sup>3</sup> We were given to understand that these marketing materials were prepared and provided by the product providers for the advisers to use.

**Case One:** An IA actively distributed certain non-SFC authorized collective investment schemes (“CIS”) and provided marketing materials that contained information that conflicted with the underlying offering memorandum (“OM”).

Example A: while the OM indicated this CIS was for “sophisticated and experienced investors” who could bear the risk of losing “their entire investment”, the marketing materials described the CIS as suitable for “conservative investors with low risk-tolerance” and “Retirees who require predictable income”.

Example B: the marketing materials of the CIS specified that it is principal-protected although there was no such statement in the OM.

The above inconsistencies are material and would likely mislead investors to invest in a product with a totally different and possibly unsuitable risk profile. Some of the investors (in one case a client who did not disclose any financial data, investment experience or investment data) may not be sophisticated enough to fully understand the risks arising from investing in such a CIS.

12. Furthermore, we noted that most of the IAs inspected did not have any established product due diligence policies or procedures to ensure a proper review of investment products before allowing their sales staff to recommend such products to clients. IAs should develop appropriate product due diligence policies or procedures and strictly adhere to them. This becomes more important when the products being sold have investment risks that are very different from that posed by the more traditional products and are hence more difficult to understand and assess, or where the fund managers have either no track record or only a very short one.

***Ensuring suitable investment advice to match product against clients’ profile***

13. There were a number of cases where Commission staff felt that the advice given might not be suitable for the clients concerned.

**Case Two:** A retiree indicated his investment objective in the client profile form to be security of capital but subsequently had his portfolio switched to higher risk funds (such as energy funds) without any justification for the switch on the file. Management did not investigate or inquire further about this inconsistent investment decision with the client or the responsible sales staff.

**Case Three:** A client disclosed a monthly income of approximately HK\$12,000 and personal net worth of some HK\$80,000 in his client profile form and was advised to invest a lump sum of HK\$120,000 in a collective investment scheme. We were not provided with any documentation which recorded the rationale why this advice was given and approved.

14. Whilst the above may only be isolated cases, it does indicate that there is room for improvement in this area, or at least in the area of keeping proper documentation.

**Case Four:** A client with only limited investment experience signed a disclaimer indicating that he had initiated the purchase of a collective investment scheme investing in insurance policies. The offering document stated that an investor may lose his entire investment and the product is only suitable for sophisticated investors.

However, the investment proposal found in that client's files that was prepared by the responsible sales staff and approved by a responsible officer indicated that this client was advised to invest in this product.

15. We continue to see investors signing off on acknowledgement or confirmation forms stating that their advisers did not offer them advice but only carried out their orders. In view of the existence of this practice, the SFC will continue with its efforts to remind investors to be wary of signing disclaimers and giving up their rights. Moreover, in order for the IA to properly discharge its obligation of acting in the clients' best interest, it should explain the key risks and restrictions of the relevant product to the client and provide the client with the relevant offering memorandum etc.
16. As for cases where a client has been properly advised and has chosen to accept a mismatch between the product and his own personal profile, an IA should have this properly documented to avoid potential dispute with the client in the future.
17. We note another phenomenon in Hong Kong that IAs are typically remunerated wholly or in part by commission rebate from product providers. Therefore, there are potential conflicts between IAs' obligations to act in the best interests of clients and their own interests in earning higher commission.
18. While some IAs disclose to clients that they receive commission rebates from product providers, the current market practice is that IAs usually do not disclose to clients the quantum of their remuneration or soft dollar benefits which they receive from product providers. To mitigate potential conflicts of interest and to enhance transparency so that investors can make informed decisions, the SFC is currently reviewing this issue and may consult the market on disclosure.

#### *Maintaining proper documentation*

19. Maintenance of proper audit trail enables the management and the regulators to review the compliance level of its staff and to improve the compliance culture of the firm. Keeping good records is also in the firm's own interests and it can avoid future disputes with the clients. During the course of our inspection, we noted that nearly all the firms inspected had failed to maintain sufficient documentation in order to ensure a proper audit trail.
- In one case, a member of the sales staff simply put down the words "good

product” as the reason for recommending a fund to a client who did not indicate his risk attitude in the profile form. This practice surely did not meet the substance of the relevant requirement.

- In another case, a member of the sales staff advised an elderly individual to invest in a collective investment scheme with a term to maturity of 20 years and annual contribution which accounted for a very substantial portion of this client’s personal net worth as stated in the client profile form.

The client agreement gave a reason for recommending the product which was different from that stated in another piece of client documentation. Furthermore, upon our enquiry, the firm gave yet another completely different reason!

- In a different case, the IA was unable to produce any record to demonstrate that they had tried to verify the professional investor status of the client, who as a result has less protection available to him, before treating the client as such.

20. In addition to poor documentation of the rationale underlying specific advice, the inspections also identified many instances of substandard documentation on product due diligence work done and key personal information of clients.

#### *Management supervision*

21. Senior management are responsible for both guiding and supervising their staff in the way they (a) develop policies and procedures and (b) monitor business conduct of their sales personnel and ensure compliance with the relevant rules and regulations. A number of the IAs inspected have actually adopted an internal policy requiring their management to review and approve every recommendation made or advice given by their sales staff. While this extra layer of control should generally provide added assurance of reasonable recommendation and advice, our inspection findings revealed that the management might not always detect and follow up on glaring exceptions and mismatches even though they had signed off the approval of the relevant recommendation or advice. In one case, there were only two responsible officers to monitor and supervise the activities of more than 200 sales staff.

#### *Compliance with licensing requirements*

22. Our review also uncovered the following instances whereby the IAs concerned had failed to comply with specific licensing requirements:
- 2 firms had remunerated their unlicensed investment consultants for selling investment products to their clients.
  - Another firm had ignored the licensing condition that restricted it to only advise on mutual funds and unit trusts and advised its clients on investing in equity linked financial instruments.

The above is now under consideration for possible disciplinary action. IAs are reminded not to allow unlicensed staff to conduct any regulated activity and to be mindful of any restrictions on the scope of services to be rendered.

#### **IV. Proposed Action**

23. Effective enforcement action will have an impact. The SFC will take regulatory actions against those who committed serious breach of the law, rules and code. Investigation has already commenced on the more serious deficiencies and breaches noted in this second round of theme inspections. We will continue to monitor and inspect IAs to assess their level of compliance with the relevant regulatory requirements.
24. Further, we will continue with our investor education efforts. For example, we plan to highlight to investors the common pitfalls when dealing with IAs, in particular, the need not to rely solely on marketing materials when making an investment decision.



## Appendix 1

### Summary of the 2005 Report on Selling Practices of Licensed Investment Advisers

1. In order to examine the selling practices of licensed investment advisers, the SFC initiated a thematic inspection of 15 firms in 2004. We summarised the findings of the inspections and our proposed regulatory responses in a report published in February 2005. The key findings set out in the report include: -
  - Insufficient understanding about clients such as their financial positions, investment objectives and risk appetites;
  - No proper product due diligence conducted by investment adviser before recommending the product to clients;
  - Lack of justification maintained by investment adviser to illustrate how investment recommendation given was suitable to the client;
  - Not enough assistance initiated by investment adviser to ensure clients understand the characteristics of the recommended investment products; and
  - No established procedures and use of technology to help senior management to identify, monitor and control selling activities of the sale staff.
2. The 2005 report also indicated that the SFC would carry out another theme inspection in 2006 to further evaluate whether any improvement in the level of compliance with the relevant regulatory requirements.