

Guidance on Adoption of Portfolio-based Approach to Suitability Assessment

Current suitability framework

Pursuant to Paragraphs 5.2 and 5.5(a) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“SFC”) (“SFC Code of Conduct”), the suitability requirement focuses on suitability of an investment solicitation or recommendation or a transaction in a complex product in the customer’s circumstances, rather than focusing on mechanical procedural steps of matching risk levels of individual products with the customer’s risk tolerance level.

Meanwhile, intermediaries can solicit or recommend a portfolio or a combination of investment products to a customer, as long as the intermediary ensures the suitability of such solicitation or recommendation for that customer is reasonable in all the circumstances. Question 5A of the SFC’s Frequently Asked Questions (“FAQs”) on Compliance with Suitability Obligations by Licensed or Registered Persons (“FAQs on Compliance with Suitability Obligations”) provides that where intermediaries recommend investment products to their customers, as part of the suitability assessments, they should consider the overall effect of their recommended investment products on their customers’ portfolios. For example, for a customer with low or medium risk profile, a proportion of high risk products in the customer’s portfolio may not be unsuitable so long as this is commensurate with the risk return profile of the portfolio and the intermediary is able to satisfy itself that any investment products recommended are likely to meet the investment objectives and other personal circumstances of the customer.

Portfolio-based approach to suitability assessment

The HKMA notes that some banks adopt a portfolio-based approach to suitability assessment (“PBA”) in providing investment advisory and trade execution services, while some banks might have hesitation in doing so having regard to various considerations. While suitability assessment is a risk-based process that banks could tailor their own procedures according to the customer’s circumstances, the HKMA aims to provide further guidance and clarifications to facilitate understanding of the expected standards when adopting PBA and

thereby facilitating an informed decision of banks on whether or not to adopt PBA.

For the purposes of this guidance, under the PBA, at the outset an RI seeks information about a customer's personal circumstances and sets up an investment agreement with the customer which sets out the key elements such as the types, risks and allocation of investments which produce a portfolio suitable for the customer in terms of, for example, the portfolio's overall risk level, liquidity and concentration. At the transaction level, the RI may solicit, recommend, advise or execute a transaction on an investment product for the customer, so long as the outcome of the customer's portfolio is consistent with the investment agreement.

The PBA is essentially a holistic approach for complying with the requirements to ensure suitability under paragraphs 5.2 and 5.5(a) of the SFC Code of Conduct on the portfolio level, while obviating suitability assessment on a transaction-by-transaction basis.

Applicability

As provided by the current suitability framework, the adoption of PBA is not confined to private banking customers in principle. In other words, RIs may adopt a PBA for any customers in lieu of transaction-based suitability assessment so long as the RI has adequate capability (including staff, systems and internal controls) to conduct the PBA for the customer properly.

When adopting PBA for retail banking customers, it is expected that RIs are more interested in adopting PBA for higher-end segment in their retail banking business, given the higher inputs on RIs' resources and capability associated with PBA. Generally speaking, RIs planning to adopt PBA for retail banking customers who are also professional investors may proceed with implementation direct after informing the HKMA. For RIs planning to adopt PBA for retail banking customers who are not professional investors, they should approach the HKMA for discussion first before implementation, with a view to demonstrating that the investment service is adequately designed for the target customer segment, and RIs are generally not expected to adopt PBA for such retail banking customers who are vulnerable customers.

Detailed guidance

General

In adopting PBA, an RI should take reasonable steps to seek information from the customer about the customer's personal circumstances (including investment objectives and horizon, risk tolerance, investment experiences and knowledge, financial situation, etc.), and clearly explain to and establish with the customer an investment agreement. The investment agreement should set out the key elements of a portfolio suitable for the customer, (e.g. the types, risks and allocation of investments, liquidity and concentration).

The investment agreement and the basis of the key elements should be sound and reasonable taking into account all circumstances of the customer including investment objectives and horizon, risk tolerance level, investment experience/knowledge, financial situation, and other relevant factors such as product type and nature and risk return profile. In case a customer does not disclose information about the investable assets or investment objectives/agreements outside the RI, the RI could, as an alternative, recommend an investment agreement based on the customer's investable assets under its management and other information available.

To ascertain a customer's circumstances, RIs should use methods that are appropriate in the circumstances, which might include accepting customers' declaration where appropriate. RIs should beware of any inconsistencies between the information provided and that held with the RI, and in such cases, clarify with the customer.

There are different methodologies in constructing an investment portfolio. The HKMA is not prescribing any methodology for the PBA or specific content for investment agreements. The aforementioned key elements to be set out in an investment agreement are suggestions, and there is flexibility for RIs to take into account other or different factors appropriate for the circumstances when determining the suitability of an investment agreement.

The rationale of recommendations for such investment agreement should be properly recorded. A copy of the investment agreement and the rationale of recommendations for the investment agreement (including the rationale for any change in the investment agreement, see below) should be provided to the customer.

Once an investment agreement for an account is established, the RI should provide the investment services in accordance with the agreement. For any transaction effected in accordance with the agreement, it would not be necessary for the RI to record and provide the rationale for the transaction.

RIs should clearly communicate and explain to a customer that the investment service will be provided using a PBA. Appropriate records should be maintained for this purpose.

Handling of deviations

In the case where a transaction would result in any deviation of the customer's portfolio from the investment agreement (e.g. in terms of risk level, liquidity, concentration risk or other relevant parameters of the portfolio as set out in the investment agreement), the RI should alert the customer of such deviation, document the rationale for the deviation (e.g. justification of why a deviation from the investment agreement is suitable for the customer), and obtain the customer's acknowledgement for the transaction with the deviation. A copy of the document recording the rationale for such deviation should be provided to the customer regardless of whether the customer requests so. In the case of online transactions, there should be appropriate system control for assessing the justification (e.g. could be in the form of some pre-set choices of reasons) for the transaction.

Controls and monitoring

RIs should put in place adequate systems and controls for proper implementation of the PBA. RIs should perform proper assessment, monitoring and review on the operation as well as the outcome of the portfolios to ensure transactions are effected in a way consistent with the investment agreement.

The appropriateness of a customer's investment agreement (including portfolio allocation) should be reviewed when conducting a review of the customer risk profile. Customers should also be reminded to advise the RI of any material changes in their circumstances that warrant updates to their risk profile, and/or investment agreement (e.g. portfolio allocation) at the RI. Customers should be provided with a copy of the rationale for any change in the investment agreement.

The requirement of informing customers of an upward revision in a product risk rating also applies when a PBA is adopted. Where appropriate, RIs should also review whether the upward revision of a product's risk rating would warrant any

need for any updates to the customer’s investment agreement (e.g. portfolio allocation), and discuss and agree with the customer accordingly.

RI should also provide adequate training and support to staff for the adoption of a PBA.

Additional measures for adoption of PBA for retail banking customers

If adopting PBA for retail banking customers subject to the guidance under the section “Applicability” above, RIs should also observe regulatory requirements applicable to retail banking customer¹, unless otherwise specified in this circular.

For retail banking customers, the assessment of a customer’s risk profile would not be required to be carried out by non-sales staff², as the collection and consideration of customer’s personal circumstances is part and parcel of the establishment process of an investment agreement under the PBA. However, for such retail banking customers, RIs should observe the prevailing audio-recording requirement for face-to-face assessment process of customer risk profile, and the audio record should also cover the establishment and reviews of investment agreement. RIs should also continue to comply with the existing audio-recording requirement for product disclosure and explanation, and order placement and confirmation³, where applicable.

For retail banking customers, in the case where a transaction would result in any deviation from the investment agreement, there should also be an appropriate level of supervision to review and approve as appropriate a transaction that would result in any deviation from the investment agreement.

¹ Including but not limited to the HKMA’s circular dated 25 September 2019 on “Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products”.

² Per section (A)(III.1) of Annex 1 to the HKMA’s circular dated 25 September 2019 on “Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products”.

³ Per section (A)(II.1) of Annex 1 to the HKMA’s circular dated 25 September 2019 on “Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products”.