HONG KONG MONETARY AUTHORITY
香港金融管理局

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30 July 2014

The Chief Executive
All Authorized Institutions

Dear Sir / Madam,

**Issues and good practices in relation to the sale of investment products**

The purpose of this circular is to share with Authorized Institutions (AIs) certain issues and good practices in relation to the sale of investment products identified during our supervisory process, and to reiterate the applicable regulatory requirements as well as the Hong Kong Monetary Authority (HKMA)'s expected standards.

In our recent rounds of on-site examinations and off-site surveillance of AIs' controls in respect of the sale of investment products, it was revealed that whilst AIs in general had put in place policies and procedures to comply with relevant regulatory requirements, some issues and good practices identified warrant further attention by AIs. The details are set out in **Annex**. AIs should give due regard to these issues, review their own policies and procedures, and implement necessary enhancement measures. AIs are also encouraged to adopt the good practices, as applicable, to improve their sales practices and relevant controls.

The HKMA will continue to monitor compliance of AIs and take appropriate supervisory action against AIs found to have failed to observe the regulatory requirements and expected standards.

If you have any questions on this circular, please contact Ms Candy Tam at 2878-1292 or Ms Florence To at 2878-1582.

Yours faithfully,

Meena Datwani

Executive Director (Banking Conduct)

Encl.

c.c. Securities and Futures Commission (Attn: Mr James Shipton, Executive Director (Intermediaries)

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## Issues and good practices

### Product due diligence

*Issues/ Pitfalls*

- Sole reliance was sometimes placed on the product due diligence work performed by group company or head/ regional office outside Hong Kong without due consideration of local regulatory requirements, local market circumstances and target customers' needs.

- Product risk rating methodology did not always give adequate consideration to product features and related risk factors. For example, an AI only used asset class in determining the product risk rating (e.g. all equity funds were rated as medium risk rating), and did not assess different salient features of various products within the asset class (e.g. equities in the emerging markets versus equities in developed markets) and other relevant factors which may directly or indirectly impact on risk return profiles and growth prospects of the investments (e.g. market and industry risks, and economic and political environments). Another example was that an equity fund investing solely in equities in a single developing country was assigned with a medium risk rating. It was however noted that the issuer gave the fund the highest risk rating but the AI concerned did not conduct any due diligence or verify the rating with the product issuer.

*HKMA's expected standards*

In determining product suitability, AIs should conduct adequate product due diligence and obtain a thorough understanding of the investment products they solicit or recommend to customers. The mechanism for assessing product risks and assigning product risk ratings to investment products should be reasonable, taking into account all relevant factors. While AIs may take into account due diligence work of group company or head/ regional office as appropriate, they should establish proper policies and procedures to ensure that adequate product due diligence is performed taking into consideration the local regulatory requirements and other local circumstances to assess whether the investment product is suitable for target customers. An independent risk management function of the AI should ensure that all risks are well understood and adequately assessed, and all relevant functions (e.g. risk control and legal and compliance) should be consulted as appropriate. Approval from senior management should be obtained, and proper documentation of the product due diligence work done should be maintained.

### Training for sales staff

*Issues/ Pitfalls*

- Training on new product was sometimes provided to sales staff within an unreasonably short period of time before the launch of the new product (e.g. a few hours before product launch).

- In some cases, no functional unit was responsible for overseeing the training and performing review of the training materials so as to ensure that the training materials were in line with regulatory requirements and internal policies.

*HKMA's expected standards*

AIs should provide regular and appropriate training to their staff, and ensure that staff are equipped with necessary knowledge and skills and kept abreast of relevant developments in the industry. In respect of training materials provided by product issuers or third parties, AIs should review and ensure that the training materials are accurate, adequate and balanced.

*Good practices*

Some examples of good practices are providing refresher courses on investment products to sales staff at least annually; making it mandatory for sales staff to attend certain courses on product knowledge and selling procedures (especially those for the launch of new products or services), and monitoring their attendance and reporting to team / unit head any non-attendance; putting in place assessment mechanism (e.g. written test and/ or role play after the training courses to ensure that the sales staff can properly explain the product key features and risks to customers); and including in training programme experience sharing about issues identified internally as well as by regulators, and enforcement news from regulators.

**Marketing materials of investment products not regulated by the Securities and Futures Ordinance (SFO)**

*Issues/ Pitfalls*

- Some AIs displayed marketing materials (e.g. in bank branches, banking halls or on websites) highlighting the high rate of return of an investment product (e.g. structured currency-linked deposits), while relevant risk disclosures were not shown with the same prominence.

*HKMA's expected standards*

For marketing materials of investment products not regulated by the SFO, AIs are expected to follow standards similar to the Securities and Futures Commission (SFC)'s standards on marketing materials, such as the Advertising Guidelines Applicable to Unlisted Structured Investment Products under the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products. In particular, marketing materials must be clear, fair and present a balanced picture with adequate and prominent risk disclosure.

**Know-Your-Customer (KYC) process and customer risk profiling**

*Issues/ Pitfalls*

- Some AIs placed sole reliance on a third party to design the customer risk profiling system, without performing due diligence to ensure the reasonableness of the design and reliability of the results generated therefrom. Examples of the flaws noted included the prejudicial effect on the profiling results due to unjustified higher scores assigned to certain questions; and unreliable assessment results due to unclear or ambiguous questions.

- Inconsistent or even improper practices were noted among some bank staff in customer risk profiling process due to a lack of standardised procedures and guidance (e.g. advised customers that having experience in Mandatory Provident Fund scheme or exchanging foreign currencies for travel purpose are equivalent to having investment experience).

- Some bank staff attempted to influence customers during the customer risk profiling process in order to obtain results which could match with particular investment products (e.g. staff suggested customers to change their answers or suggested preferred answers to customers).

- Customer information for identifying less sophisticated customers (e.g. education level) was not obtained in some cases and hence additional safeguards were not offered to these customers during the sale process.

*HKMA's expected standards*

In order to fulfil suitability obligations, AIs are reminded that they should obtain from customers relevant information about their personal circumstances so as to ensure that any investment solicitation or recommendation provided is suitable for customers. AIs should have in place adequate systems and controls to conduct a reasonable assessment of customer's risk tolerance and avoid anomalous profiling results. AIs should act with due skill, care and diligence and seek clarification from the customers on any conflicting information provided. Besides, AIs should ask customers to confirm their agreement with the risk profiling assessment and provide customers with a copy of the risk profiling assessment. Audit trails evidencing customers' confirmation of risk profiling assessment result and clarification obtained from customers (if any) should be properly maintained.

*Good practices*

Some examples of good practices include testing the customer risk profiling mechanism and results to assess the appropriateness of the mechanism, and the reasonableness and reliability of the results generated therefrom; reviewing regularly the risk profiling mechanism and the results (e.g. statistics of customer assessment results) to assess their continued appropriateness; and providing written guidelines or standard profiling questions to facilitate bank staff and customers in conducting the customer risk profiling process, which may include guidelines on handling the situation where a customer disagrees with the assessment results. Written guidelines or standard profiling questions can facilitate customers' understanding and make the customer risk profiling process more transparent and

well-defined, and help ensure that all staff adopt proper, consistent and objective practices and standard.

**Suitability assessment and selling practices**

*Issues/ Pitfalls*

- Some sales staff only considered the assessed customer risk tolerance level, but not other key relevant factors such as customer's investment experience and investment objective as obtained, in investment solicitation or recommendation.

- The alternative products recommended to customers were not properly recorded in some cases.

- Some sales staff merely sent product documents to customers, and assumed customers understand the products unless customers made subsequent inquiries.

- Some sales staff did not adequately explain salient features and risks of products and did not properly answer customers' queries about the product features and risks.

- Some private banks claimed that front-line staff had explained product features and risks, and had alerted customers of the risk-mismatches during face-to-face meetings with customers, but the private banks did not maintain adequate record or evidence.

*HKMA's expected standards*

AIs should take all reasonable steps to ensure that any investment solicitation or recommendation made is suitable for the particular customer having regard to all relevant information relating to the customer which the AI has obtained. Adequate controls should be put in place in this regard. AIs should have controls to address any conflicting information collected about a customer during the KYC and/ or the sales process, such as highlighting to the customer the implication of the conflicting information on his/ her suitability for the product, and seeking clarification from the customer before he/ she makes an investment decision. Clarification obtained from customers (if any) should be properly maintained. Also, AIs are expected to adopt a cautious approach and take into account customers' vulnerability, such as lack of investment experience, in making product solicitation or recommendation.

The sales staff's underlying rationales for product solicitation or recommendation and the alternative investment products considered should be properly documented.

In order to help customers make informed investment decisions, AIs should properly disclose and explain the key features and risks of the investment products to customers. It is not enough for AIs to merely provide product documents to customers. Customers should be given sufficient time to digest, consider and evaluate the information and recommendations provided by AIs.

AIs should have proper procedures and maintain proper records to demonstrate that they have complied with regulatory requirements.

**Handling of mismatches or exceptions and compliance monitoring**

*Issues/ Pitfalls*

- Controls to guard against unsuitable transactions were inadequate in some cases. For example, where a transaction involved multiple mismatches (such as both in risk level and in asset concentration), some AIs merely mechanically followed the control procedures for risk mismatched transaction and high asset concentration transaction respectively, instead of assessing in totality the suitability of such a transaction.

- Flaws appeared in the approval mechanism for mismatched transactions in some cases. For example, the approval authority was allowed to approve the transactions handled by him.

- Some supervisors approved transactions with mismatch or exception without any justification from the customer, the staff, or the supervisor.

*HKMA's expected standards*

AIs should put in place adequate controls and provide appropriate level of supervision in respect of mismatched transactions or exceptions such as high asset concentration, and risk/ objective/ tenor mismatch. There should be more stringent controls over transactions having serious or multiple mismatches or exceptions. The level of controls and supervision should reflect the seriousness of mismatch or exception involved in the transactions.

*Good practices*

Examples of good practices of heightened controls include:

- Disallowing, or requiring pre-trade independent approval for, transactions with serious or multiple mismatches or exceptions;

- Disallowing mismatches or exceptions (or requiring pre-trade independent approval) for vulnerable customers; and

- Establishing mechanism involving higher levels of authorities to approve transactions with serious or multiple mismatches or exceptions.

**Monitoring and review mechanism**

*Issues/ Pitfalls*

- Review of suitability assessment was conducted in a mechanical manner by some bank staff who merely compared the product risk rating and the customer's risk tolerance level, without checking other relevant information provided by the customer during the KYC and the suitability assessment processes.

- In some cases compliance function did not perform a robust role in compliance monitoring, such as ensuring the effectiveness of internal controls and compliance reviews to ensure compliance with regulatory requirements.

*HKMA's expected standards*

AIs should have adequate management supervision of the sale of investment products to ensure compliance with all applicable laws and regulations. They should compile proper management information system (MIS) reports to draw senior management's attention to risks or non-compliance, and conduct effective regular compliance reviews, covering mismatched transactions, exceptions and high risk areas. The sampling methodology should be commensurate with the risks (e.g. transactions involving more serious mismatch or exception, or significant increase in business volume, may warrant a larger sample size). There should be clear allocation of duties (including scope and coverage) of compliance review between the compliance function and other relevant independent functions (e.g. risk management function).

Compliance function should play a robust role in ensuring that the AI is in compliance with the statutory provisions, regulatory requirements and codes of conduct applicable to the sale of investment products, monitoring and testing compliance, and reporting regularly to senior management on compliance matters[1].

**Complaint handling procedures**

*HKMA's expected standards*

AIs are expected to interview complainants (e.g. face-to-face interview or phone interview) to obtain and clarify details of the complaints where appropriate and practicable, except for complaint cases which can be substantiated and resolved simply by review of documents without the need of contacting the complainants, or are trivial in nature.

[1] For more guidance on the key attributes and responsibilities of the compliance function, please refer to subsection 5.3 of Supervisory Policy Manual module IC-1.