Annex 2

Key observations by the Hong Kong Monetary Authority

1. This annex shares key observations in relation to the thematic review of the distribution of non-exchange traded investment products conducted by the Hong Kong Monetary Authority (HKMA) on registered institutions (RIs). The thematic review covered the selected RIs' policies, systems, controls and management supervision on distribution to customers of non-exchange traded investment products such as funds, bonds and structured products.

A. Product due diligence process and assignment of product risk rating ("PRR")

Existing requirements

2. RIs should establish and implement appropriate and effective systems and controls to ensure that product due diligence assessment of the investment products should be fair and balanced, taking into account the local circumstances and regulatory requirements, as well as other relevant information that is reasonably available. The mechanism for assessing product risks and assigning PRR to investment products should be reasonable, taking into account all relevant factors. Any special features or complex structure of investment products and the applicable regulatory requirements should be taken into account.

3. The selected RIs generally put in place policies and procedures governing the product due diligence process and assignment of PRR. There were some instances that the RIs did not give due consideration to some key features and risk factors during the assignment of PRR to the investment products.

HKMA's observations
(i) The PRR model of some RIs did not take into account some key features and risk factors which may directly or indirectly impact the risk return profiles and growth aspects of investments when assigning the PRR to corporate bonds (e.g. salient product risks such as market risks, industry risks, country risks etc.). As a result, some corporate bonds were assigned a PRR which was lower than warranted given the risk factors and complex features, and sold to customers with conservative risk appetite. (ii) When assigning a PRR to structured products, an RI mainly considered the financial features of the products (e.g. market price, payoff, strike price of the underlying assets etc.) without adequate consideration of key risks inherent to structured products (e.g. principal at risk, risk of underlying asset, risk associated with a basket of underlying equities, etc.).

(iii) An RI lowered the PRR of a bond to the lowest risk rating based on the consideration that the bond was close to the maturity date without consideration of the salient product risks (such as market risks, industry risks, default risks, etc.) which might remain despite the shorter time to maturity.

B. Suitability assessment

Existing requirements

4. RIs are reminded that they should obtain relevant information from customers about their personal circumstances for assessing suitability of investment products for customers. RIs should have in place adequate systems and controls to conduct a reasonable assessment of customer's risk tolerance and avoid anomalous profiling results. RIs should act with due skill, care and diligence and seek clarification from the customers on any conflicting information provided.

5. Some RIs adopted risk scoring questionnaire to assess a customer's risk tolerance level for the purpose of suitability assessment but they did not implement adequate checking mechanism to ensure the final profiling result could truly reflect the customer's risk appetite.

HKMA's observations

(i) Some RIs did not put in place consistency check between answer of individual questions against the customer's final risk profile result. It was noted in an instance where a customer's risk tolerance level could be "very aggressive" despite that a customer's answers to questions concerning the investment objective and attitude towards risk were relatively conservative. Also, the RIs did not require their staff to make proper enquiries with, or seek clarification from customers about the possible inconsistencies.

C. Best execution

Existing requirements

6. Delivering best execution is fundamental to market integrity and protection of investors who rely on RIs to act in their best interests during the execution process. RIs should execute customer orders on the best available terms to deliver best execution. RIs should establish proper policies and procedures regarding best execution to cover different types of investment products and which should be reviewed and updated on a regular basis. RIs are expected to have in place arrangements, including controls, monitoring and management supervision, to obtain the best available terms. Arrangements should be subject to periodic review to ensure best execution is achieved consistently.

7. Some deficiencies and issues were revealed in this aspect.

HKMA's observations
(i) Some RIs did not have in place proper policies and procedures about best execution. Deficiencies were identified about the RIs' performance of ensuring best execution; records keeping; disclosure to customers about best execution arrangement; and inadequate controls and monitoring by relevant functional units.