October 2012

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Executive Summary

1. This report summarises the findings of the SFC thematic inspection on the selling practices of 10 licensed corporations (LCs). The LCs inspected were from a wide cross-section of the industry that is involved in the sale of investment products.

2. During the inspection, the SFC observed, among other things, varying degrees of inadequacies or deficiencies within these LCs in respect of:

   (a) Management oversight, training and compliance monitoring;

   (b) Suitability assessment process

:

Introduction

Selling practices requirements

1.

6. The investment products distributed or sold by these LCs ranged from plain vanilla investment funds and bonds, to more complex products such as accumulators and decumulators, over-the-counter options and other structured notes (e.g. with underlying equity, currency or commodity assets).

7. In these inspections, a top-down review combined with the sample testing of sales transactions was conducted on the controls to assess their effectiveness in ensuring with the selling practices requirements set out in the Code of Conduct, Suitability FAQ and where relevant, the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**Management Supervision Guidelines**).

Findings

8. This part of the report details our findings and includes case examples illustrating various breaches, deficiencies and weaknesses. The findings are grouped into five sections as follows:

    (a) Management oversight, training and compliance monitoring;

    (b) Suitability assessment process;

Case 1

The SFC found that transactions involving a risk mismatch (i.e. the risk rating of the investment product was higher than the risk profile of client) were not detected by the Head of Sales, a Responsible Officer of the LC, for further review to ensure suitability. The Head of Sales in question was solely responsible for directly supervising all the selling activities undertaken by over 70 sales staff of the LC. The detection failure was potentially attributable to the inability of a single supervisor to exercise effective supervision over a large number of sales staff.

13. Furthermore, it was noted that while the inspected LCs all had procedure manuals that provided guidance to staff on conducting investment advisory business and dealing with clients, certain key process areas were not covered in the manuals nor otherwise communicated clearly to staff as demonstrated by the following examples.

Case 2

Example A: No guidance was given to sales staff to document the rationale underlying the investment recommendations they made to clients, nor was there adequate supervision to ensure that the required documentation is being properly maintained by the sales staff.

Example B: There were no written guidelines on how to conduct suitability assessments based on the overall of investments. While individual investment transactions handled by sales staff were subject to review and approval by supervisory staff, the management had not provided clear guidance to the supervisory staff on the approval criteria for individual investment transactions, nor were there compensatory measures in place, to ensure that the level of risk of every transaction was suitable to the client .

Training for staff

14. Providing adequate and appropriate product training to staff and promoting staff awareness of relevant selling practices requirements would help foster a compliance culture and ensure

15. The SFC noted that larger firms tended to provide more structured compliance and product training for their sales staff. While it may be possible for the management of smaller firms to train their sales staff in a less structured or formal manner via close day-to-day supervision, it is important for all intermediaries to ensure that adequate training is provided both initially and on an ongoing basis to sales staff and other staff members that is appropriate for the specific duties which they are required to perform.

16. Intermediaries should also establish a system to monitor the frequency and sufficiency of training and staff attendance to ensure that all sales staff have up-to-date knowledge.

17. The SFC inspection findings indicate that there was room for improvement in the training programme for sales staff in a number of cases. In one case, the lack of training had potentially led to an incorrect understanding by a sales staff of a product which he recommended to his clients as illustrated in the following example.

Suitability assessment process

24. In order to meet their suitability obligations, it is important for intermediaries

29. The SFC found that some LCs did not conduct product due diligence on SFC authorized funds. They only reviewed the reputation, track record and financial standing of the fund houses, but did not focus on the features and risks of the individual products sold by these fund houses. These LCs had a misconception that no product due diligence work on SFC authorized funds was necessary.

30. Some of the LCs inspected did not conduct any product due diligence themselves but merely relying on the information available on a fund platform. Given the product information provided by the fund platform was limited, these LCs would unlikely have a sufficient understanding of the investment products.

31. As part of the product due diligence process, many LCs assign risk ratings to approved products after evaluating the key risks in order to facilitate the suitability determination process. The SFC found that some LCs simply adopted the risk rating of funds published by an independent research company which classified risks of funds based mainly on the three-year annualised volatility, without taking into account the due diligence work performed by the LCs themselves. While intermediaries may take into account any relevant information they deem appropriate in conducting their own product due diligence, they should arrive at their own risk assessment of the product.

32. The SFC found that in a number of cases, there was inadequate documentation of the due diligence work performed. This is a fundamental requirement towards demonstrating whether the LCs have properly discharged their suitability obligations. For all products that are offered to clients, intermediaries

Use of disclaimers and signing of declarations

38. The SFC found that some LCs inspected had inserted

consultation paper[1] and consultation conclusions[2] published in September 2009 and May 2010 respectively.

Investor characterization

48. The i stment products is a crucial factor in determining whether an investment product is suitable for a client. As investment products with embedded derivative elements are generally difficult for investors to understand, intermediaries
characterize the client based on his knowledge of derivatives.

49.
and characterize a client based on his knowledge of derivatives, and to assess whether an investment product is a derivative product for the purpose of the Code of Conduct.

50. The SFC found that some LCs declaration that he has attended training or has prior working experience or trading experience relating to derivative knowledge. Intermediaries are expected to make appropriate enquiries of or gather relevant information about the client during the Know Your Client process so as to enable them to carry out a proper assessment instead of merely relying on the

51. In assessing whether investment products are derivatives, LCs in general had treated structured products (e.g. equity-linked notes, accumulators, etc.) as derivatives, but some LCs had not implemented procedures to assess if a fund is a derivative product for purpose of paragraph 5.1A of the Code of Conduct.

Case 19
An LC incorrectly assumed that only structured products, but not funds (whether or not embedded with derivatives), would be considered as derivative products.

Eligibility verification of Professional Investors

52. Under the Securities and Futures (Professional Investor) Rules (**PI Rules**), high net worth investors who meet the requisite portfolio threshold can be treated as Professional Investors (**PIs**). If an investor is a PI, certain legal restrictions do not apply. In addition, the term PI is also referred to in the Code of Conduct which sets out the specific actions that an intermediary is required to take when the intermediary wishes to waive certain Code of Conduct requirements for a high net worth client classified as a PI under the PI Rules. If a client is both a PI under the PI Rules and assessed to be a PI under the Code of Conduct, certain Code of Conduct requirements can be waived including the requirement to ensure the suitability of a recommendation or solicitation made to the client.

53. This section discusses the inadequacies and
assessment of the eligibility of their PI customers.

54.

57. Prior to waiving certain requirements under the Code of Conduct, an intermediary should, amongst others, assess and be reasonably satisfied that the client is knowledgeable and has sufficient expertise and investment experience in relevant products and markets. Such assessment should be in writing. Records of all relevant information and documents obtained in the assessment should be kept so as to

Concluding Remarks

62. In this round of thematic inspections, the SFC noted that all LCs had established procedures to implement relevant requirements governing their selling practices.

63.

Appendix

Examples of good practices adopted by certain licensed corporations

During the course of our inspections, the SFC noted some good practices and internal controls being adopted by certain LCs in providing advisory services. The examples listed below are not exhaustive nor should intermediaries treat them as the only methods of meeting regulatory requirements. Intermediaries should always take into account their own particular circumstances when adopting these examples.

Training for staff

1. Some LCs have established a formal assessment procedure (such as quizzes) to test the understanding of their staff on the training received.

2. Refresher training was provided to staff periodically to remind staff about regulatory requirements, reinforce basic principles and concepts, and provide updates on regulatory changes and developments.

Compliance monitoring procedures

3. An LC established an elaborate compliance monitoring program which comprise of:

   (a) employing a checklist to check if all necessary information has been obtained by the sales staff and the suitability assessment has been properly carried out by the sales staff as part of a systematic process for performing compliance monitoring to ensure effectiveness;

   (b) staff performing these compliance checks report directly to the Compliance Department and senior management regarding any exceptions or issues identified; and

   (c) establishing a penalty system for breaches of policies and procedures (e.g. warning letters to sales staff) to impress on staff