# REPORT ON SELLING PRACTICES

As part of our continuing efforts to raise industry standards amongst IAs, we plan to conduct another theme inspection in 2006 to assess whether the levels of compliance have improved.

(b) Issues requiring further consideration:

We plan to further consider and, where appropriate, engage IAs to explore some of the issues arising from this report. These include (i) the feasibility and benefits of requiring IAs to disclose to clients the commission and rebates received from product providers (ii) possible measures to enhance investor protection, such as requiring them to take emphasizes the important role that IAs, licensed or otherwise, play in giving their clients suitable advice when selling financial products.

4. For some time, the SFC has been monitoring the issues of mis-

(d) those that employ varying number of sales staff (e.g. ranging from a few sales staff to over 50 sales staff);

(e) those that serve varying number of clients (e.g. those with less than 50 advisory clients to those with over 1,000 clients); and

(f) those with varying amounts of shareholders' funds (e.g. ranging from less than HK$1 million to over HK$10 million).

**Clarification of existing requirements**

8. Our inspection and investigations have identified a number of areas concerning IA selling practices that require improvement. Starting with this report, the SFC plans to generate awareness regarding the conduct issues and problems that have been noted, and clarify the existing requirements applicable to IAs. Where we have come across unacceptable or undesirable conduct by IAs, we provide examples of what we believe should be improved.

9. IAs should critically review their existing systems and practices in the light of this report and enhance them where necessary. While we recognize that the market is very competitive, with banks and insurance intermediaries all seeking greater share in the lucrative investment advisory business, we believe that it is all the more important for IAs to adhere closely to high conduct standards to build up trust among their clients. Indeed, clients' trust is the vital element that underpins the entire investment advisory/ financial planning industry.

10. The standard of conduct upon which we assessed the selected IAs was based on the high-level principles set out in the Code of Conduct. The following requirements are of particular relevance to IAs:

(a) to act in their clients' best interests;

(b) to give suitable advice;

(c) to avoid conflicts of interest; and

(d) to employ competent staff and other resources and procedures for ensuring compliance with relevant law, etc.

IAs are advised to consider their own circumstances when developing their own systems and controls for meeting our expectations.

**Main conduct issues and clarification of existing requirements**

11. A range of issues have been identified in the theme inspections. These can be grouped into three main categories: (a) integrity and professionalism, (b) reasonable suitability of recommendations and (c) compliance matters. For a quick overview, these issues are summarized in Table 1 below:

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|---|---|---|---|
| **III. COMPLIANCE MATTERS** | | | |
| III.1 | Clients agreements | IAs should enter into client agreements with all their clients, setting out clearly the terms, obligations and scope of the services. | 42-46 |
| III.2 | Waivers and disclaimers | IAs should not include waivers and disclaimers that are unreasonable or place undue reliance on them for protection. | 47 |
| III.3 | Management supervision | Senior management should be responsible for ensuring proper standards of conduct and compliance with all applicable rules and regulations, such as the SFO, the Code of Conduct and the Internal Control Guidelines. | 48-50 |
| III.4 | Selling of unauthorized products | It is an offence to sell unauthorized financial products to the public. | 51-53 |

## I. INTEGRITY AND PROFESSIONALISM

### I.1 Acting in the clients' best interests

12. The best way to build clients' trust and confidence lies in the integrity and professionalism of IAs. The overarching principle governing an SFC licensed person's conduct is that he/it treats clients honestly and fairly, ensures suitability of products recommended, helps clients make informed decisions by making appropriate disclosures and above all, acts in their best interests.

13. Clients entrust the planning, preservation and growth of wealth (sometimes their lifetime savings) to IAs and rely on the IAs' integrity and professional investment advice to meet their own financial goals. One of the complaints levelled against IAs is that some IAs have exploited their clients' trust. An IA commits <u>serious misconduct</u> if it fails to advise clients when it should have been aware of fundamental problems in the products that it sells.

### I.2 Avoiding conflicts of interest

14. The current way in which IAs are remunerated in Hong Kong presents potential conflicts of interest. Our inspection confirmed that there are three ways i-53

(a) For commission-based services (most common way), IAs receive commission from the product providers for each investment product sold/invested in by clients.

The commission rebate is usually derived from the investment amounts that clients pay to product providers. If clients keep their investments, IAs may receive further payment (known as trail commission) from product providers. In addition to such 'hard' commission, we were advised that some IAs or their sales staff receive soft dollar benefits (e.g. free air flight ticket and meal coupons) from product providers.

(b) For portfolio-based services, IAs charge management fees based on the total value of investments under management.

## II. REASONABLE RECOMMENDATIONS

19. In order to ensure that investment recommendations and advice to clients are reasonably suitable, an IA should

    (a) know the client's financial situation, investment experience and investment objectives (II.1);

    (b) conduct adequate due diligence on the products and their providers to assess the risks (II.2);

    (c) make recommendations that are reasonably suitable given the client's specific circumstances (II.3);

    (d) help the client make informed decisions by giving the client a proper explanation of the basis of the investment recommendation, as well as the nature and extent of the risks (II.4); and

    (e) employ competent staff and provide appropriate training (II.5).

20. We have investigated a number of cases in which clients have complained that the nature of and the risks associated with a financial product were not adequately explained to them. We have determined that some of these complaints are valid and reveal serious shortcomings in the performance of certain IAs. In particular, we have found that on occasions, the risks associated with products have been misrepresented, so that clients are led to believe they are investing in a lower risk product when, if properly described, the product is higher risk and therefore not suitable for conservative investors. As a point of reference, we have provided (in paragraph 39) three cases in which the basis of investment recommendation appears questionable given the clients' specific circumstances.

### II.1 "Know your clients"

21. There is a positive obligation on IAs under paragraph 5.1 of the Code of Conduct to seek sufficient information from a client about his financial situation, investment experience and investment objectives and risk tolerance.

22. Moreover, it is in the interests of both the IA and the client that a full and

each specific case should be taken into account in determining whether investment advice was actually provided by IAs and/or relied upon by their clients.

24. We wish to remind IAs that "Know your client" obligations and anti-money

terms of language and layout), particularly for lay investors. Where IAs seek to recommend such unauthorized products to clients, they should ensure that they do not offer these products to the public and that clients understand the risks of investing in these products. As to the issue regarding improper sales of unauthorized funds, this is dealt with separately in paragraphs 51 to 53 of this report.

## II.3 Proper basis of recommendations

30. Under paragraph 5.2 of the Code of Conduct, IAs should make investment recommendations and advice to clients that are reasonably suitable given a client's specific circumstances. In addition, paragraph VII(3) of the Internal Control Guidelines state that IAs should document the reasons for the recommendations and advice given to clients.

31. After the IA has assessed the client's current financial situation, the IA would start developing a written financial plan based on the client's lifestyle aims and objectives. Generally, the IA develops this plan based on the information provided by the client such as the client's risk preference, expected rates of return, investment horizon and other factors. However, in some cases encountered during our inspection, the details of how such factors had led to the particular strategies being chosen were found to be lacking. In other words, it was difficult to understand (and justify) how the recommended strategies or investments would achieve the client's investment objectives or in what way they could be considered suitable based on the information given by the client.

32. We have found that some IAs appeared to only recommend "in-house" products or only one product. One IA even went as far as to advise its clients to sell or liquidate all of their existing investments and use the proceeds to invest in these products. There was no explanation or basis to indicate why the "in-house" products should be considered to be more suitable to clients. Furthermore, it was not evident that the IA had considered the inevitable transaction costs for restructuring clients' existing investment portfolios.

33. In summary, any recommendation to clients must be suitable, taking into account information and recommendations (including assumptions and parameters), which should be recorded in writing and kept on the IAs' client files.

## II.4 Helping clients make informed decisions

34. IAs are obliged to help clients make informed decisions by giving clients a proper explanation of the basis of the investment recommendation, the nature of the product recommended and the nature and extent of the risks it bears. In our view, it is not enough for an IA to hand over documents saying "read these, they explain the product and its risk". Instead of just focussing on the good points of a financial product, the IA should always present a balanced view, drawing clients' attention also to the disadvantages and risks as well. Our investigations have shown that in some cases, documents given to clients do not adequately explain the risks inherent in products. The onus is on the IA

to ensure that it provides a full explanation to clients. It is also not enough for the IA to rely on brochures and offering documents as being self-explanatory. Frequently, they are not, and clients have every right to expect IAs to explain the contents to them.

35. The level of risk could vary from high to low depending on characteristics and features of specific products. In some financial plans, there were, at best, vague summary explanations (and in some cases, none at all) of the specific risks associated with the unique features of particular products being recommended. Based on such limited disclosure of information by IAs, we are concerned whether clients are able to make informed decisions, particularly in relation to complex products.

## II.5 <u>Competency</u>

36. The IA business is essentially a skill and talent business. The sales staff of IAs must have an adequate level of knowledge and skill and be able to effectively apply that knowledge and skill towards providing quality advice and services to clients. Such skills come with education, perceptive ability, experience and knowledge of the latest trends and financial products. In view of rapid changes in business environment, IAs and their sales staff must have a continuing commitment to learn, improve and keep abreast of the latest developments in the industry.

37. As competency is a prerequisite for IAs to effectively discharge their duty to investors, it is important that all IAs employ competent staff and provide appropriate training. Owing to the [illegible] positions they are [illegible]
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reason why this unconventional fund was considered appropriate for this investor. While the client had signed a pro-forma statement declaring that it was he who had requested to invest in the product and that he fully understood the offering document, there might be ground for skepticism bearing in mind that:

(a) the offering document was a highly complex technical document; and

(b) by concluding the transaction, the sales staff earned a commission rebate that was double the amount that he would otherwise have earned from recommending other products to the client.

**Example 2: An unsophisticated investor was advised to gear up his investment**

An investor in the lower income bracket and only a few years away from retirement age was advised to invest more than 50% of his total net worth in a particular fund and pay the balance of his investment by bank borrowings (at almost 3 times gearing). The bank obtained security on the investment to secure repayment of the bank's debt. The obvious concern was that the investor might not have sufficient resources to meet the necessary financial obligations. Given that this particular fund happened to offer high commission rebate to the sales staff, there was again this issue of perceived conflict of interest.

In the past, some investors who had highly geared investment portfolios were required by their banks to repay their loans, in whole or in part, when their investments declined in value. When they could not meet the banks' demand for payment, these investors were obliged to liquidate their investments and suffered substantial losses in the circumstances.

Asia, IAs could be asked to pay very substantial claims that they might not be able to honor.

41. There is thus merit in IAs buying professional indemnity insurance. In other countries such as Australia, IAs are required to take out professional indemnity insurance. The SFC will further examine this issue, and consult the market on what would be appropriate measures to take.

## III. COMPLIANCE MATTERS

### III.1 Client agreements

42. As mentioned above, we are concerned with the way some IAs have been treating their so-called "execution-only" clients, especially where there are no client agreements or any other types of record to confirm that client transactions have indeed been carried out on such a basis.

43. In other cases, clients have provided written statements confirming that they themselves made the investment decisions and only asked IAs to execute transactions on their behalf. By signing such statements, clients who have

46. In relation to "execution-only" clients, clear explanation of the limited scope of the services provided by the IA and of its obligations to clients could serve to minimise any subsequent misunderstanding and disputes with clients. The Barber Asia case offers an example as to how such an issue may arise.

**III.2**

rebates (as well as soft dollar benefits) received from the product providers ;

(ii) requiring IAs to take up professional indemnity insurance; and

(iii) informing the client of the exact nature of services to be provided to the client.

*Follow-up theme inspection*

(c) We will carry out another IA theme inspection in 2006 to assess whether the levels of compliance with the SFO, the Code of Conduct, the Internal Control Guidelines and the guidance provided herein have improved.

*Disciplinary action*

(d) We will take action against IAs that are involved in serious breaches of the relevant law such as selling unauthorized financial products to the public. A number of cases already under investigation are likely to be publicized in due course. The SFC will draw the industry's attention to any specific failings that are established.

*Investor education*

(e) The SFC will continue with its efforts to help investors know their rights, responsibilities and risks when seeking advice from IAs.

**Appendix 3**

**Recommended Sales Practice Checklist for Licensed Investment Advisers (“IAs”)**

1. Before recommending an investment product to a client, an IA should develop a thorough understanding of the product, and in particular the nature and level of its risks. Where the IA plans to promote an investment product not authorized by the SFC, the IA should record in its files thorough due diligence work in connection with the product, and ensure that all material aspects of the product are understood.

2.