

May 2024

Lessons learned from the SFC and HKMA's joint review on distribution practices of non-exchange traded investment products



Introduction

A [joint circular](#) to intermediaries on findings from a review of the distribution of non-exchange investment products was issued by the Securities and Futures Commission ("**SFC**") and the Hong Kong Monetary Authority ("**HKMA**") on 18 April 2024 (the "**Joint Circular**"). The SFC and HKMA's observations set out in the Joint Circular are based on the review of the policies, systems, controls, and management supervision of licenced corporations ("**LCs**") and registered institutions ("**RIs**") for the distribution of non-exchange traded products like unlisted bonds and structured products. The regulators identified various issues on intermediaries' practices in performing product due diligence ("**PDD**") and suitability assessment, providing sufficient information to clients and ensuring the trading of investment products is in the best interests of the client.

This briefing note summarises the key observations of the SFC and HKMA, as well as the important takeaways that intermediaries should bear in mind.

Findings on the distribution of non-exchange traded investment products

Issues identified	Remarks	Observations
1. Product due diligence		
Lack of proper verification work and management supervision	- Failure to verify investment products and approving them for offering to clients despite omissions and errors during PDD. - Failure to sufficiently review investment products to identify key terms and features, representing an inability to adequately assess the characteristics, nature, and extent of risks.	- Senior management approved substandard PDD documentation that had obvious omissions or inaccurate analyses on investment products without verifying respective work. - Some LCs did not identify special features of bonds for their clients, such as variable coupons, loss absorption, or multiple credit support structures which could fundamentally alter the risks and payout of the bonds.
	- Failure to consider qualitative factors such as heightened market and industry risks, or adverse economic and political environments that could also impact the risk return profiles and growth prospects of the investment products. - The HKMA similarly reported instances where RIs did not give due consideration to key features and risk factors when assigning product risk rating ("PRR") to investment products.	- Despite an LC requiring staff to consider the credit risks of product issuers, it did not provide guidance on the criteria of approval for credit risks during PDD. - An RI lowered the PRR of a bond to the lowest risk rating based on the bond being close to the maturity date, without consideration of salient product risks such as market risks, industry risks, etc. which may remain despite the shorter time to maturity.
Inconsistent assessment of product risks	Failure to provide adequate guidance to staff who were allowed to exercise discretion to adjust calculated risk scores or deviate from the LCs' risk assessment methodology.	An LC classified funds into high, medium, or low risks but did not provide guidance to staff on the respective criterion for determination.
Failure to adequately consider the nature and extent of risks of structured products	- Failure to demonstrate a good grasp of the characteristics, terms and features of structured products, particularly accumulators and decumulators. - Failure to thoroughly understand the nature and risks of structured products could severely inhibit such LCs from helping clients make informed investment decisions.	One LC classified a foreign exchange target redemption forward contract ("FX-TARF") as medium risk based on the nature of the underlying asset. However, the FX-TARF characteristics were akin to accumulators, where investors could incur unlimited losses during a volatile market.
Insufficient ongoing PDD	Failure to have procedures in place to ensure PDD was conducted on a continuous basis or at intervals to ascertain whether products remain suitable for their clients.	An LC did not review previous PDD work when selling investment products in instances where a bond issuer had defaulted repayment on its other bonds, or when the investment manager of a fund was changed.

Issues identified	Remarks	Observations
2. Suitability assessment		
Inadequate risk profiling of clients	Where clients' answers to risk profiling questionnaires ("RPQ") are used to support a suitability assessment, some LCs overlooked whether the design of the questions or underlying scoring mechanism could produce skewed results towards a high-risk tolerance.	An RPQ used by an LC assigned significant weighting to a client's investment experience, but not tolerance level of the risk of capital loss. This would hence produce skewed results for experienced investors.
Inadequate consideration of clients' concentration risk	- Failure to properly and consistently assess clients' concentration risk, as clear guidance was not always provided to staff on the types and categories of investment products that would add to a client's risk concentration level. - Focusing only on the concentration risk of a transaction but neglected other information such as a client's aggregate investments in the account. - Arbitrary use of net worth values without further inquiry.	- Different staff took different interpretations as to whether products falling within the same type. - Some RIs did not put in place consistency checks between the answers to individual questions and the final risk profile results, and there was no requirement for staff to seek clarification from customers on possible inconsistencies.
3. Information for clients		
Delivering relevant transaction-related information to clients when distributing investment products	- Failure to disclose the maximum percentage of monetary benefits. - Failure to correctly describe the independence status when receiving fees and commissions. - Failure to disclose affiliations with product issuers adequately. - Failure to explain of professional investors status risks properly.	- Many LCs did not disclose the maximum percentage of the monetary benefits receivable per year and per fund on a transaction basis when receiving tailer fees from fund managers indirectly through their execution brokers. - Using proforma notices that may confuse clients regarding the application of SFC's Code of Conduct provisions.
Best execution	Intermediaries should ensure the best execution, which is fundamental to market integrity and protection of investors.	Insufficient record keeping, disclosure to customers on best execution arrangement, and inadequate controls and monitoring on such arrangements.

Key takeaways

The SFC and HKMA warn of the risks arising from inappropriate investment recommendations to clients. The fundamental requirement is for LCs and RIs to exercise due skill, care and diligence to help clients with different risk categories make informed investment decisions, which will require the assessment of non-exchange traded products to be fair and balanced by taking into account appropriate information that is reasonably available.

In view of the findings set out in the Joint Circular, LCs and RIs are expected to review their policies and procedures and address the issues relevant to their firms to enhance compliance. In particular, LCs and RIs are reminded to:

Product due diligence

- (i) develop a thorough understanding of structured products during PDD and identify the key terms and features of investment products which delineate respective characteristics, nature, and extent of risks, and consider the market, industry, economic, political, and regulatory factors impacting risk profiles;
- (ii) provide clients with product literature with proper and sufficient explanation to help clients understand the characteristics of more complex structured products;
- (iii) assess the risk return profiles of the products adequately and perform a review of product risk ratings at appropriate intervals;

Suitability assessment

- (iv) consider all relevant circumstances (e.g. financial situation, investment experience, horizon, and concentration risk) specific to each client when assessing the suitability of an investment product;
- (v) put in place adequate checking mechanisms to ensure the final profiling result of RPQs truly reflects the client's risk appetite;

Selling process and disclosure

- (vi) disclose all relevant transaction related information that is accurate and not misleading;
- (vii) ensure that any representations made, and information provided to the client are accurate and not misleading;

Governance and management supervision

- (viii) procure senior management to make appropriate enquiries or verification on the investment products and relevant documentation; and

Staff training

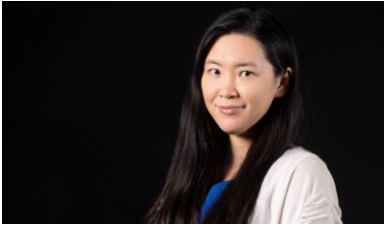
- (ix) provide adequate guidance to staff to ensure they are fully familiar with the characteristics, nature and extent of risks of the products recommended to clients.

How we can help

The Joint Circular sets out the SFC and the HKMA's observations on practices of intermediaries that fall short of the regulators' expectation to ensure investment products recommended to clients are in their best interests. Our team has extensive experience in advising LCs and RIs on regulatory requirements applicable to their businesses, policies and procedures and in relation to the distribution of non-exchange traded investment products.

Please get in touch if you are interested in discussing any of the above.

Contact us



Katherine Liu

Partner, Head of finance and financial services regulation

T: +852 2533 2717

E: katherine.liu@shlegal.com



James Wong

Associate

T: +852 3166 6933

E: james.wong@shlegal.com



Alan Wong

Associate

T: +852 2533 2719

E: alan.wong@shlegal.com



Monica Jia

Associate

T: +852 2533 2795

E: monica.jia@shlegal.com

Stephenson Harwood is a law firm of over 1300 people worldwide, including 200 partners. Our people are committed to achieving the goals of our clients – listed and private companies, institutions and individuals.

We assemble teams of bright thinkers to match our clients' needs and give the right advice from the right person at the right time. Dedicating the highest calibre of legal talent to overcome the most complex issues, we deliver pragmatic, expert advice that is set squarely in the real world.

Our headquarters are in London, with eight offices across Asia, Europe and the Middle East. In addition, we have forged close ties with other high quality law firms. This diverse mix of expertise and culture results in a combination of deep local insight and the capability to provide a seamless international service.