

Our Ref: B1/15C

1 March 2007

The Chief Executive
All Registered Institutions

Dear Sir/Madam,

Thematic Examinations on Investment Advisory Activities

The Hong Kong Monetary Authority (HKMA) has recently completed a round of on-site examinations on selected Registered Institutions (RIs)¹ which are active in conducting investment advisory activities. The objective of these thematic examinations is to ascertain the RIs' level of compliance with the relevant regulatory standards required by the Securities and Futures Commission (SFC). We have reviewed their controls in respect of product due diligence, information about clients, selling practice and product suitability, complaint handling and monitoring of investment advisory activities.

Our thematic examinations were performed concurrently with the SFC's inspections on their licensed investment advisers on the basis of common objectives and co-ordinated review programmes.

In general, all of the RIs examined had implemented the baseline control requirements, with some exceeding the requirements to varying degrees, for complying with the SFC's relevant regulatory standards. In particular: -

- The retail banks examined have established policies and procedures on various key aspects in relation to their investment advisory activities. Most of them had adequate controls over high risk areas including the avoidance of mismatch of client risk tolerance level and product risk rating, and selling of investment products to vulnerable clients such as the elderly. All the retail banks examined have implemented reasonable controls over the selling of unauthorized investment products.
- The private banks examined relied largely on support from regional offices in product approval and researches, and normally provided investment advice to clients on the basis of internal "house views". Their clients were more sophisticated and the recommended investment products did not appear obscure or unusually complicated.

The major issues and good practices adopted by certain RIs identified during our on-site examinations are set out in Annex 1 and Annex 2 respectively for your reference. I would like to take this opportunity to remind RIs of the importance to ensure an effective monitoring of proper compliance with the relevant regulatory requirements in relation to their investment advisory activities, as well as other areas of regulated activities, on an on-going basis.

Should you have any questions about the content of this circular, please contact Mr Shu-pui Li at 2878-1826 or Ms Alice Lee at 2878-1603.

Yours faithfully,

Arthur Yuen
Executive Director
(Banking Supervision)

¹ The selected RIs included both retail banks and private banks.

Encl. [Annex 1](#) (PDF file, 94KB)
[Annex 2](#) (PDF file, 69KB)



Issues Identified

■ Retail Banks

No breakdown on clients' investment experience by types of products

- All the RIs examined have taken reasonable steps to comply with the SFC's requirement to establish the clients' financial situation, investment experience, and investment objectives. Nevertheless, some RIs only documented information on general investment experience of clients through risk profiling exercises, but information on clients' investment experience by types of products was not kept in written form.

No procedure to ensure comparison of investment horizons of clients with product tenors

- All the RIs examined have documented information on the investment horizons of clients and established policies to ensure suitability for clients in the selling of investment products. However, a number of RIs did not have specific procedures requiring frontline staff to properly compare the investment horizons of clients and the product tenors during the selling process of investment products.

■ Private Banks

No distribution of prospectuses and annual reports of mutual funds to clients

- In offering mutual funds to private banking clients, the relationship managers gave explanation on the product features and risks in details, and provided relevant product documents to the clients before entering into any transaction. However, certain RIs provided only product term sheets to clients, but not the prospectuses and annual reports of the mutual funds unless the clients requested such documents from the RIs. For better protection of clients and the RIs, these private banks should take the initiative to provide the prospectuses and annual reports of the mutual funds to clients.

No formal procedures to implement internal policies for selling unauthorized investment products

- A few RIs did not have formal policies for carrying out the required procedures under the SFC Code of Conduct² before classifying a client as a "professional investor". In addition, some RIs did not maintain any central log for keeping track of the offer of unauthorized investment products to clients. Nevertheless, all relevant clients of these RIs were able to meet the definition of "professional investor" under the Securities and Futures Ordinance.

Inadequate compliance monitoring

- Due to resource constraints, several RIs did not perform regular compliance reviews on their private banking investment advisory activities to ensure proper compliance with relevant regulatory requirements.

² This refers to the Code of Conduct for Persons Licensed by or Registered with the SFC.

Good Practices Adopted by Certain RIs

Know Your Client and Product Suitability

- A risk tolerance level was assigned to each client for matching against risk ratings of investment products to ensure product suitability. Special handling procedures, such as supervisor's approval or declaration by clients, were required if the product risk ratings exceeded clients' risk tolerance levels.
- Specific criteria for classifying clients into "vulnerable clients" were established. These clients were subject to special handling procedures, such as further explanation of the products by a separate staff, supervisor's approval or third party witnessing of transaction.

Management Supervision

- Specific MIS reports on investment advisory activities were generated (e.g. mis-matched client tolerance levels / product risk ratings, unusual patterns on switching of mutual funds) to facilitate management supervision.
- Regular compliance reviews were conducted on investment advisory activities (and also other areas of regulated activities) to ensure compliance with relevant regulatory requirements.
- "Mystery shopper" inspections were conducted on the selling practices of frontline staff of retail branches to ensure compliance with internal policies / procedures and relevant regulatory requirements.
- "Post transaction surveys" were conducted with clients to ascertain whether the selling processes of frontline staff were in line with internal policies / procedures and relevant regulatory requirements.

Selling Process

- Formal checklists were established to ensure that frontline staff were reminded to provide all required offering documents to clients during the selling process.

Staff Competence

- Frontline staff were required to, in addition to satisfying the regulatory requirement on training, pass an internal competence test on an annual basis to ensure the continuous fitness and propriety of staff.