



Hong Kong

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SFC ISSUES NEW GUIDANCE ON LICENSED INTERMEDIARIES' SUITABILITY OBLIGATIONS

Introduction

The Securities and Futures Commission of Hong Kong (the **SFC**) has issued new guidance to SFC-licensed and registered persons providing guidance on their obligations to ensure the suitability of client recommendations and solicitations under the Code of Conduct for Persons Licensed by or Registered with the SFC (the **Code of Conduct**).

The SFC guidance is set out in:

- Circular to Intermediaries - Frequently Asked Questions on Triggering of Suitability Obligations (the **Suitability Circular**) which gives examples of situations in which the suitability obligations will typically arise;
- Frequently Asked Questions on Triggering Suitability Obligations (the **Suitability FAQs**) providing guidance on compliance with the suitability obligations when providing discretionary account services; and
- Circular to Intermediaries – Frequently Asked Questions on Compliance with Suitability Obligations notifying intermediaries of the issue of its updated Frequently Asked Questions on Compliance with Suitability Obligations which replace the SFC's May 2007 FAQs of the same name. These provide useful guidance on conducting product due diligence and the requirement that investment recommendations must be documented in audio or written form.

The Hong Kong Monetary Authority (**HKMA**) has also issued a circular to all authorized institutions drawing their attention to the new SFC guidance. In line with the SFC guidance, HKMA has updated its requirements¹ for authorized institutions so that they are now required to provide customers with a copy of the rationale for investment solicitations or recommendations upon the customer's request.

Triggering the Suitability Obligations

1. The suitability obligations

Paragraph 5.2 of the Code of Conduct requires a licensed or registered person who recommends an investment product to a client, or solicits a client in relation to an investment product, to ensure that the recommendation or solicitation is reasonably suitable for the particular client. In making that assessment, the licensed or registered person must have regard to information about the client of which he or she is, or should be, aware through the exercise of due diligence.

The Suitability Circular notes that the suitability obligations under Paragraph 5.2 apply to recommendations and solicitations in relation to *all* investment products, whether or not the product is traded on an exchange.

¹ The HKMA's requirements are set out in the circular "Implementation of Recommendations in the HKMA's Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers" of 25 March 2009 (Recommendation 15 of Annex 1); the circular "Applicability of Enhanced Measures to Sales of Investment Products to Private Banking Customers" of 20 January 2012 (Recommendations 13 and 15 of the Annex); and the circular "Applicability of Enhanced Measures to Sale of Investment Products to Corporate Customers" of 20 December 2012.

The triggering of the suitability obligations requires the existence of a solicitation or recommendation. Whether a licensed or registered person has made a solicitation is a question of fact and depends on the particular circumstances of each case.

2. When are the suitability obligations triggered?

2.1 Advertisements, Research and Marketing Materials

The Suitability Circular explains that to determine whether the suitability obligations are triggered on the posting of an advertisement for an investment product, or the provision of research reports or other product-specific materials such as stock commentaries (together **Research and Marketing Materials**), the assessment should be made at **the point of sale or advice**. The focus of that assessment should be the communications between the client and the licensed or registered person leading up to and including the point of sale or advice. Factors to take into account in making that assessment include the content and context of any Research and Marketing Materials, and the extent to which they created an environment in which the client was induced or recommended to enter into the transaction.

Merely posting an advertisement for an investment product in newspapers or magazines or disseminating research reports, on the other hand, will not normally trigger suitability obligations if there is no direct communication with the client.

2.2 Interactive Communications between Licensed or Registered Persons and their Clients

General principles

The suitability obligations will be triggered when a solicitation or recommendation is made by a licensed or registered person to a client (whether made face-to-face, by phone or electronic communication). The assessment of whether the suitability obligations have been triggered requires an analysis of the content and context of communications with clients, including any messages or materials sent and other relevant factors which include:

a) the content and context of the communications, for example, whether the communication is limited to the provision of factual, fair and balanced information about a product, information about a market or an industry, or whether it contains a representation involving an invitation or inducement to act on it and invest in a specific product;

b) whether the communication is delivered to targeted clients; and

c) the series of actions taken, for example, whether the communication forms part of a multiple step solicitation or recommendation process and thus triggers the suitability obligations.

These factors are not exhaustive and should be considered in totality.

Thus while the dissemination of a research report of itself will not normally trigger the suitability obligations, those obligations will be triggered by the licensed or registered person subsequently making a follow-up call to a client recommending that the client buy or sell a product covered by the research report. Likewise, communicating a short list of investment products for a client's consideration followed by a suggestion that the client place an order through the licensed or registered person's online trading platform is likely to trigger the suitability obligations.

Specific examples

The Suitability FAQs set out a number of scenarios illustrating when the suitability obligations are likely or unlikely to be triggered.

Situations where the suitability obligations are **unlikely** to be triggered include where a licensed or registered person:

a) executes a client's order without any other communication with the client that seeks to solicit the client, or recommend that the client trade in a particular listed stock;

b) discusses the overall market environment, industry, sector trends or general financial and investment information (including basic investment concepts such as risk and return of an asset class, differences in returns of asset classes etc.) with a client;

c) provides factual information about a specific listed company, such as corporate news or announcements about that company or its financials such as earnings growth trend, or P/E ratio, without any prior communication or any accompanying message which seeks to solicit or recommend the client to trade in that company's stock;

d) provides factual information about specific fund(s) or bond(s) at a client's request, e.g., prospectuses, fact sheets, annual reports and price quotations for products, without

- any prior communication or any accompanying message which seeks to solicit or recommend the client to trade in the specific fund(s) or bond(s);
- e) only discusses the merits of investing in certain geographical areas or asset classes with the client; and
- f) provides alerts to a client at his or her request when there are updates of factual information about a listed company, e.g., when a particular stock reaches a particular price, without any prior communication which aims to solicit or recommend the client to trade in that stock.
- i) where licensed or registered persons manage clients' portfolios under a mandate or a predefined model investment portfolio established or chosen by clients; and
- ii) where discretionary account services are provided as an ancillary part of client brokerage services with no specific mandate.
- Provision of Discretionary Account Services under a Mandate or Predefined Model Investment Portfolio

Situations where the suitability obligations are **likely** to be triggered include where the licensed or registered person:

- a) makes a follow-up call to the client recommending the purchase or sale of a listed stock after providing factual information to the client about that listed company;
- b) discusses the merits of a particular investment product or a portfolio of investment products with a client, or a selected group of clients, and expressly or implicitly presents the investment as suitable for the client(s);
- c) communicates with the client with respect to investing in a particular investment product in a way that could be perceived to be based on a consideration of the client's circumstances (e.g., risk appetite);
- d) calls a client recommending him or her to buy a listed company's stock during any fund raising activity by a listed company or listing applicant;
- e) shortlists investment products based on a client's circumstances and gives factual information about those products to the client; and
- f) finding or structuring an investment product based on a client's personal circumstances and the parameters or specifications provided by the client.
- Where a licensed or registered person manages a client's portfolio in accordance with an agreed mandate or a predefined model investment portfolio chosen by the client, its suitability obligations could be discharged by:
- a) ensuring that the mandate or predefined model investment portfolio is suitable for that client based on information about the client's personal circumstances of which the licensed or registered person is or should be aware through the conduct of due diligence. The suitability assessment can be conducted on a holistic basis when the mandate or portfolio is agreed. A predefined model investment portfolio can be established with a particular overall risk profile giving the licensed or registered person discretion to invest in products with a lower or higher risk profile, so long as the overall risk profile of the portfolio is maintained. The licensed or registered person should document its assessment and provide a copy of the rationale to the client in writing.
- b) conducting transactions effected on behalf of the client in accordance with the agreed mandate or predefined model investment portfolio. If transactions are effected in accordance with the agreed mandate or model investment portfolio, the licensed or registered person does not need to record the rationale for each transaction or provide clients with the rationale of its recommendation for that transaction.
- c) documenting any material queries raised by a client about specific products in the portfolio or about the portfolio's composition during the course of the investment management relationship. The licensed or registered person should also document its response to any such queries.
- d) reviewing the mandate or predefined model investment portfolio on a regular basis (e.g. annually or when there are significant market movements), having regard to the client's

2.3 Providing Discretionary Account Services to Clients - Compliance with Suitability Obligations

The SFC makes clear that licensed or registered persons providing discretionary account services to their clients must comply with the Code of Conduct's suitability obligations. There are essentially two main types of discretionary account services:

latest circumstances and where appropriate recommending revisions to the mandate or predefined model investment portfolio and agreeing them with the client. The licensed or registered person should also document the rationale for recommending the revised mandate or predefined model investment portfolio and provide a copy of the rationale to the client in writing.

It is not necessary for a licensed or registered person who provides discretionary account services to a client to provide prospectuses or other product information to the client for each and every investment decision made on the client's behalf.

Provision of Discretionary Account Services Ancillary to Brokerage Services

Where discretionary account services are provided to a client as an ancillary part of the brokerage services for clients without an agreed mandate or predefined model investment portfolio, licensed or registered persons are required to follow the documentation requirements set out in the Suitability FAQs for compliance with the suitability obligations.

Compliance with Suitability Obligations

3. What are Licensed and Registered Persons' Suitability Obligations?

Licensed and registered persons are required to:

- know their clients;
- understand the investment products they recommend to clients (conduct product due diligence);
- provide reasonably suitable recommendations to clients by matching the risk return profile of each investment product with the personal circumstances of each client;
- provide all relevant material information to clients and assist them in making informed investment decisions;
- employ competent staff and provide appropriate training (the competency requirement also applies to the appointment of agents, consultants, contractors and similar arrangements); and

- document and retain the reasons for each investment recommendation given to each client.

4. What are the "Know Your Client" Requirements?

Licensed and registered persons must comply with the "know your client" (KYC) requirement of paragraph 5.1 of the Code of Conduct. This requires them to seek information from clients about their financial situation, investment experience and investment objectives, regardless of whether a solicitation or recommendation is to be made. Relevant information includes:

- annual income, liquid assets or net worth in order to assess the client's financial situation;
- the types of investment products in which the client has invested and the period over which investment in such products has occurred in order to evaluate the client's investment experience; and
- the purposes of investment, such as income generation or capital preservation, in order to assess the client's investment objectives.

Licensed or registered persons should:

- collect from each client information that includes the client's investment knowledge, investment horizon, risk tolerance (including risk of loss of capital) and capacity to make regular contributions and meet extra collateral requirements, where appropriate;
- alert the client and seek clarification from the client before performing the suitability assessments if conflicting or incomplete information is provided by a client;
- assess the client's attitude to risk and his expectations based on the information the client has disclosed;
- explain to the client the inherent limitations of recommendations made if the licensed or registered person is unable to make the assessment properly due to the client's limited disclosure of information. In this case, the licensed or registered person should also explain to the client any assumptions made in relation to such recommendations; and

- properly document and update each client's information on a continuous basis.

Licensed or registered persons can rely on information provided by clients if they have used reasonable efforts to obtain client information and they are not aware that such information is inaccurate or out of date.

5. How should Licensed or Registered Persons Assess Clients' Attitude to Risk

A client's attitude to risk can be assessed by having verbal discussions with the client supplemented by a questionnaire with a risk-scoring mechanism. Licensed or registered persons who use a risk-scoring questionnaire must take particular care in designing the questions and underlying scoring mechanism. For example, questions, lists of possible answers and the risk-scoring mechanism should be designed to accurately reflect the personal circumstances of a client, and to avoid producing skewed results towards high risk tolerance. Clients should not be asked to answer questions in a particular way so as to produce a risk tolerance level that is commensurate with the risk of a product the licensed or registered person is recommending to the client.

6. How should Licensed or Registered Persons Conduct Due Diligence on Investment Products

Licensed or registered persons should only recommend investment products which they understand. They need to conduct due diligence in selecting appropriate investment products for clients.

In conducting product due diligence, licensed or registered persons need to understand the nature and extent of risks of the investments products and may also need to consider market and industry risks, economic and political environments, regulatory restrictions and any other relevant factors, which may directly or indirectly impact on risk return profiles and growth prospects of investments.

Licensed or registered persons are required to conduct their own product due diligence and make a fair and balanced assessment of investment products on the basis of all relevant information that is appropriate and reasonably available. Risk ratings published by independent research companies or credit ratings assigned by credit rating agencies are only one of the factors to be considered in conducting product due diligence.

A proportionate approach can be adopted in the conduct and documentation of product due diligence. In particular, the level of product due diligence and the documentation of due diligence work can be proportional to the nature and extent of risks of relevant investment products. Product due diligence should be conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of particular investment products.

6.1 Due Diligence on Non-Exchange Traded Products

Licensed or registered persons need to obtain a thorough understanding of non-exchange traded investment products they recommend to their clients. Examples of matters relevant to that understanding include the structure of investment products, how they work, the nature of underlying investments, the level of risks they bear, the experience, financial condition and reputation of product issuers, guarantors (if any) and service providers, fees and charges, the relative performance and liquidity of investment products, lock-in periods, termination conditions, valuation and unit pricing, and safe custody arrangements.

Licensed or registered persons are required to make their own enquiries and ask for full explanations from product issuers about the risks inherent in investment products, where appropriate. They should not rely on prospectuses, offering circulars or marketing materials as necessarily being self-sufficient and self-explanatory.

Licensed or registered persons should also document their verification work and enquiries which they make about investment products, the criteria for selecting the products and why they are considered suitable for different risk categories of investors, and the approvals they obtain from senior management for recommending the products.

6.2 Due Diligence on Exchange Traded Products

Similarly, licensed or registered persons should develop a thorough understanding of exchange traded products that they recommend to clients, including the risks and features of different types of exchange traded products. Certain types of exchange traded products (e.g. derivative warrants, callable bull/bear contracts and leveraged and inverse products) may have a higher level of risk than others.

The level of product due diligence and the documentation of the due diligence work can be proportionate to the complexity, opaqueness, risk and liquidity of the different types of exchange traded products.

7. How to Provide Recommendations that are Reasonably Suitable for Clients

7.1 Ensuring Suitability

Licensed or registered persons must use their professional judgment to diligently assess whether each recommended investment product is suitable for, and in the best interests of, the client. This requires matching the characteristics and the risk return profile of each recommended investment product with each client's personal circumstances. In making this assessment, licensed and registered persons should consider:

- a) the characteristics and risk exposures of recommended investment products, including transaction costs, effect of gearing and foreign currency risks, where appropriate; and
- b) the client's investment objectives, investment horizon, investment knowledge and experience, risk tolerance, financial situation and all other relevant circumstances specific to a client, including concentration risk. Concentration risk should be assessed based on available information about the client (e.g. the investment portfolio held with the licensed or registered person and information about the client's financial situation) and should take into account all relevant factors, including in particular the risk profile and nature of a product and a client's risk tolerance level and financial situation.

Licensed or registered persons should consider the overall effect of their recommended investment products on their clients' portfolios. The SFC emphasizes that merely mechanically matching a product's risk rating with a client's risk tolerance level assessed by the licensed or registered person may not be sufficient to discharge their suitability obligations.

7.2 Commissions

Where licensed or registered persons or their related companies will receive commission rebates or other benefits for transacting in particular investment products for clients, licensed or registered persons are prohibited from taking such commission rebates or other benefits as the primary basis for recommending particular investment products to clients. Further, where the licensed or registered persons only

recommend investment products which are issued by their related companies, the limited availability of products should be disclosed to clients.

7.3 Elderly or Unsophisticated Clients

Licensed or registered persons should exercise extra care when making recommendations to elderly or unsophisticated clients, or those who may not be able to make independent investment decisions on complex investment products and rely on the licensed or registered persons for recommendation, particularly when these clients invest in investment products with long maturity periods and those which will attract hefty penalty charges upon early redemption or withdrawal.

8. How to Help Clients Making Informed Decisions

Licensed or registered persons should:

- provide each client with recommended investment products' up-to-date prospectuses or offering circulars and other up-to-date documents relevant to the investments. For exchange-traded products, it is good practice to inform the client where up-to-date documents or information can be accessed such as a hyperlink to the offering documents in relation to the stock's IPO. As for non-exchange traded products, up-to-date product offering documents or offering circulars should be provided as a minimum;
- give proper and fair explanations to the client as to why recommended investment products are suitable for the client and the nature and extent of risks the investment products bear. It is not enough for licensed or registered persons to simply hand over product offering documents and ask the client to read them, or to merely read the documents to the client;
- present balanced views of investment products drawing the client's attention to a product's disadvantages and downside risks as well as its good points;
- use simple and plain language that the client can readily understand;
- give clients sufficient time to digest, consider and evaluate the information and recommendations given and sufficient opportunity to raise queries with the licensed or registered person.

High-pressure or unfair techniques must not be used in any circumstances to force or entice a client to make hasty investment decisions.

9. What are the Documentation Standards for Licensed or Registered Persons?

Licensed or registered persons are required to keep records documenting the rationale underlying investment recommendations made to clients. They must also provide a copy of the rationale to the client upon request. Licensed or registered persons that adopt a portfolio-based approach in assessing suitability when providing services to Private Banking Customers (**PB Customers**) should follow the requirements set out in the Circular on Compliance with Suitability Obligations issued by the SFC on 17 July 2012 for the purpose of compliance with the requirement of providing the rationale of recommendations to their PB Customers.

Licensed or registered persons should document and record contemporaneously the information given to each client, including any material queries raised by the client and the responses given. They must also keep sufficient documentation on all client transactions including orders placed to product providers.

Licensed or registered persons may choose to fulfil the documentation requirement by maintaining a written record or an audio record. Records for exchange traded products should be retained for at least 2 years, while records for non-exchange traded products should be retained for a minimum of 7 years.

10. Suitability Obligations' Application to Licensed or Registered Persons Using Computer Models to Generate Investment Recommendations

Licensed or registered persons are subject to the suitability obligations when they use computer models to generate investment recommendations for clients which make reference to specific client information input into the computer. Licensed or registered persons should ensure that the computer models:

- take into account all relevant information about each client;
- use objective criteria to generate investment recommendations that match the client's personal circumstance against suitable investment products; and
- operate in an unbiased manner.

11. What should be included in Client Agreements regarding Nature and Scope of Services?

Before providing services to clients, licensed or registered persons should establish and define their relationship with each client by entering into a client agreement. The client agreement should define each party's rights and obligations and properly reflect the nature and scope of the services to be provided. Client agreements should be reviewed and updated on a regular basis where continuous services are provided to clients.

12. Responsibilities of Senior Management

Governing bodies of licensed or registered persons (including senior management) are required to:

- maintain a good corporate governance structure, with clear lines of responsibility and authority so that the licensed or registered person's activities are managed and controlled in a manner that serves the best interests of clients;
- ensure that licensed or registered persons comply with all applicable laws, rules and codes. Senior management should review, assess and be satisfied that the licensed or registered person has adequate systems and controls to promptly identify issues and matters that may be detrimental to a client's interests (such as cases in which investment recommendations may have been made merely to meet sales targets or may be driven by financial or other incentives);
- recruit staff who are fit and proper and have an adequate level of skills and knowledge to make recommendations to clients.
- ensure that the licensed or registered person provides regular and appropriate staff training to keep staff informed of industry developments;
- on an ongoing basis, ensure that transactions and related documents are reviewed by qualified and competent staff. Sampled selection of transactions and related documents should be risk-based and cover investments in complex products by elderly or unsophisticated clients or those who may not be able to make independent investment decisions in relation to such investment products;

- investigate client complaints promptly in accordance with a properly documented procedure and take appropriate remedial measures without undue delay; and
- have escalation policies and procedures in place to ensure that senior management is kept informed on a timely basis of all issues and matters that may call into question compliance with applicable laws, rules and codes and the protection of client interests.

Conclusion

The considerations and requirements set out in the Circulars are non-exhaustive and each case should be assessed on its own facts. Licensed or registered persons should bear in mind that, in addition to the requirements in the Codes, the SFC will take into account compliance with guidance in the FAQs to determine whether a licensed or registered person is fit and proper to carry on the relevant activities in Hong Kong.

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