

Key Observations and Good Practices
Noted in Recent Reviews on Selling of Investment Funds by RIs

1. Suitability assessment and selling practices

Control deficiencies/malpractices

- Some sales staff solicited/recommended customers into highly frequent trading of investment funds, and as a result the customer accounts incurred substantial commissions and/or fees and charges, adversely affecting the customers' investment returns.
 - The trading pattern contradicted the investment objective/investment horizon of the customer, and the medium-to-long term investment objectives of the investment funds concerned, but the RIs failed to provide any justification.
 - Despite the transaction costs and the associated risk (e.g. market risk), some customers were solicited/recommended to switch frequently between different currency classes of the same funds that made little or no economic sense.
- While soliciting/recommending customers into frequent trading of investment funds, the sales staff concerned only performed suitability assessment on a single transaction basis. The suitability assessment did not take into account that the frequent trading pattern and the resultant transaction costs could be inconsistent with the nature and objectives of investment funds, the customers' circumstances and the customers' best interest.
- An RI assessed that the frequent transactions of investment funds were not solicited/recommended by the RI, primarily based on the customers' declarations. However, the actual practice adopted by the RI on investment funds reflected that the transactions could have involved solicitation/recommendation, despite the customers' declarations. The RI was unable to justify the reasonableness of soliciting/recommending the customers into the highly frequent trading of investment funds.
- Some RIs had established tools and systems which made available information (such as fund transaction details, costs incurred, profit/loss position of each fund) within the customer's existing portfolio. Nevertheless, the RIs did not provide any guidance for sales staff to make use of the available information for the suitability assessment and for information

disclosure to customers, especially if soliciting/recommending customers into frequent trading of investment funds.

Good practice

- For customers identified by an RI as having frequent trading of investment funds, the RI had put in place pre-trade controls (such as obtaining the customers' rationale for subscription, seeking endorsement from supervisors) for investment fund transactions conducted by those customers.

Expected standards

RIs should ensure the suitability of the recommendation or solicitation for the customer is reasonable in all the circumstances¹, whether in an online or offline environment. RIs should refer to the SFC's requirements² in determining whether solicitation or recommendation is involved.

The HKMA has provided guidance to RIs through the circular dated 8 April 2016 on "Feedback from recent reviews of the selling of investment products" ("2016 Circular") and another circular dated 21 December 2018 on "Misconduct Risks in Selling of Investment Funds" ("2018 Circular") that soliciting/recommending customers into frequent switching of investment funds can hardly be justified, especially those making little or no economic sense to the customers. RIs should ensure that due consideration is given to the circumstances of the customers (including investment objective, investment horizon, etc.) as well as the risks of and consequences arising from certain trading pattern (such as transaction costs involved in frequent switching of funds) in the suitability assessment. Appropriate disclosure of relevant material information should be provided to the customers to facilitate them to make informed investment decisions. Moreover, adequate staff training should be provided.

RIs may review the existing holding of investment products in the portfolios of their customers, or provide rebalancing services for the portfolios. Such reviews/services may be conducted upon the triggering of certain internal criteria or at specific intervals. RIs should ensure that such reviews/services will not increase fund churning risk and will comply with all applicable regulatory requirements.

¹ Paragraph 5.2 of the "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission" ("SFC Code of Conduct").

² SFC's "Frequently Asked Questions on Triggering of Suitability Obligations" dated 23 December 2016, "Guidance on Online Distribution and Advisory Platforms" dated July 2019 and the relevant frequently asked questions.

2. Monitoring and review

Control deficiencies/malpractices

- A few RIs did not monitor or review investment fund transactions on an account basis, customer basis or trading pattern basis. Hence, the RIs were unable to identify any suspicious trading pattern for managing any potential misconduct risk in the selling of investment funds.
- While some RIs had performed compliance review and identified some suspicious trading patterns of customers, no/inadequate follow-up action was taken in some of the cases, due to unreasonable internal criteria set by the RIs for triggering follow-up action. The effectiveness of the compliance review of these RIs was undermined as a result.
- For any customer account identified with suspicious trading pattern through the compliance review of an RI, the reviewer would request for explanation from the supervisor of the sales staff concerned. While the same customer account was detected in a number of times, the reviewer merely repeated the request for explanation. The reviewer did not take further action despite the recurrence of suspicious trading pattern.
- Some RIs had not put in place adequate management information system to generate reports for monitoring and analysing investment fund transactions on the customer, account or trading pattern basis, or for providing analysis on individual sales staff, branches or districts basis. Therefore, the senior management of the RIs was not given adequate information for effective management oversight over any misconduct risk in the selling of investment funds.

Good practice

- As part of the regular post-trade monitoring mechanisms, an RI took follow-up actions upon detecting frequent trading of investment funds in customers' accounts. The follow-up actions included issuing letters to or meeting the customers concerned, so as to alert them that frequent trading of investment funds had been observed in their accounts and the potential consequences (e.g. disproportionate transaction costs and reduction of investment return), etc.

Expected standards

RIs should follow the expected standards set out in the sections on “Management supervision” and “Monitoring and review” of the 2018 Circular. RIs are reminded that they should formulate adequate and effective systems and control, as well as monitoring and review mechanisms to guard against any potential investment fund churning.

3. Incentive systems and feedback mechanism

Control deficiencies/malpractices

- The sales target of an RI was formulated in a way that it would be the easiest to achieve the sales target by conducting investment fund transactions as compared with other investment product types. Given that the sales performance of sales staff would be multiplied (or discounted) for outperforming (or underperforming) the sales target, sales performance in investment funds would magnify the incentives to be rewarded to the sales staff. As such, the RI’s incentive system, and the setting of sales target would in effect encourage sales staff to conduct more transactions in investment funds and might increase the risk of investment fund churning.

Good practice

- An RI offered customers engaging in frequent trading of investment funds a type of investment account which charged a single monthly account fee based on the customers’ average holding balance of investment funds (i.e. no initial subscription charges and/or switching fees on transaction basis). Frequent trading activities in these investment accounts would not generate commissions to sales staff, and thus it could avoid incentivising the sales staff to solicit/recommend customers into frequent trading of investment funds for the sake of commission income. This was further demonstrated in the RI’s remuneration mechanism for sales staff that it did not solely take into account the trading activities and/or commissions generated from trading of investment funds.

Expected standards

RIs should properly design their incentive systems such that proper risk culture and business conduct of staff are encouraged and incentivised, and that improper risk taking and misconduct are deterred. Incentive systems and sales targets that will in effect target at specific investment products should be avoided.

RIs should take all reasonable steps to ensure fair treatment of customers and properly disclose and manage any conflict of interest (e.g. avoid higher incentives for selling in-house funds; avoid disproportionate sale of particular investment products where the RIs will receive more benefits).

RIs should apply the expected standards set out in this section as well as the section on “Incentive systems and feedback mechanism” of the 2018 Circular to the selling of investment products (including but not limited to investment funds).

4. Staff training

Control deficiencies/malpractices

- While some customers were solicited/recommended into frequent trading of investment funds, some RIs did not provide adequate staff training to ensure that their sales staff would duly consider the customers’ circumstances in the suitability assessment and that the relevant disclosure would be made (e.g. impact of frequent switching on transaction cost).

Good practice

- Some RIs provided training to frontline staff to guard against investment fund churning. The training included guidance for assessing the reasonableness of subscription/switching/redemption of investment fund before processing; potential scenarios of fund churning; the medium-to-long term nature of investment funds; the serious consequences of fund churning activities, etc.

Expected standards

RIs should ensure that relevant staff are equipped with adequate skills and knowledge, and demonstrate adequate understanding of regulatory requirements. In particular, RIs should follow the expected standards set out in the section on “Staff training” of the 2018 Circular.