

Key observations by the Securities and Futures Commission

This annex shares the key observations from the thematic review conducted by the Securities and Futures Commission (SFC) of spread charges and other practices of licensed corporations (LCs). The thematic review covered selected LCs' policies, systems, controls and management supervision for the distribution of non-exchange-traded investment products (such as bonds and structured products).

Some issues, control deficiencies and examples of good practices observed during the thematic review are set out below.

A. Internal control and management supervision over order handling and spread charges

Deficiencies and non-compliance

1. An LC represented that it would not retain any benefits from price improvements. However, it did not have written policies to clearly communicate this practice to its staff or any pre-trade controls or post-trade surveillance reviews for checking whether benefits were passed on to the clients. During our sample review, we noted an instance where the benefit of price improvement was not fully passed on to the LC's client. This deviated from the representation made by the firm.
2. Another LC represented that it could retain partially, or in full, the benefits from price improvement so long as the final spread charges were within the percentage ceiling of the spread charges agreed with or disclosed to the clients. However, the LC did not provide any guidance on the factors for client-facing staff¹ to consider to determine whether the benefits could be retained partially or in full. Also, during our thematic review, we noted some instances where the LC did not inform its clients that it might retain the benefits from price improvements.

Examples of good practices

We noted that an LC required its staff to pass all benefits from price improvements on to clients and adopted various measures to ensure that its staff comply with the firm's policy:

- the policy was communicated to all staff via the firm's intranet, training sessions and compliance reminders to staff;
- client-facing staff were required to advise the central dealing desk of the intended spread on each transaction to be executed for clients. If the central dealing desk executed the client order at a better price, all the benefits will be passed on to the client without changing the intended spread indicated by the client-facing staff. The LC also enhanced its internal pricing system so that bond spreads could not be changed after trades were executed with counterparties; and

¹ Client-facing staff were allowed to determine the spread to be charged on each transaction executed for clients, subject to the firm's internal limits.

- the firm's independent control function performed regular monitoring reviews to identify errors, omissions and other deficiencies in order handling and spread charges (eg, charging a client a fee over the thresholds stated in the firm's policies) and disclosures of transaction-related information to clients.

B. Disclosure of transaction-related information

Deficiencies and non-compliance

(a) Trading capacity

- We noted that an LC failed to disclose the capacity in which it acted for its clients prior to or at the point of entering into transactions in fixed income securities and structured products. When we interviewed the LC's staff members², they were not able to say whether the firm acted as a principal or an agent in the sampled transactions involving third-party issued structured products (eg, equity-linked notes). After numerous enquiries, the LC represented that it acted as an agent in distributing such products to its clients and received commissions from the product issuers.

(b) Affiliations with product issuers and independence

- Some LCs which transacted in non-exchange-traded products (eg, bonds and funds) issued by its group affiliates failed to disclose their affiliation with product issuers, whether or not they were independent and the bases for such determination as required under the Code of Conduct prior to or at the point of entering into transactions with their clients.

(c) Monetary benefits

- An LC made a uniform disclosure of the maximum percentage of trading profits from back-to-back fixed income securities transactions³ by disseminating the fee schedule to clients at the account opening stage and annually. It failed to make specific disclosures on a transaction basis.
- In one case, an LC failed to disclose the existence, nature and the maximum percentage of trailer fees receivable for transactions in funds. We noted in another case that an LC disclosed the trailer fees receivable from fund houses to its clients in an email prior to or at the point of entering into a transaction. However, the LC only provided a uniform disclosure of the maximum percentage of the trailer fees receivable based on all the funds on its distribution list. It failed to make specific disclosures of the maximum percentage of the trailer fees receivable for particular funds on a transaction basis.

² Including staff from client-facing, product dealing and compliance functions.

³ For example, an LC made a disclosure of 5% (rounded to the nearest whole percentage point) whereas it might receive a trading profit of 2.5%, 3.5% or 4.5% as allowed by the LC's internal pricing policy.

Examples of good practices

1. In disclosing its trading capacity, an LC made a one-off disclosure in client agreements. In addition, it disclosed how its affiliate was involved in a transaction by stating that the firm will typically act as an agent to arrange an affiliate to act as a principal for primary offerings and secondary market transactions of fixed-income securities and structured products.
2. In a pre-trade document provided to clients on a transaction basis, the LC also disclosed the monetary benefits receivable by the firm and its affiliate as a percentage ceiling of the investment amount for particular types of products under primary offering or secondary market trading.