



25 March 2014

Circular to Licensed Corporations
Selling of complex bonds and high-yield bonds

From our recent on-site inspections, we have identified some common issues suggesting that certain areas of the selling process for bonds with special features¹ and high-yield bonds (collectively referred to as "Complex/HY Bonds") need better attention of some LCs. The Commission reminds all licensed corporations ("LCs") that sell Complex/HY Bonds of their obligations to:

- conduct proper product due diligence to ensure that the firm understands the important aspects of Complex/HY Bonds;
- explain the key features and risks of Complex/HY Bonds and provide relevant and material information to the client;
- implement a proper suitability assessment process to ensure that Complex/HY Bonds which the firm solicits or recommends a client to buy are reasonably suitable to the client in all the circumstances;
- disclose the trading profit made from a back-to-back transaction to the client prior to or at the point of entering into the transaction; and
- put in place adequate supervisory controls to ensure compliance with all relevant regulatory requirements in relation to the sale of Complex/HY Bonds².

LCs should pay due regard to the issues and guidance set out in the Appendix, and critically review their policies and procedures to address any issues that are relevant to their firms with a view to improving compliance.

The Commission will take appropriate regulatory action against LCs found to have breached the selling practices requirements and will continue to use a range of supervisory tools, including inspections and mystery shopping programmes, to monitor compliance.

Should you have any queries regarding the contents of this circular, please contact Ms Seine Luk at 2231 1696.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

Enclosure

End

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¹ Examples of special features include perpetual, subordinated, callable, variable and/or deferral of interest payment terms, extendable maturity dates, convertible/ exchangeable, contingent write down or loss absorption feature, etc.

² Please see also the circular "Regulatory Compliance regarding Cross-border Business Activities" issued by the Commission on 28 January 2014 should the LCs conduct business activities in other jurisdictions.



A) Conduct proper product due diligence to ensure that the firm understands the important aspects of Complex/HY Bonds

In determining product suitability, LCs should develop a thorough understanding of the attributes and associated risks of the Complex/HY Bonds they are recommending to clients. We found that some LCs did not make reference to the offering memorandum when performing product due diligence review. They might not have developed enough understanding of the bond product especially Complex/ HY Bonds in the circumstances (see Case 1).

Case 1

Most of the LCs primarily relied on the information available from Bloomberg for obtaining an understanding of some features¹ of bonds and performing risk assessment of the bonds. They mainly assessed a Complex/HY Bond's credit risk and liquidity risk, and by referring only to the credit rating and the pricing spread quoted. Such assessment of the product may not be adequate for establishing enough understanding of all important aspects of the Complex/ HY Bond.

B) Explain the key features and risks of Complex/HY Bonds and provide relevant and material information to the client

We found that some LCs did not have adequate procedures to ensure that specific product information gathered from the due diligence review was properly communicated to the sales staff. As a result, the sales staff might not in turn be able to make adequate disclosure of product information to clients even when they could explain the basic features of, and risks of investing, in bonds generally (see Case 2).

Case 2

The sales staff was not aware of the special features of a Complex/HY Bond (unrated perpetual note with a loss absorption feature) sold to clients. The principal invested may be written off fully on the occurrence of a trigger event. The sales staff had only provided the client with the Bloomberg screen shot of the product which did not contain all the details regarding the special features, and he did not provide the prospectus nor refer the client to read the prospectus which contained details regarding the special features of the product.

Under the Suitability FAQ², LCs are required to provide client with recommended investment products' prospectuses or offering circulars and other documents relevant to the investments. Some LCs advised that the prospectus would only be provided to clients upon request. In one case, the LC had not provided the prospectus nor referred the clients to read the prospectus of a bond that had a particular special feature³ the full details of which were not available from the Bloomberg screen shot provided to the clients.

¹ Features such as tenor, ranking (e.g. subordinated), when and if periodic interest payments will be made, whether the issuer may call the bond.

² Answer to question 5 of the "Questions and answers on suitability obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities" issued in May 2007 ("Suitability FAQ").

³ Basel Tier 2 Capital instruments with statutory loss absorption clause.



Some LCs would also prepare a summary information sheet of the bonds they solicited/ recommended the clients to buy. We found a case where the sales staff prepared the summary based on the limited information available from Bloomberg and such summary was inaccurate and potentially misleading (see Case 3).

Case 3

An LC provided a product summary setting out the key features of a product it sold without providing the offering document to clients. We further found the product summary to be inaccurate and potentially misleading:

- i) The product which had a discretionary and non-cumulative coupon was differently named in the product summary, which when read together with other information stated therein might mislead investors to think that the payout was fixed till the first call date.
- ii) The estimated return rate (i.e. the yield) shown on the product summary was based on the assumption that there would be a fixed payout till the first call date without mentioning that the payout was in fact discretionary and non-cumulative.
- iii) The product summary did not present a balanced view by showing the estimated return rates without mentioning any disadvantages and downside risk associated with the discretionary nature of the payout.

C) Implement a proper suitability assessment process to ensure that Complex/HY Bonds which the firm solicits or recommends a client to buy are reasonably suitable to the client in all the circumstances

Many LCs classified products into risk categories and sales staff would use such product risk classification to match the product risk to client's risk tolerance level as part of the suitability assessment. Therefore, it is critically important that LCs adopting such an approach take into account the relevant factors including but not limited to the asset class, features (e.g. whether a bond has special features) and risks (e.g. credit risk of the issuer and additional risks associated with any special features of the bond) in the product risk classification methodology. We found instances where there were apparent inadequacies in the LC's risk classification methodology for Complex/HY Bonds (see Case 4).

Case 4

Some LCs assigned risk rating of a bond based on some basic features of the bond such as type of issuer (e.g. government, corporations), issuer country rating, tenor and credit rating of the bond or the issuer but with no regard to special features of the bond which bear additional risks.

LCs should give due consideration to all relevant circumstances specific to a client, including concentration risk, when assessing the suitability of a product to the client. We found that some LCs did not provide guidelines to their sales staff on how to assess the concentration risk in a client's portfolio investing in products of related issuers or products of different risk levels in the same asset class although they required the sales staff to assess whether the concentration level was acceptable (see Cases 5 and 6).



Case 5

In one case, we found that the clients had invested in Complex/HY Bonds issued by companies in the same group, and the total holdings in these Complex/HY Bonds constituted a significant amount of the clients' portfolio with the LC. In case of deterioration of the credit profile of any of these group companies, the other related group companies may be exposed to contagion risk. However, the sales staff had not taken this into consideration when assessing concentration risk and had not drawn clients' attention to the risks of investing in Complex/HY Bonds issued by companies in the same group.

Case 6

In another case, the LC had provided internal guidelines to sales staff on the recommended asset allocation of each product group for clients under different risk profiles, but the concentration limit was not set in such a way to provide sufficient differentiation for the higher-risk products within the defined product group. For example, for a client with a low risk profile, a recommended allocation of 25% was set for "non-government bonds" which did not distinguish Complex/ HY Bonds which generally carry additional risks compared to others in that broadly defined product group.

The risk tolerance of a client should also be taken into account when assessing the suitability of a product to the client. In establishing a client's risk tolerance, LCs often use a risk profiling questionnaire ("RPQ"), and we found that some LCs' scoring methodology for classifying the client's risk profile had flaws (see Case 7). The score for a client calculated from a deficient RPQ, if relied upon as the only basis for recommending any particular product to the client, might lead to an unsuitable sale (whether the product is a Complex/HY Bond or other investment product).

Case 7

In two cases, clients were classified as "aggressive" clients based on responses to the LCs' risk profiling questionnaire ("RPQ"). However, the scoring methodology of the RPQ appeared to be flawed in that, for example:

- i) Where a client ticked all middle choices for the RPQ questions, the client would be classified as an aggressive investor despite that the middle choices for some questions suggested that the client was more likely to be not an aggressive investor. Examples of such middle choices were:
 - Age: 50-59 years old (a person nearing retirement typically have a shorter investment horizon and seeks to reduce volatility and thus tends not to be risk taking);
 - Description of client's investment behaviour: willing to take a little risk in pursuit of potential return.
- ii) A risk-averse client (who stated in the RPQ that his investment objective was capital preservation and to avoid losses) would still be classified as an aggressive investor if he scored high in other questions.



D) Disclose the trading profit made from a back-to-back transaction to the client prior to or at the point of entering into the transaction

LCs transacted bonds for clients mostly as principal in back-to-back transactions with mark up/ mark down giving rise to trading profit, and such monetary benefits are subject to pre-sale disclosure requirements under the Code of Conduct⁴. LCs are also required to disclose the capacity in which they are acting. We found instances where the LCs failed to disclose trading profits earned by the firm and the capacity in which the LCs were acting (see Case 8).

Case 8

In one case, the LC misrepresented to clients that it acted as agent in those transactions and did not disclose the trading profits earned by the firm. This might have misled clients to believe that the LC did not have an interest in the clients' transactions.

E) Put in place adequate supervisory controls to ensure compliance with all relevant regulatory requirements in relation to the sale of Complex/HY Bonds

Post-trade suitability review

Under the Suitability FAQ⁵, intermediaries are required, on an ongoing basis, to ensure that client files are reviewed by qualified and competent personnel. Such review helps to ensure that the proper suitability process is completed. We found that in some LCs the review did not cover Complex/ HY Bonds even when they would as a policy perform post-trade suitability review on transactions in other high risk products (e.g. structured products such as accumulators).

Training

Provision of product training to sales staff is essential to equip them with an adequate level of knowledge and skills to provide advice to clients. In addition to the case highlighted above (Case 2) which demonstrated inadequate understanding of Complex/HY Bonds sold by the sales staff, we also found that some LCs did not make it mandatory for the sales staff to attend the relevant product training.

⁴ Paragraph 8.3 and 8.3A of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct").

⁵ Answer to question 9 of the Suitability FAQ.