



HONG KONG MONETARY AUTHORITY
香港金融管理局



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

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Joint reviews by HKMA and SFC on managing conflicts of interest in financial groups

This circular shares with intermediaries¹ some key observations and good practices in relation to potential conflicts of interest that may arise from the sale of in-house products².

Conflicts of interest are a major regulatory focus for both the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC). In Hong Kong, the business conducted by conglomerate financial institutions through their Registered Institutions (RI) and Licensed Corporations (LC) ranges from manufacturing and managing financial products to distributing them to clients. Conflicts of interest may arise during the day-to-day operations of the intermediaries³. It is therefore fundamental for protecting the interests of clients that conflicts of interest are identified and managed. In essence, intermediaries should act in the best interests of clients⁴, disclose the potential conflicts and take all reasonable steps to ensure fair treatment of clients, if the conflicts of interest cannot be avoided⁵. In particular, intermediaries should take into account clients' interests when recommending or soliciting in-house products to the clients or making discretionary investment decisions on clients' behalf.

To assess the effectiveness of controls in respect of conflicts of interest, the HKMA and the SFC have jointly conducted thematic reviews on the sale of in-house products by intermediaries within the same financial group. The scope of the joint thematic reviews included order execution, product due diligence, selling processes, the management of discretionary accounts, management supervision, and controls and monitoring. The reviews revealed that, while intermediaries in general had put in place policies and procedures in respect of conflicts of interest, some key areas warrant further attention by intermediaries. Details are set out in the **Annex**. In respect of the issues identified, the intermediaries concerned have been required to undertake remedial actions.

¹ As defined in Schedule 1 to the Securities and Futures Ordinance (Cap.571), "intermediary" means a licensed corporation or a registered institution.

² In-house products refer to various investment products that are manufactured and distributed by different entities within the same financial group, including but not limited to, structured products and investment funds.

³ For example, RI and/or related entities provide wealth management and/or private banking related services to their clients, while LC and/or related entities provide asset management related services as well as execution and investment banking services to RI and/or related entities.

⁴ General Principle 1 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct").

⁵ General Principle 6 and Paragraph 10.1 of the Code of Conduct.

Senior management of intermediaries are reminded that they bear the primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper policies and procedures. They should holistically review the robustness and effectiveness of the controls relating to the identification and management of potential conflicts of interest arising from the sale of in-house products, and ensure that intermediaries comply with relevant regulatory requirements pursuant to General Principle 9 of the Code of Conduct and Part I of the Internal Control Guidelines⁶. Intermediaries are also encouraged to adopt the good practices, as applicable, to manage potential conflicts of interest in carrying out regulated activities on a group basis.

Should you have any queries regarding the contents of this circular, please contact Ms Eloise Pun at the Banking Conduct Department of the HKMA on 2878 1903 or Ms Lorraine Chan at the Intermediaries Supervision Department of the SFC on 2231 1751.

Banking Conduct Department
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⁶ Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission.

Key Observations and Good Practices Noted in Joint Reviews**1. Order execution and related disclosures**

- For transactions in some structured products, some intermediaries would only select their related entities as counterparties without sufficient disclosure of such arrangement to clients. We further noted instances where a number of these client orders were not executed at better prevailing prices.
- Some intermediaries required their staff to obtain quotes from different market participants when they executed the orders of certain investment products for clients. But we found that the staff of an intermediary were not required to follow such requirement if they considered that the in-house quote was reasonable based on the staff's own assessment. In other cases, staff were required to input quotes obtained in their internal systems so that control functions could check whether execution was made on the best available terms. However, we found that:
 - (i) no guidance was provided to staff on how to assess whether the in-house quote was reasonable compared with those of other market participants; and
 - (ii) the staff did not correctly input the quotes obtained from different market participants into their internal systems, which might potentially affect the review work conducted by control functions.

Examples of good practices

- An intermediary implemented policies and procedures requiring staff to compare in-house quotes with those of other market participants.
- An independent unit was deployed to perform specific thematic reviews of the effective implementation of conflicts of interest policies.

Regulators' expected standards

Intermediaries are reminded that they should execute client orders on the best available terms when acting for or with clients pursuant to Paragraph 3.2 of the Code of Conduct. Intermediaries should implement proper controls and monitoring to ensure compliance with their established policies and procedures, including requiring staff to obtain and compare quotes from external market participants. Where no external quote is obtained or is not available, intermediaries should sufficiently disclose to clients of that fact. In respect of disclosure of monetary and non-monetary benefits and affiliation⁷ with the product issuer, intermediaries should make relevant disclosure pursuant to Paragraph 8.3 of the Code of Conduct.

Furthermore, intermediaries should disclose material interests in a transaction with or for a client and take all reasonable steps to ensure fair treatment of the clients and act in compliance with Paragraph 10.1 of the Code of Conduct, including performing regular reviews of disclosure of information, and providing an appropriate level of training and

⁷ Pursuant to Paragraph 8.3A(a)(ii) of the Code of Conduct, the licensed or registered person should disclose affiliation of the licensed or registered person with the product issuer to client prior to or at the point of entering into the transaction.

guidance to staff. Effective controls should be put in place to ensure sufficient disclosure to clients in relation to conflicts of interest arising from sale of in-house products.

2. Product due diligence

- For product due diligence, an intermediary did not have sufficient policies and procedures governing the assessment of conflicts of interest in the sale of in-house products.
- In the absence of any independent assessment, an intermediary relied on its related entities (who were competitors of third-party managed funds)⁸ to perform product due diligence on some third-party managed funds.

Regulators' expected standards

Intermediaries should have a thorough understanding of their in-house products before they solicit investment from or recommend such products to clients. While intermediaries may take into account the due diligence work of related entities as appropriate, they should establish proper policies and procedures to ensure that assessment is adequately and independently conducted to identify if bias exists. Such assessment should also be conducted with due consideration of actual or potential conflicts of interest, taking into account applicable regulatory requirements and other circumstances. The mechanism for assessing actual or potential conflicts of interest should be reasonable, taking into consideration all relevant factors such as relationship between the product issuers and the distributors as well as the benefits received for distributing the in-house products.

As part of the product due diligence process, relevant control functions should ensure that conflicts of interest have been adequately identified and assessed. Approval from senior management should be obtained and proper documentation of product due diligence should be maintained.

3. Selling process and discretionary portfolio management (DPM)

- Some in-house products were categorised into different classes, where lower fees and charges would be applied to certain classes if transaction amounts exceeded the thresholds pre-determined by the intermediaries. However, we noted instances where an intermediary made solicitations of a specific class of such products without disclosing to the clients that they were entitled to invest in another class where lower fees and charges could apply. The clients eventually paid higher fees and charges.
- In respect of DPM mandates, we noted instances where the investment portfolio concerned was comprised of substantial investments in in-house products. However, there were insufficient monitoring tools or controls in place to ensure:
 - (i) compliance with internal guidance in selecting in-house products;
 - (ii) adequate disclosure about the strategy or practice of investing in in-house products; and

⁸ For instance, LC and/or related entities provide asset management related services and at the same time, RI and/or related entities rely on the product due diligence conducted by LC and/or related entities on some third-party funds. The intermediary advised that they had such arrangement because (a) staff of RI and/or related entities did not have capacity and knowledge in the due diligence of asset management firms and the funds they managed (b) staff of LC and/or related entities had extensive knowledge in asset management.

- (iii) overall risk exposure (including selection of in-house products) for DPM investment portfolios matched with the investment strategies and risk expectations agreed with clients.

Examples of good practices

- An intermediary required staff to properly disclose to clients about the intermediary's preference for internally managed strategies, and provide clients with an option to exclude certain investment products managed or issued by the intermediary's group companies.
- Disclosure was made in clients' monthly statements about the percentage split of the investment allocation between in-house managed and third-party managed strategies to help clients understand the intermediary's material interest in the relevant transactions.

Regulators' expected standards

Intermediaries should implement appropriate policies and procedures to ensure that clients are fairly treated and actual or potential conflicts of interest in the sale of in-house products and investment in such products by discretionary accounts are properly addressed, monitored and disclosed to clients and that the intermediaries comply with General Principle 6 and Paragraph 10.1 of the Code of Conduct.

In respect of advisory models, intermediaries should take steps to ensure that their solicitations or recommendations for in-house and third-party products for clients are reasonable in all circumstances having regard to all relevant information about the clients available to the intermediaries. Intermediaries should also ensure that the general course of dealing or advising a client, and the application of charges, mark-ups or fees should be fair and reasonable in the circumstances, and be characterised by good faith pursuant to Paragraph 2.2 of the Code of Conduct.

In respect of discretionary management models, intermediaries should ensure the selection of in-house and third-party products match with the investment strategies and risk expectations agreed with clients. Intermediaries should demonstrate in a sufficiently clear manner that due consideration has been given to third-party products as an alternative to in-house products having regard to the clients' personal circumstances.

4. Management supervision, and controls and monitoring

- The following deficiencies in controls and monitoring mechanisms were noted in some intermediaries:
 - (i) policies and procedures for handling conflicts of interest in the sale of in-house products were inadequate;
 - (ii) conflicts of interest and the circumstances under which staff should escalate related matters to management were not clearly defined; and
 - (iii) periodic reviews of conflict-related issues were inadequate.
- Control functions, including compliance and internal audit, did not appear to adequately cover identification of actual or potential conflicts of interest arising from the sale of in-house products and execution of orders where intermediaries and/or their related entities were the only counterparties selected.
- Some intermediaries did not provide training to equip staff with adequate knowledge about managing conflicts of interest arising from the sale of in-house products.

Examples of good practices

- An intermediary established written guidance about conflicts of interest with a list of focus areas and scenarios to help identify actual and potential conflicts of interest.
- Conflicts of interest are included as a standard item in annual risk assessments and specific check points are specified to ensure the effectiveness of tracking and assessing risk in business activities with potential conflicts of interest.

Regulators' expected standards

Intermediaries are reminded that effective management supervision as well as controls and monitoring should cover issues arising from the distribution of in-house products, particularly in relation to conflicts of interest.

To ensure the robustness of internal controls and effective implementation of internal guidance and compliance with applicable regulatory requirements, intermediaries should review from time to time, and enhance where appropriate their practices, controls and monitoring, including but not limited to:

- (i) establishing proper policies and procedures in relation to conflicts of interest arising from the sale of in-house products;
- (ii) reviewing the scope, coverage and frequency of monitoring carried out by control functions (e.g. compliance and internal audit) to assess on whether conflicts of interest are properly addressed, monitored and managed; and
- (iii) providing regular training and guidance to ensure that staff are equipped with adequate knowledge and skills to handle actual or potential conflicts of interest in the sale of in-house products and related matters.