



25 January 2018

Circular to all licensed corporations**Compliance failures in the
distribution of fixed-income and structured products**

The Securities and Futures Commission (SFC) has identified a number of compliance failures during its on-site inspections and investigations of the distribution of complex bonds and structured products by licensed corporations (LCs). The SFC reminds LCs to comply with the following expected standards, which are further elaborated in the Appendix.

- (a) Maintain adequate management oversight and effective compliance monitoring to ensure product due diligence is properly conducted and put in place appropriate measures, systems and controls to ensure that the features and risks of each investment product are duly considered.
- (b) Provide staff with adequate training on the investment products they distribute and how to appropriately disclose the products' features and risks to clients, particularly for complex and risky products.
- (c) Implement proper policies and procedures, ensure sufficient guidance is provided to staff and put in place appropriate monitoring procedures in order to identify when suitability obligations¹ have been triggered.
- (d) Regularly perform a holistic assessment of the suitability framework to ensure compliance with suitability obligations, which includes management supervision, know your client, product due diligence, suitability assessment, the sales process, record retention and staff training.
- (e) Maintain adequate records to ensure compliance with suitability obligations and to enable reviews or investigations to be carried out by the LCs, their auditors and the SFC.

Suitability assessment is important for investor protection and reviewing compliance with suitability obligations is an SFC priority. The SFC expects the board and other senior management of each LC, including the Managers-In-Charge of Core Functions, to maintain effective oversight of the firm's business activities and to put in place appropriate systems and controls to ensure full compliance with the relevant regulatory requirements governing the distribution of investment products.

LCs should review the areas of concern discussed in this circular and the Appendix and take immediate action to rectify any deficiencies. The SFC will continue to monitor selling practices and will take action against delinquent LCs.

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



Should you have any queries regarding the contents of this circular, please contact Ms Pauline Chan at 2231 1952.

Intermediaries Supervision Department
Intermediaries Division
Securities and Futures Commission

Enclosure

End

SFO/IS/003/2018



Appendix

Compliance failures and expected standards in the distribution of fixed-income and structured products

Product due diligence

To fulfil the suitability obligations¹, it is crucial that licensed corporations (LCs) conduct proper due diligence to understand the investment products they recommend to clients, taking into account the features and risks of the products. Our inspections and investigations found the following deficiencies.

- (a) Some LCs failed to consider the special or complex features of certain bonds, for example, by ignoring the contingent write-down or loss absorption features of contingent convertible bonds. Specifically, a number of bonds listed under Chapter 37 of the Main Board Listing Rules (Chapter 37 Bonds) had multiple credit support providers with no material operations or other complex structures² the aim of which were to subordinate the bondholders' rights to those of the credit support provider³, and some LCs failed to take these features into account.
- (b) Some LCs assigned risk ratings to bonds based solely on credit ratings assigned by credit rating agencies. For example, an LC classified some bonds with contingent write-down or loss absorption features as low-risk solely on the basis of credit ratings.
- (c) Some LCs failed to maintain adequate records to demonstrate they conducted proper due diligence.
- (d) An LC treated a wide array of structured products, including accumulators and decumulators, as "simple" products (representing the firm's lowest rating for product complexity) without due consideration of their specific features.

Failure to properly perform product due diligence casts doubt on the LCs' capability to provide appropriate training to their account executives (AEs) who make solicitations or recommendations to clients. In such circumstances, AEs may not be able to provide sufficient and accurate product information.

Expected standards

(a) Proper product due diligence

Among the wide variety of bonds and structured products, some may have complex or opaque features and involve substantial risks, including liquidity risk. LCs should put in place appropriate measures, systems and controls to ensure that the features

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

² Some bonds have both.

³ We have seen structures with up to 100 guarantors with no material operations where if an event of default were triggered, the bondholders' rights would effectively be subordinated to most of the obligations of the issuer and guarantors jointly and severally.



and risks of each investment product are duly considered⁴. In particular, LCs should not treat all bonds or structured products as plain vanilla and assign the same low risk rating to all of them.

LCs should conduct their own due diligence, properly document the work performed and arrive at a fair and balanced assessment by taking into account all appropriate and reasonably available information.

(b) Sufficient staff training

LCs should be able to demonstrate that they have educated their sales staff about the investment products they distribute and how to appropriately disclose product features and risks to clients⁵. They may want to provide additional training to staff who perform due diligence on complex and risky products and to sales staff who must explain such products to their clients. LCs should not solely rely on having sales staff review offering documents on their own to develop an understanding of such investment products.

Triggering of suitability obligations

The SFC noted that some LCs did not implement proper policies and procedures to identify when suitability obligations had been triggered and therefore failed to fulfil them when they were triggered. The following deficiencies were noted.

- (a) Some LCs relied heavily on AEs to determine whether an investment recommendation or solicitation had been given or made to clients and failed to put in place sufficient measures to monitor and assess whether a recommendation or solicitation had in fact been given or made.
- (b) An LC advised that its AEs generally would not actively solicit or recommend bonds to clients. However, some of its AEs periodically sent lists of bonds to selected clients based upon the clients' preferences, which amounted to solicitation.

Expected standards

Solicitation may cover a wide range of acts on the part of LCs. Whether an LC has made a solicitation is a question of fact which should be assessed in each case⁶. The SFC reminds the senior management of LCs that they should ensure staff are provided with sufficient guidance and training and should put in place appropriate monitoring to identify transactions which resulted from a solicitation or recommendation.

⁴ Answer to question 4 of the Circular on Frequently Asked Questions on Compliance with Suitability Obligations dated 23 December 2016 (2016 Suitability FAQs).

⁵ Answers to questions 4, 6 and 10 of 2016 Suitability FAQs.

⁶ Circular on Frequently Asked Questions on Triggering of Suitability Obligations dated 23 December 2016.



Suitability assessment framework

The SFC's inspections noted cases where there were gaps and anomalies in the suitability framework. In other cases, management supervision was inadequate and compliance monitoring was insufficient to ensure that the policies and procedures governing the suitability framework were properly implemented and regularly reviewed and updated. Certain AEs failed to properly explain product features when recommending them.

Below are some examples of deficiencies noted.

- (a) An AE recommended high risk bonds issued by a commercial firm to an elderly client but the client's preference was to invest in "prudent or safe" products, eg, products issued by government-owned entities.
- (b) A client indicated her investment objectives as both "capital preservation" and "capital appreciation", but the AE did not clarify this apparent inconsistency with the client.
- (c) An AE incorrectly explained a bond's loss absorption features to an elderly client and did not highlight the possibility of the bond's book value being written off in certain scenarios.
- (d) An AE recommended equity accumulators and decumulators to a client and documented the rationale underlying this recommendation as "product aligns with the client's target asset allocation". There was no further explanation despite the fact that the client previously indicated a preference to invest in mutual funds and bonds.

Further, some LCs distributed Chapter 37 Bonds to clients. The SFC considers that Chapter 37 Bonds, which are meant to target professional investors, are generally unsuitable for sale to retail investors. While a few Chapter 37 Bonds may be high-quality plain vanilla bonds and reasonably liquid, many are highly complex, risky and illiquid.

The listing documents of Chapter 37 Bonds are not vetted by the Hong Kong Exchanges and Clearing Limited⁷. In distributing such complex bonds, LCs are required to demonstrate that they have performed proper product due diligence and complied with the suitability obligations. LCs should also refer to the SFC's circular issued on 31 March 2016⁸ when distributing Chapter 37 Bonds⁹.

Expected standards

Each LC should establish proper systems and controls to ensure compliance with suitability obligations. It is expected to regularly perform a holistic assessment of its suitability

⁷ LCs need to bear in mind that listing documents of Chapter 37 Bonds are not publicly available, nor are such bond products subject to detailed disclosure requirements under the Main Board Listing Rules.

⁸ Circular on Distribution of bonds listed under Chapter 37 of the Main Board Listing Rules and local unlisted private placement bonds.

⁹ In particular, LCs should not take the listing status of Chapter 37 Bonds to denote any commercial merit, a low product risk rating or high credit quality and should not represent the listing status as an endorsement of the offer or the Chapter 37 Bond during the selling process. They should draw clients' attention to the prescribed disclaimer in the listing document to assist clients to make an informed decision.



framework and adopt measures to evaluate and ensure adherence to it. The key components of the suitability framework¹⁰ include:

- (a) management supervision (eg, corporate governance structure and transaction monitoring);
- (b) know your client (eg, collecting information about clients and identifying clients who require extra care);
- (c) product due diligence (eg, new product approval and product removal);
- (d) suitability assessment (eg, consideration of clients' profiles as well as the features and risks of recommended products);
- (e) the sales process (eg, providing all relevant material information to clients and helping them make informed investment decisions, determining whether suitability obligations are triggered, properly explaining why recommendations are suitable and the nature and extent of the risks and taking into account available alternatives when providing advice to clients¹¹);
- (f) record retention (eg, retaining proper records to ensure compliance with the suitability obligations¹² and to enable the firm, its auditors and the SFC to carry out reviews or investigations); and
- (g) staff training (eg, covering internal policies and procedures and the relevant regulatory requirements governing selling practices).

The senior management of LCs, including relevant Managers-In-Charge of Core Functions, are reminded that they bear primary responsibility for ensuring appropriate standards of conduct and adherence to proper procedures. They should diligently supervise the distribution of investment products to their clients and enforce prudent policies and rigorous controls to safeguard their business operations and the interests of clients.

¹⁰ See 2016 Suitability FAQs.

¹¹ Paragraph 3.4 of the Code of Conduct

¹² In particular, as specified in 2016 Suitability FAQs, records should be maintained documenting the product due diligence work, the rationale underlying investment recommendations, information given to clients and responses to material queries raised by clients.