

Questions and answers on suitability obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities (“FAQ”)

Paragraph 5.2 of the Code of Conduct¹ sets out the obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities relating to the provision of investment advice, making of recommendations and/or solicitation (hereinafter referred to as “Investment Advisers” (“IAs”)). These FAQ set out some practical considerations that IAs should take into account when they seek to comply with the standards of conduct expected of them under the existing Code of Conduct and Internal Control Guidelines (hereinafter referred to as the “Codes”).

The statements below are general statements and IAs should consider their own circumstances and review their existing systems and practices in the light of the FAQ. Where necessary, IAs should enhance their own systems and controls to meet the standards set out in the Codes.

Owing to significant differences that exist in the nature, features and risks of investment products and the personal circumstances of investors, the FAQ are neither intended to be, nor should be construed as, an exhaustive list of all factors that IAs should consider in the conduct of their business.

IAs should note that, in addition to the requirements in the Codes, the SFC will take into account compliance with guidance in the FAQ to determine whether a licensed or registered person is fit and proper to carry out financial planning and wealth management business in Hong Kong.

Apart from the following guidance in the FAQ, IAs are urged to consider taking all necessary action in their particular circumstances to ensure compliance with the Codes. Where appropriate, IAs should seek independent legal advice before taking action on matters to which the answers may be relevant or if they have doubt about how the law applies to them.

1. What are the suitability obligations expected of IAs?

IAs should:

- a) know their clients;
- b) understand the investment products they recommend to clients (*Product due diligence*);
- c) provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom it is recommended;

¹ Paragraph 5.2 of the Code of Conduct states that:

“Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.”

- d) provide all relevant material information to clients and help them make informed investment decisions;
- e) employ competent staff and provide appropriate training; and
- f) document and retain the reasons for each product recommendation made to each client.

2. What are the “Know your client” requirements?”

There are positive obligations on IAs under the Code of Conduct to seek information from clients about their financial situation, investment experience and investment objectives. In order to better understand this client information, IAs should collect from each client information that includes their investment knowledge, investment horizon, risk tolerance (including risk of loss of capital) and capacity to make regular contributions and meet extra collateral requirements, where appropriate.

Each client’s information should be fully documented and where appropriate, updated on a continuous basis.

Even if a client does not fully disclose his personal circumstances (e.g. financial situation) to an IA, this would not stop the IA from making an assessment of the client’s attitude towards risk, his expectations and so on. If an IA is unable to make that assessment, the IA should, as a minimum, explain to the client the inherent limitations of the advice as a result of the lack of information. Furthermore, the IA should explain to the client the assumptions he made in relation to the advice given.

3. How should IAs conduct due diligence on investment products?

IAs should not recommend investment products which they do not understand. They should conduct due diligence work in selecting appropriate investment products for each client.

Due diligence involves IAs developing a thorough understanding of the structure of investment products, how they work, the nature of underlying investments, the level of risks they bear, the experience and reputation of product issuers and service providers, fees and charges, the relative performance and liquidity of investment products, lock-in periods, termination conditions, valuation and unit pricing, and safe custody arrangements.

Depending on the nature of the investment products and services provided to clients, other factors which IAs need to consider include market and industry risks, economic and political environments, regulatory restrictions and any other factors which may directly or indirectly impact on risk return profiles and growth prospects of investments.

IAs should make their own enquiries and obtain full explanations from product issuers about the risks inherent in the investment products. It is not advisable for IAs to rely on prospectuses, offering circulars or marketing materials as necessarily being self-sufficient and self-explanatory.

IAs should document verification work and enquiries which they have made about the investment products, the criteria for selecting the products and in what aspects they are considered suitable for different risk categories of investors, and the approvals they obtain from senior management for promoting the products.

Lastly, IAs should ensure that product due diligence is conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products.

4. How may IAs provide advice that is reasonably suitable for clients?

Suitability involves IAs matching the risk return profile of each recommended investment product with each client's personal circumstances. Therefore, IAs should use their professional judgement to assess diligently whether the characteristics and risk exposures of each recommended investment product (including transaction costs, effect of gearing and foreign currency risks, where appropriate) are actually suitable for the client and are in the best interests of the client, taking into account the client's investment objectives, investment horizon, risk tolerance, and financial circumstances, etc.

IAs must not take commission rebates or other benefits to be received by them or their related companies as the primary basis for recommending particular investment products to clients. Where IAs only recommend investment products which are issued by their related companies, they should disclose this limited availability of products to each client.

Lastly, IAs should exercise extra care in advising elderly or unsophisticated clients or those who may not be able to make independent investment decisions on complex investment products and rely on IAs for advice, particularly when these clients invest in investment products with long maturity periods and those which will attract hefty penalty charges upon early redemption or withdrawal.

5. How can IAs help clients make informed decisions?

IAs should provide each client with recommended investment products' prospectuses or offering circulars and other documents relevant to the investments. It is not enough for IAs to hand over these documents, ask the client to read them, or merely read the documents to the client.

IAs should help each client make informed decisions by giving the client proper explanations of why recommended investment products are suitable for the client and the nature and extent of risks the investment products bear. In addition to explaining the good points of the investment products, IAs should always present balanced views, drawing the client's attention to the disadvantages and downside risks as well. IAs should use simple and plain language, and in a language that the client can readily understand. The explanations must be fair and not misleading.

Each client should be given sufficient time to digest, consider and evaluate the information and recommendations provided by an IA and be given sufficient opportunity to raise queries with the IA. Under no circumstances should IAs use high-pressure or unfair techniques to force or entice any client to make hasty investment decisions.

6. What are the documentation standards expected of IAs?

IAs should document and provide a copy to each client of the rationale underlying investment recommendations made to the client.

To demonstrate compliance with regulatory requirements, IAs should document and record contemporaneously the information given to each client and the rationale for recommendations given to the client, including any material queries raised by the client and the responses given by the IA. In addition, IAs should keep sufficient documentation on all client transactions including orders placed to product providers.

7. Would IAs who use computer models to generate investment recommendations be subject to suitability obligations?

IAs are also subject to the suitability obligations set out in Question 1 above when they assist clients to make investment decisions by using computer models to generate investment recommendations which make reference to specific client information input into the computer.

IAs should ensure that such computer models take into account all relevant information about each client, use objective criteria to generate investment recommendations which match the client's personal circumstances against suitable investment products and operate in a manner that is not biased.

8. In terms of the nature and scope of services, what is expected of IAs in client agreements?

IAs should establish and define their relationships with each client by way of a client agreement before providing services to the client. The client agreement should define rights, obligations and responsibilities of each party and properly reflect the nature and scope of the services to be provided.

For those IAs who provide continuous services to clients, they should review each of their client agreements on a continuous basis to ensure that the nature and scope of the services they provide to each client is properly updated and recorded.

9. What is senior management of IAs expected to do?

Governing bodies of IAs (including senior management) should maintain a good corporate governance structure, with clear lines of responsibility and

authority, by which IAs' activities are properly directed, managed and controlled in order to serve the best interests of clients.

Senior management is responsible for ensuring that IAs comply with all applicable laws, rules and codes. It should review, assess and be satisfied that the IAs have adequate systems and controls to promptly identify issues and matters that may be detrimental to a client's interest (e.g. cases in which investment advice may have been given merely to meet sales targets or may be driven by financial or other incentives).

In addition, the IAs' senior management should recruit the staff who are fit and proper and have an adequate level of knowledge and skills to provide advice to clients. IAs should also provide regular and appropriate training to their staff and ensure that they keep abreast of developments in the industry.

On an ongoing basis, senior management should ensure that client files are reviewed by qualified and competent personnel. Sampled selection of client files should be risk-based and cover investments in complex investment products by elderly or unsophisticated clients or those who may not be able to make independent investment decisions concerning such investment products.

Client complaints should be promptly investigated in accordance with a properly documented procedure and appropriate remedial measures should be taken without undue delay.

The escalation policies and procedures of IAs should be such that senior management is kept informed on a timely basis of all issues and matters that may call into question compliance with applicable laws, rules and codes and protection of client interests.