

## Investment Management Alert

January 26, 2017

### Key Points

- Clarification and new guidance relating to suitability obligations under the Code of Conduct.
- Outlines the regulatory obligations of licensed or registered persons.



---

## SFC Publishes Circulars and Updates FAQs on the Triggering of, and Compliance with, Suitability Obligations

### Introduction

On 23 December 2016, the Securities and Futures Commission (“Commission” or “SFC”) published the following guidance regarding the suitability obligations of licensed or registered persons when recommending or soliciting investments:

- a circular titled “Frequently Asked Questions on Compliance with Suitability Obligations” addressing, among other things, guidance on how to conduct suitability assessments for the purpose of paragraph 5.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) (“Code of Conduct”) and how to conduct product due diligence and document investment recommendations (“Suitability FAQs”)
- a circular titled “Frequently Asked Questions on Triggering of Suitability Obligations” which provides further clarification on the circumstances in which the “suitability” obligations under paragraph 5.2 of the Code of Conduct are relevant to licensed persons (“Triggering FAQs”).

The Suitability FAQs and the Triggering FAQs are relevant to any licensed or registered person and its clients where there is a solicitation or recommendation to a client with respect to a security (including shares/units an investment product).

The issuance of the two new FAQs follows significant revisions to the professional investor regime provided for in the Code of Conduct in 2016, in particular, with respect to the marketing of securities to Category B professional investors who are high net worth investors (“HNWIs”) and entities owned by such HNWIs.

## **Product Suitability: Background and a Reminder of the Current Position**

Paragraph 5.2 of the Code of Conduct requires that a licensed person should, when making a recommendation or solicitation, ensure that the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances (“Suitability Obligation”).

The updated professional investor rules as set out in Section 15 of the Code of Conduct provide that the Suitability Obligation remains applicable to solicitations by a licensed person to:

- All Category B investors who are HNWI regardless of the perceived level of “sophistication” of that individual in investment-related matters
- those Category B corporate professional investors not meeting the assessment criteria in Paragraph 15.3A of the Code of Conduct (i.e., not meeting the requirement to be knowledgeable; having an appropriate corporate structure, investment process and controls; having sufficient investment background; and being aware of the risks in making investment decisions) or with respect to whom the relevant licensed person has not undertaken the minimum criteria in Paragraph 15.3A of the Code of Conduct i.e. provide a written explanation of the risks and consequences of being treated as a ‘professional investor’ and obtain a signed acknowledgement of the same from the investor.
- non-professional investors.

## **The Suitability FAQs**

### **Compliance with Suitability Obligation — General**

At a general level, the Suitability Obligation can be distilled to the practice of ensuring that the risk return profile of an investment product recommended to a client is matched to that client’s specific personal circumstances. This requires that a licensed corporation must, with respect to each investment product recommended to a client:

- know its client
- understand the nature of the investment product being recommended (including transaction costs, effect of gearing and foreign currency risks, where appropriate)
- on the basis of the information known about the client, and the information known about the investment product, assess whether the characteristics and risk exposures of the recommended investment product are actually suitable for the client and are in the best interests of the client, taking into account, among other things, the client’s investment objectives, investment horizon, investment knowledge and experience, risk tolerance and financial situation.

## **1. Knowing Your Client**

### **Background**

The Suitability FAQs restate the requirement in Paragraph 5.1 of the Code of Conduct that a licensed corporation take “all reasonable steps to establish the true and full identity of each of its clients, and of

each client's financial situation, investment experience, and investment objectives.” Examples of the type of information available for collection include information regarding:

- annual income, liquid assets or net worth in order to assess the client's financial situation
- the types of investment products in which the client has invested and the period over which investment in such products has occurred in order to assess the client's investment experience
- the purposes of investment, such as income generation or capital preservation, in order to assess the client's investment objectives.

A licensed corporation can discharge this requirement by making a reasonable effort to obtain information from clients. The licensed corporation may then rely on the information provided by the client, unless it is aware (or should reasonably be aware) that such information is inaccurate or out of date.

### **Investment Approach**

In addition to understanding a client's financial status, a licensed corporation is also required to assess each client's investment knowledge, investment horizon, risk tolerance (including risk of loss of capital), and capacity to make regular contributions and meet extra collateral requirements. These considerations enable a licensed corporation to gauge whether a particular investment product is indeed suitable for that client.

This type of “risk assessment” information may be gathered in several ways, including by making a record of a verbal discussion with the client or by having the client complete a written risk-scoring questionnaire.

### **Record Keeping**

The Suitability FAQs recommend that a licensed corporation properly document (and keep updated) each client's information. In practice, this means maintaining clear records of all client-related information and correspondence between the licensed corporation and the client, together with the licensed corporation's internal assessment of the client, and ensuring that this information is periodically reviewed and refreshed where it is deemed to be out of date.

## **2. Product Suitability**

The suitability requirement also requires that a licensed corporation understand the nature of the investment product being recommended.

A licensed corporation is required to conduct its own product due diligence and arrive at its own assessment of a product by taking into account all relevant information that is appropriate and reasonably available for a fair and balanced assessment before selecting appropriate investment products for a client.

The product due diligence exercise is recommended to be conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products. Particular emphasis is placed on the licensed corporation “understanding” the investment product – the

Commission's position being that if a licensed corporation does not understand the nature of an investment product, then it cannot be in a position to recommend the suitability of that investment product to a client.

In addition to understanding the nature and extent of risks of the investment products, the product due diligence process should also take into consideration market and industry risks, economic and political environments, regulatory restrictions and any other factors that may directly or indirectly have an impact on risk return profiles and growth prospects of the relevant investments, depending on the nature of the investment products.

The Commission also provided specific guidance regarding a licensed person's obligation to understand exchange-traded funds ("ETF") investment products. Licensed persons should ensure that they have appropriate procedures in place to solicit investors with respect to ETFs.

### **3. Making Recommendations as to Suitability**

A licensed corporation that has established a proper understanding of (i) its client and its client's financial position, financial aspiration(s) and tolerance to risk. And (ii) the suitability of the investment product under consideration is considered to be in a position to match the risk return profile of an investment product with a client's personal circumstances.

In assessing suitability, a licensed corporation is required to exercise, in a diligent manner, its professional judgment as to whether the particular characteristics and risk exposures of an investment product are actually suitable for the client and are in the best interests of the client, taking into account all relevant factors applicable to that client.

The Commission indicated that adopting a protocol of simply matching a client's risk tolerance to a product's risk rating is considered to be insufficient to discharge the assessment requirement.

The Commission also provided the following guidance regarding the suitability of recommendations:

- Where a recommendation is made as to suitability, the licensed corporation should also consider the overall effect of the investment product on the client's portfolio.
- Where a licensed person (or one of its related companies) will receive a commission, rebate or other benefit from the investment product being recommended, this should not form the primary basis for the licensed corporation recommending a particular investment product to the client.
- Where a licensed corporation recommends only investment products that are issued by its related companies (such as a fund manager recommending an investment fund that it manages), the licensed corporation should disclose this limited availability of products to each client.

### **Documenting the Suitability Analysis**

For each client, a licensed person should maintain clear records documenting the rationale underlying each investment recommendation made to that client. This record must be provided to the client upon request.

To demonstrate compliance with the Suitability Obligation, the licensed person must document and record (contemporaneously) information given to each client (including any material queries raised by the client and the responses given). The requirement to document the client interactions may be discharged either through written records or through audio records.

In terms of retaining details of the suitability analysis, with respect to non-exchange-traded products, such records should be retained for at least seven years. For recommendations regarding exchange-traded products, such records should be retained for at least two years.

### **Assisting Clients in Making an Informed Decision**

Licensed corporations should assist their clients in making informed investment decisions by providing a proper explanation of:

- the reason(s) that a recommended investment product is suitable for a client
- the nature and extent of the risks that a recommended investment product bears.

In doing so, the licensed corporation should present the client with a balanced view of the investment product, including explaining the advantages and disadvantages of the recommended investment.

Each client should be afforded sufficient time to (i) digest the information provided and (ii) raise queries regarding the investment product.

A licensed corporation should ensure that written materials are presented using simple and plain language, and are presented in a language that the investor can readily understand. Asset Managers marketing to HNWI's based in China must therefore consider whether it is necessary to provide a Chinese translation of marketing materials. All written materials are required to be "fair" and "not misleading."

### **Specific Requirements for Senior Management Personnel**

The Suitability FAQs also clarify the position regarding requirements imposed on the senior management personnel of a licensed corporation.

The senior management personnel of a licensed corporation are required to maintain a good corporate governance structure, with clear lines of responsibility and authority, pursuant to which sales activities are properly directed, managed and controlled in order to serve the best interests of clients.

Among other requirements, the senior management personnel of a licensed corporation are required to:

- review, assess and be satisfied that the licensed corporation has implemented adequate systems and controls in order to promptly identify matters that may be detrimental to a client's interest (e.g., cases in which investment recommendations may have been made merely to meet sales targets)
- ensure that transactions and related documents are reviewed by qualified and competent personnel on an ongoing basis.

## The Triggering FAQs

### Guidance on when the Suitability Obligation is Triggered

The Commission recognizes that investment product solicitations cover a wide range of client interactions, including face-to-face communication, phone conversations and electronic communications with clients, or a combination of any such formats.

Accordingly, the Triggering FAQs provide guidance on whether the Suitability Obligation applies to a particular client interaction.

Whether a communication regarding an investment product between a licensed corporation and a client triggers the Suitability Obligation will depend on whether there is a "solicitation" or a "recommendation," having regard to the facts and circumstances of each interaction.

The Triggering FAQs provide that, among others, the following facts and circumstances should be taken into account when evaluating whether the Suitability Obligation is applicable to a particular client interaction:

- the content and context of the communication with a client
- whether the communication is delivered to targeted clients
- the series of actions taken (e.g., whether the communication forms part of a multiple-step solicitation or recommendation process and hence triggers the suitability obligations).

### Interactive Communications Likely to Trigger the Suitability Obligation

The Commission has provided an indicative (non-exhaustive) list of scenarios illustrating the circumstances in which the Suitability Obligation would be considered **likely** to be triggered during interactive communications. These include (but are not limited to):

- discussing with a client or a selected group of clients the merits of a particular investment product or a portfolio of investment products, and presenting the investment product or portfolio implicitly or explicitly as suitable for the client(s)
- after provision of factual information about a listed company to a client, following up with a call to the client and recommending that the client buy or sell that stock

- having any communication that may be perceived to be based on consideration of the circumstances of the client (e.g., risk appetite) to invest in a particular investment product
- during any fundraising activity of a listed company or listing applicant, calling a client and recommending that the client buy the company's stock
- shortlisting investment products based on the circumstances of a client (e.g., risk appetite) and providing factual information about the shortlisted investment products to the client
- having regard to the personal circumstances of a client, finding or structuring an investment product based on parameters or specifications provided by the client.

### **Interactive Communications Unlikely to Trigger the Suitability Obligation**

The Commission provided an indicative (non-exhaustive) list of scenarios illustrating the circumstances in which the Suitability Obligation would be considered **unlikely** to be triggered during interactive communications. These include (but are not limited to):

- provision of factual information about specific fund(s) or bond(s) at a client's request (e.g., prospectuses, fact sheets, annual reports and price quotations for the products), without any prior communication or any accompanying message that seeks to solicit or recommend that the client trade in the specific fund(s) or bond(s)
- discussion with a client on the merits of investing in certain geographical areas or asset classes only
- execution of an order from a client only without any other communication that seeks to solicit or recommend that the client trade in a particular listed stock
- discussion with a client on overall market environment, industry, sector trends, or "general financial and investment information." General financial and investment information includes basic investment concepts, such as risk and return of an asset class and differences in returns of asset classes (bonds, equities).

### **Discretionary Account Services**

The Commission confirmed that the Suitability Obligation applies to a licensed corporation providing discretionary account services (including making, as well as executing recommendations).

The Commission suggested that where a licensed corporation provides discretionary account services to a client (either in accordance with an agreed mandate or a predefined model investment portfolio), the Suitability Obligation could be further discharged as follows:

- Conduct client due diligence to ensure that the mandate or predefined model investment portfolio established or chosen by the client is suitable for that particular client. The licensed corporation should document its suitability assessment and provide a copy of the rationale to the client in writing.
- Transactions effected on behalf of the client should be conducted in accordance with the agreed mandate or predefined model investment portfolio.

- Where, after a mandate or predefined model investment portfolio is agreed, and during the course of the investment management relationship, the client raises any material queries about specific products in the portfolio or about the portfolio's composition, the licensed corporation should document such queries and responses.
- The licensed corporation should review the mandate or predefined model investment portfolio on a regular basis (e.g., on an annual basis or where there have been significant market movements), having regard to the client's latest circumstances and, where appropriate, recommend revisions to the mandate or predefined model investment portfolio and agree them with the client. The licensed corporation should also document the rationale for such recommendations and provide a copy of the rationale to the client in writing.

The Commission further clarified that it would not be mandatory for a licensed corporation providing discretionary account services to a client to provide a prospectus (or other product information) to the client for each and every investment decision made on behalf of the client.

That said, where a licensed corporation provides discretionary account services to a client as an ancillary part of its brokerage services for that client, and the discretionary account services are provided without any agreed mandate between the parties, the licensed corporation must comply with the documentation requirements set out in the Suitability FAQs (as outlined above).

### **Client Agreements — Minimum Requirements**

Where a client agreement is required (for all clients except "Institutional Professional Investors" and Category B corporate investors which have met the requirements under the Code of Conduct) licensed or registered persons are expected to ensure that, before providing services to a client, the relationship with the client is clearly presented in the form of a client agreement, setting out the rights, obligations and responsibilities of each party and properly reflecting the nature and scope of the services to be provided to the client.

Where services are provided to a client on a continuing basis, the SFC expects that a licensed person will review client agreements on an ongoing basis in order to ensure that the nature and scope of the services being provided to a client are properly updated and recorded in the client agreement.

The full text of the circulars can be accessed via the link below:

<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC73>

<http://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=16EC71>



**Contact Information**

If you have any questions regarding this alert, please contact the Akin Gump lawyer with whom you usually work or:

**Anne-Marie Godfrey**

[anne-marie.godfrey@akingump.com](mailto:anne-marie.godfrey@akingump.com)

+852 3694.3040

Hong Kong