Concurrent SFC-HKMA thematic review on distribution of non-exchange traded investment products

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Introduction

In October 2021, the Securities and Futures Commission ("SFC") and the Hong Kong Monetary Authority ("HKMA") released the findings from the first joint survey of the sale of non-exchange traded investment products by licensed corporations ("LC") and registered institutions ("RI").

The SFC and HKMA have been closely coordinating their supervision to address areas of common concern. In March 2022, the regulators announced that they will commence a concurrent thematic review of such product distribution, which will cover selected firms' policies, procedures, systems and controls, as well as management oversight of the distribution of popular products such as equity-linked structured products and corporate bonds. The objectives of this review are to assess the firms' compliance with the suitability requirements of the regulators, including their practices for performing product due diligence, conducting suitability assessments and disclosing information to clients.

This publication summarises the key elements of the concurrent thematic review, highlights the specific risks and suitability obligations for certain type of high-risk products, and outlines how our financial advisory service offerings can assist you in preparing for the thematic review.

Proposed thematic review

1. Proposed product scope

This thematic review will focus on non-exchange traded investments products. As noted from the latest SFC-HKMA joint product survey released in October 2021, the predominant non-exchange traded investment product type sold by respondent intermediaries are:

a. Structured products,

b. Collective Investment Schemes ("CIS"), and

c. Debt securities.

Among these 3 product types, the more commonly traded investment products are set out below:

	Structured products	CIS	Debt securities
1.	Other equity-linked	Money market funds	Non-investment grade corporate bonds
2.	Equity accumulators/ decumulators	Bond funds	Sovereign bonds
3.	Commodity-linked	Equity funds	Investment grade corporate bonds
4.	Other currency-linked	Balanced funds	Unrated corporate bonds
5.	Currency accumulators/ decumulators	Private equity funds	Others

2. Proposed review scope

Given that the review's objectives are to assess firms' compliance with the suitability requirements under the Code of Conduct, the review scope will generally fall under the following areas:

Requirements for specific types of bonds

A. Generic risks of bonds

In general, intermediaries should be aware that the holders of bonds, including plain-vanilla bonds, are subject to various types of risks, for example:

Credit risk

Issuer may default on its obligations, and the credit ratings assigned by credit rating agencies do not guarantee its credit worthiness

Liquidity risk

Some bonds may not have active secondary markets, so it would be difficult or impossible for investors to sell it before its maturity

Interest rate risk

More susceptible to fluctuations in interest rates and the prices of bonds will generally fall when interest rates rise

B. General suitability obligations

- Should not market or treat all bonds as risk-free products that are suitable for all investors
- Should not simply assign a lower risk rating to all fixed income products
- Perform review of product risk ratings at appropriate intervals, since factors affecting product risk may change over time, such as a product's or issuer's credit rating

C. Three specific types of high-risk bonds

Type 1: High-Yield Bonds ("HY Bonds")

1A. Specific risks for HY Bonds

HY Bonds are typically rated below investment grade or are unrated, so they are generally of higher risk than investment-graded bonds. In addition to the generic risks listed above, investments in HY Bonds are subject to the following risks:

Higher credit risks

Below investment grade or unrated may incur higher risk of issuer default

Vulnerability to economic cycles

During economic downturns their values typically fall more than that of investment-graded bonds because investors become more risk averse and default risk rises

1B. Specific suitability obligations for HY Bonds

Product Due Diligence	▪ Understand the important aspects of HY Bonds, should not only refer to the credit rating and the pricing spread quoted ▪ Adopt a **prudent approach** in assigning product risk ratings (generally higher than those funds primarily invest in investment-graded bonds) ▪ Could assign a **slightly lower** product risk rating with **proper risk mitigation strategies** such as having sufficient diversification through proper geographical, sector and company selection ▪ Take into account the factors including **asset class, special features** and **risks** in the product risk classification methodology
Suitability Assessment	▪ Ensure suitability by matching the risk return profile of the recommended products with the client's personal circumstances ▪ Give due consideration to all relevant circumstances specific to a client, including **concentration risk** and **risk tolerance level**
Selling Process	▪ Provide clients with prospectuses or offering circulars relevant to the investments. The information should be **accurate** and able to explain the **key features, disadvantages and downside risks** ▪ Present balanced views and not solely focus on advantageous terms such as high yields
Disclosure	▪ Disclose the **trading profit from a back-to-back transaction** to the client prior to or at the point of entering into the transaction
Governance & Management Supervision	▪ Senior management to put in place adequate supervisory controls to ensure compliance with all relevant regulatory requirements, such as **ongoing post-trade suitability review**
Staff Training	▪ Provide regular **product training to sales staff** to equip them with sufficient knowledge and skills

Type 2: Debt instruments with loss-absorption features

2A. Specific risks for debt instruments with loss-absorption features

Intermediaries are reminded to be vigilant in selling debt instruments that may be converted to common equity or written down on the occurrence of a trigger event, in particular loss-absorbing capacity debt instruments that would absorb loss when the issuer is likely to reach or has reached the point of non-viability, and when the capital ratio of a financial institution falls to a specified level.

Such products are inherently complex, high risk, so they should be only sold to professional investors ("PI"). Institutional PIs are exempted from below enhanced investor protection measures, Corporate PIs could be entitled the same exemptions, provided that intermediaries have complied with paragraphs 15.3A and 15.3B of the Code of Conduct.

2B. Specific suitability obligations for debt instruments with loss-absorption features

Know Your Client	▪ Establish the true and full identity of each of its client's financial situation, investment experience and product knowledge to ensure they fulfill the set of criteria for PI
Product Due Diligence	▪ Treat **non-leveraged** investment as of **at least high risk** ▪ Treat **leveraged** investment (i.e. transactions conducted by a client on a margin basis) as of **the highest risk** ▪ Should not assign risk rating solely based on credit ratings assigned by credit rating agencies

2B. Specific suitability obligations for debt instruments with loss-absorption features (Cont'd)

Suitability Assessment	▪ Ensure clients have adequate knowledge or experience in products with **contingent write-down or contingent convertible features** ▪ Ensure the transaction is suitable for customers in all the circumstances, irrespective of whether there is any solicitation or recommendation to the customer ▪ Should not merely conduct mechanical matching of a product's risk rating with a client's risk tolerance level ▪ Give due consideration to all relevant circumstances specific to the client, including **concentration risk** ▪ Should not allow transactions involving a risk mismatch, justify strongly for any exceptions
Disclosure	▪ Direct a potential customer to any selling restrictions and key warning statements in the offering and product documents ▪ Explain relevant information and warnings, such as key product nature, features and risks ▪ Provide sufficient relevant information, in particular: i. it is subject to the risk of being written down or converted to ordinary shares ii. the circumstances that the contingent write-down or conversion may happen, and the implications to investors (i.e. potential substantial loss) iii. it is a high-risk product iv. it is a complex product, as the circumstances in which these bonds may be required to bear loss are difficult to predict and ex ante assessments of the quantum of loss will also be highly uncertain v. it is targeted at PIs only and is unsuitable for retail investors vi. credit ranking and implications to investors

Type 3: Chapter 37 Bonds

3A. Specific risks for Chapter 37 Bonds

Chapter 37 Bonds are bonds that offered for subscription and listed under Chapter 37 of the Main Board Listing Rules of the HKEX. They contain complex features and / or inherent risks including lack of a secondary market which results in them being highly illiquid, so intermediaries should target at professional investors only.

3B. Specific suitability obligations for Chapter 37 Bonds

Know Your Client	▪ Establish the true and full identity of each of its client's financial situation, investment experience and product knowledge to ensure they fulfill the set of criteria for PI
Product Due Diligence	▪ Conduct proper PDD to understand the complex features and risks, and properly communicate them to sales staff ▪ Should not take the listing status to denote any commercial merit, a low product risk rating or high credit quality ▪ In the product documentation provided to clients, intermediaries should correctly state the issuers of the Bonds, contain accurate information regarding its assigned **internal risk rating,** and give a balanced view of its **potential upside versus the downside investment and credit risks**
Suitability Assessment	▪ Ensure the risk return profile of recommended bond matches with the client's financial situation, investment objectives, investment experience, risk tolerance, etc.
Selling Process	▪ Present balanced views and **not solely focus on advantageous terms such as high coupon rates or yields** ▪ Draw clients' attention to the **prescribed disclaimer statement** in the listing document to assist them make an informed decision ▪ Should not represent the listing status as an endorsement of the offer or the Chapter 37 Bonds
Disclosure	▪ Disclose the risks to clients such as **illiquidity and the lack of availability of secondary market**
Documentation & Record Keeping	▪ Ensure clients **sign declarations or acknowledgements** which are **consistent** with the Code of Conduct obligations and/or which describe the actual services

Requirements for specific types of structured products

A. General suitability obligations for structured products

Intermediaries are reminded that they should not treat all structured products as plain vanilla and assign them the same low risk rating. They should instead conduct 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. Specific risks for accumulators

Accumulators are derivative products associated with significant investment risks. Investors are bound by contract to take up units of the underlying assets at the strike price when the market acts against them, crystallising losses. This downside risk is magnified when a "multiplier" condition is included.

Generally, intermediaries should only sell accumulators to professional investors, extreme caution should be exercised in handing enquiries from non-PI customers.

C. Specific suitability obligations for accumulators

Know Your Client	▪ Ensure that clients fulfill the set of criteria for PI, and should not recommend them to borrow money / securities or draw credit facility for the purpose of satisfying the PI portfolio threshold ▪ Ensure that accumulators are only sold to customers who have the i. investment experience in structured investment products or writing options ii. understanding about the product structure and risks iii. risk appetite for acquiring the underlying assets with leverage iv. ability to withstand the potential financial loss
Product Due Diligence	▪ Assign **the highest risk rating** to accumulators

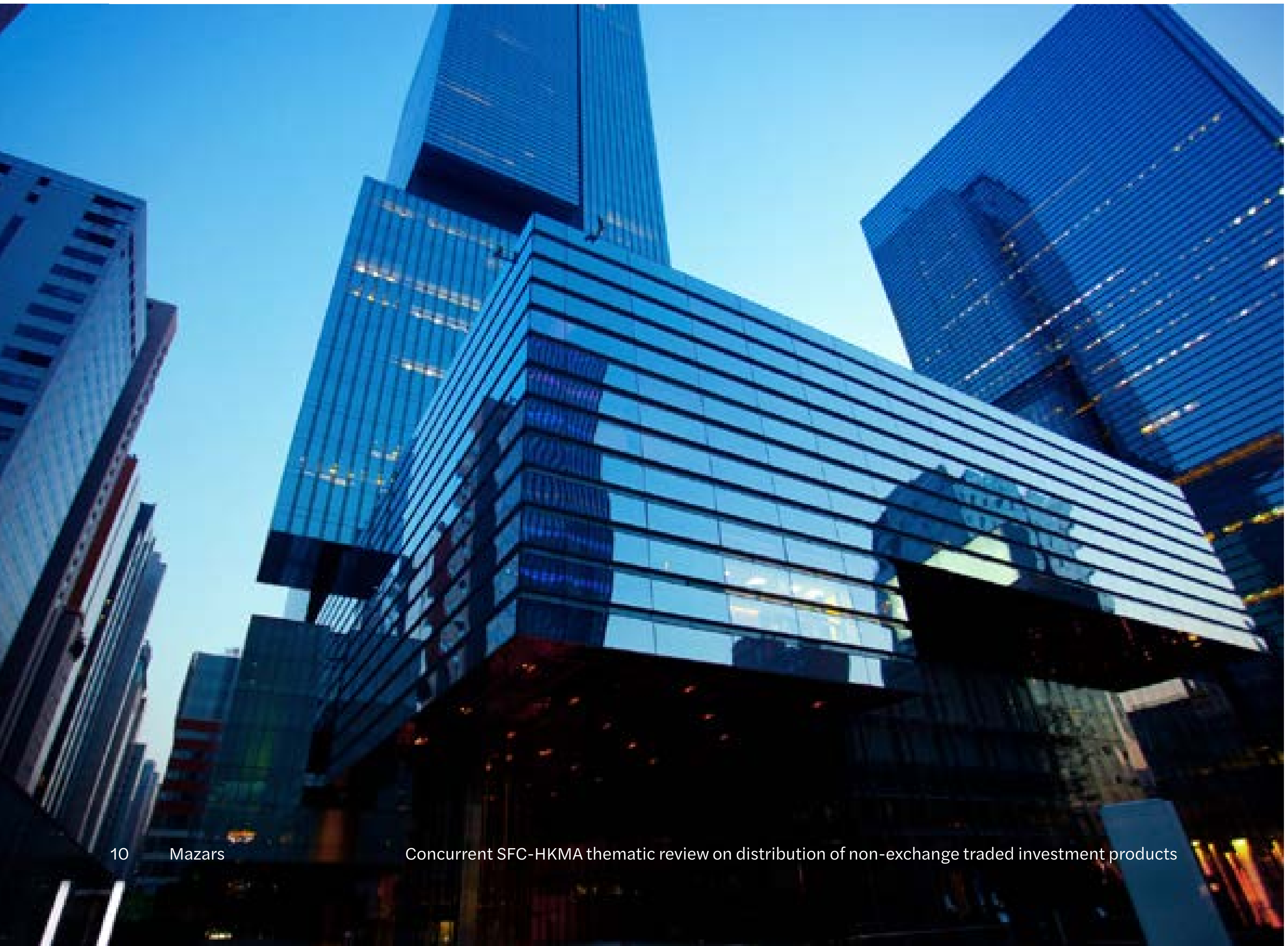
C. Specific suitability obligations for accumulators (Cont'd)

Suitability Assessment	▪ Ensure that the **potential financial impact** on the client, particularly in adverse market conditions, is fully taken into account ▪ Assess the customers' **concentration risks** ▪ Assess the following in selling **foreign exchange ("FX") accumulators:** i. the customer's hedging need ii. the customer's concentration risks iii. anticipated cash outflow iv. other exposure to the currency to be hedged v. the appropriate tenor and maximum exposure of the customer to the accumulator contracts for hedging purpose ▪ **Justify strongly for risk-mismatch transactions,** and to be reviewed by a senior officer and / or an independent internal control unit
Selling Process	▪ Should not make solicitation or recommendation of accumulator contracts to customers who already have high concentration in accumulator contracts or in the specific underlying asset ▪ Provide customers with reasonable alternative investment products with lower risks and / or less complex structure for addressing their investment needs ▪ When a client has insufficient knowledge of derivatives wishes to purchase accumulators, he / she should be warned about the transaction, and provided with appropriate advice on suitability
Disclosure	▪ Disclose and explain material information to clients, particularly the **worst-case scenario, margin requirements and credit facility** ▪ Disclose the key features and risks of accumulators, in addition to market risk of the underlying assets and counterparty risk of the contract counterparty, such as: i. <u>Potential profit is capped by the knock-out feature:</u> Accumulator contracts that have a knock-out clause will terminate when the market price of the underlying asset is at or above the knock-out price ii. <u>Potential losses are magnified and can be very substantial:</u> Under "multiplier" conditions, the clients will be required to take up multiple times of the agreed amount of the underlying asset when the market turns against them iii. <u>Contract tenor:</u> Be aware that longer tenor will be associated with higher risks and usually higher costs of early termination iv. <u>Additional risks associated with margin trading or use of credit facility:</u> Investors may need to pay interest cost for the margin / credit facility and meet margin calls which require them to make top-up payment to cover the full marked-to-market losses for the remaining contract period. If they fail to meet margin calls, the contracts may be closed out without their consent v. <u>FX accumulator contracts for hedging purpose:</u> Establish whether the accumulator is indeed a suitable instrument to serve clients' hedging purpose and whether their maximum exposure is appropriate
Documentation & Record Keeping	▪ **Record the rationale** for investing in accumulators instead of suitable alternative products with lower risk and / or less complex structure ▪ Obtain the client's **acknowledgement (audio or written)** of such investment rationale and maintain proper audit trail

How can Mazars help?

At Mazars, we have extensive experience working with the diversity of financial services players. We assist major financial institutions including brokerage houses, asset managers, investment and corporate banks, retail and private banks, central banks, insurance companies and regulators in dealing with business and regulatory issues with impacts, domestic and international.

Mazars is here to assist you in complying with the regulatory standards and requirements to prepare for the SFC-HKMA concurrent thematic review. Depending on the scope, coverage and specifics of your needs, our services would typically involve one or more of the following:



How can Mazars help?

A. Regulatory health-checks and reviews	
I.	Review your firm's current practices with respect to policies and procedures on non-exchange traded investment products, including ▪ know your client & customer risk profiling ▪ product due diligence & product design ▪ suitability assessment ▪ selling process & disclosure ▪ governance & management supervision ▪ compliance monitoring ▪ staff training; and ▪ documentation & record keeping.
II.	Provide observations and recommendations to assist you in developing or enhancing your investor protection measures.
III.	Review related documentation and records to ensure compliance.
B. Provide pre-review advice	
I.	Advise on the process of a thematic review and how to handle the enquiries and requests from the review team, including requests for information and documents about specific transactions or clients.
II.	Advise on the preparation for the upcoming review, managing communications with the regulators, and providing regulatory advice before, during and after the review.
III.	Assist your firm to understand the regulator's concerns underlying specific enquiries or requests for information, manage the flow of information to be provided to the review team to address any concerns before they become the subject of the regulator's findings, and to anticipate and / or mitigate risks of any further investigation or disciplinary action by the regulators.
IV.	Assist your firm to identify potential breaches of regulatory requirements or deviations from the regulator's expectations, prior to the regulatory review.
V.	Advise on current enforcement trends and disciplinary actions.
C. Perform mock review	
I.	Perform mock reviews and provide recommendations on the relevant controls, policies, and procedures to assess whether they comply with the relevant regulatory requirements promulgated by the SFC / HKMA. The procedures will normally include: ▪ mock interviews / discussions with management and staff members of the firm to understand the relevant business activities and workflows, ▪ review of the relevant written policy and procedure documentation which exists within the firm, ▪ walkthrough of the key processes and controls relevant to the regulatory inspection to assess the design effectiveness of the relevant internal control procedures, and ▪ testing of sampled transactions covering the key processes and controls to assess the operating effectiveness of the relevant internal control procedures.
D. Training and insights	
I.	Provide training and education for staff, the board and senior management on the suitability requirements of non-exchange traded investment products.
II.	Provide ongoing insights into how peer firms are dealing with the regulatory changes and any common challenges encountered along the way.

We also take on special projects and ad-hoc mandates. We are flexible in our approach and offerings. Please feel free to contact us with any enquiries.

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