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Client Alert
News Flash

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Hong Kong Regulators Remind Intermediaries of Selling Practice Requirements for Complex Bonds and High-Yield Bonds

Intermediaries need to review and enhance their policies and procedures to address any issues relevant to their institutions.

On 25 March 2014, the Securities and Futures Commission (SFC) issued a circular (Circular) to remind SFC-licensed corporations of their obligations when selling complex bonds and high-yield bonds. On 19 November 2012, the SFC issued a circular on fixed income products that highlighted the key risks associated with complex and high-yield bonds and the obligations of distributors. The more recent Circular serves as more detailed guidance to licensed corporations with respect to selling practice requirements for these products. The Hong Kong Monetary Authority (HKMA) issued a separate circular on the same day to all registered institutions drawing their attention to the issues and guidance in the SFC's Circular.

Background

The rising popularity of complex and high-yield bonds in recent years, driven by investors' search for yield, has given rise to regulatory concerns about the additional risks these products carry. The SFC and the HKMA have issued various circulars to intermediaries emphasizing the product risks and the regulatory requirements for selling these bonds.

Selling Practice Requirements

During recent on-site inspections, the SFC has identified deficiencies in the selling practices of licensed corporations when distributing complex and high-yield bonds. The detailed issues and guidance are set out in an appendix to the Circular. In brief, the SFC reminds licensed corporations of the following obligations:

Product due diligence

Licensed corporations should conduct proper product due diligence to ensure that they have a thorough understanding of the attributes and associated risks of the bonds. In particular, licensed corporations are expected to review the product offering memorandum. Reliance on information available from Bloomberg and mere assessment of credit risk and liquidity risk with reference to credit rating and pricing spread quoted may not be adequate.

Sufficient explanation to clients

Licensed corporations should explain the key features and risks of the bonds and provide relevant and material information to the client. Adequate procedures should be in place to ensure that specific key product information is properly communicated to the sales persons of licensed corporations, who in turn will be able to adequately disclose product information to clients. Under the guidance issued by the SFC in May 2007 ("Questions and answers on suitability obligations of licensed and registered persons who are engaged in financial planning and wealth management business activities") (Suitability FQA), licensed corporations should provide clients with prospectuses, offering circulars and other documents relevant to the investments.

Proper suitability assessment

Licensed corporations should implement a proper suitability assessment process to ensure that recommended bonds are reasonably suitable to the client in all circumstances. The SFC notes that, as a part of the suitability assessment, many licensed corporations use product risk classification to match the product risk to a client's risk tolerance level. Therefore licensed corporations must ensure they take into account relevant factors in their product risk classification methodology. These factors include the asset class, product features (e.g. special features) and risks (e.g. additional risks associated with the special features).

The SFC reminds licensed corporations to give due consideration to all relevant circumstances specific to a client, including concentration risk and risk tolerance, when assessing the suitability of a product to the client. In this regard, licensed corporations should ensure that (i) sales persons are provided with guidelines to assess the concentration risk and (ii) the scoring methodology in a risk profiling questionnaire for classifying the client's risk profile is correct.

Disclosure for back-to-back transactions

If licensed corporations transact bonds for clients as principal in back-to-back transactions, the licensed corporation must disclose the trading profit made from such transactions in accordance with the pre-sale disclosure requirements under the Code of Conduct for Persons Licensed by or Registered with the SFC. Licensed corporations are also required to, where appropriate, disclose the capacity in which they are acting in such transactions (as principal or as agent).

Supervisory controls

Licensed corporations should put in place adequate supervisory controls, including post-trade suitability review and training, to ensure compliance with all relevant regulatory requirements.

Under the Suitability FAQ, intermediaries are required to ensure that client files are reviewed by qualified and competent personnel on an ongoing basis. The review should include complex and high-yield bond transactions. In addition, providing product training to sales staff is essential to equip them with an adequate level of knowledge and skills to provide advice to clients on complex and high-yield bonds.

Conclusions

Licensed corporations and registered institutions are expected to pay due regard to the issues and guidance set out in the Circular and review and enhance their policies, procedures and controls to address any issues that are relevant to their institutions.

The SFC will take appropriate regulatory action against licensed corporations who breach the selling practice requirements and the SFC will continue to use a range of supervisory tools to monitor compliance, such as inspections and mystery shopping programmes. The HKMA will continue to monitor the compliance with regulatory requirements by registered institutions in its supervisory process.

Copies of the SFC and HKMA circulars can be downloaded via the links below:

http://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openFile?refNo=14EC18 (the SFC circular)

http://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/openAppendix?refNo=14EC18&appendix=0 (appendix to the SFC circular)

http://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2014/20140325e1.pdf (the HKMA circular)

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