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Client Alert – Mega Securities Enforcement Action (May 2020)

On 8 May 2020, the SFC released a circular detailing the disciplinary action taken following its investigation into Mega International Bank Co., Ltd. ("MICBC") after the matter was referred to the SFC by the HKMA for failing to implement adequate and effective controls and systems in relation to the sale of collective investment schemes.

Policy Failures

MICBC failed to implement effective customer due diligence procedures in relation to the sale of CIS's between August 2014 and July 2015. As it is an offence under section 107 of the SFO to fraudulently or recklessly induce others to invest money, the SFC's investigation found MICBC failed to:

- properly assess its clients' investment objective, risk tolerance level and knowledge of derivatives;
- ensure investment recommendations and/or solicitations made to its clients were reasonably suitable in all the circumstances;
- conduct adequate product due diligence on certain funds;
- ensure all relevant factors were properly taken into account before assigning the funds risk ratings; and
- identify funds which constituted derivative products.

Client Risk Profiling

MICBC had implemented a customer risk profiling questionnaire ("CRPQ") which its salespersons used to assess clients' risk tolerance level. The CRPQ consisted of two sections:-

A general information section about investment objectives, investment experience, annual income, and net worth. No scores were assigned to this section.

A second section with 8 scoring questions for determining the clients' risk tolerance level. Clients were classified into 1 out of 4 risk tolerance levels (i.e. "Conservative", "Balanced", "Balanced Growth", and "Aggressive Growth") based on the total score attained by them in this section.

The SFC concluded that for the following reasons the design of the CRPQ was deficient:

- Client information such as investment experience under the first section of the CRPQ did not carry any scores.
- There was no audit trail to show that such information was taken into account by the salespersons during the client risk profiling exercise or the sales process of each CIS transaction.
- Corporate clients were not required to answer the scoring questions under the second section of the CRPQ but could select their own risk tolerance level in the CRPQ.
- MICBC did not have any systems and controls to identify conflicting answers in the CRPQ. Clients were allowed to select multiple investment objectives under the first section which might be conflicting with each other.
- In some cases clients had selected an investment objective that conflicted with their answers provided under the second section of the CRPQ.

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Further in other cases, the risk tolerance level assigned to the clients was inconsistent with the clients' investment objective.

Failure to Assess Clients' Knowledge of Derivatives

Clients were required to complete a Derivatives Experience Profiling Form during the KYC process. The Derivatives Form contained questions from the SFC's Code of Conduct asking the clients to confirm whether they had: (a) executed 5 or more transactions in any derivative products in the past 3 years; (b) undergone training or attended courses on derivative products; (c) work experience related to derivative products; and/or (d) carried out activities related to derivatives as a licensed person.

Clients were deemed to have sufficient knowledge in derivatives simply if their answer to any of the above questions was yes and MICBC did not require its staff to make enquiry or gather relevant information about the clients' knowledge of derivatives. This is in breach of the requirement set out in the FAQs issued by the SFC on 3 June 2011.

Suitability Assessment Procedures

MICBC had implemented the following procedures for suitability assessment:

1. Salespersons were required to match a client's risk tolerance level with the product's risk rating to determine whether there was a risk mismatch. In the event of a risk mismatch, salespersons were required to inform the client of the mismatch and warn the client of the relevant investment risk. The client was required to sign an Investment Risk Acknowledgement Form to acknowledge the risk mismatch and provide reasons for entering into the risk mismatch trade. The trading documents would be passed to the Head of Wealth Management for approval after the back office had confirmed the transaction with the client over a tape-recorded call.

2. From 1 October 2014, salespersons were further required to perform the following assessments and document the results in a product checklist:-

    - whether the client was a vulnerable customer;
    - any tenor mismatch, i.e. a mismatch between the product tenor and the client's investment horizon;
    - whether the transaction would give rise to an investment objective mismatch, i.e. a client with an investment objective of "capital preservation" placing an instruction to invest in investment funds, or a client with an investment objective of "income" placing an instruction to invest in equity funds; and
    - whether the client's total investment in the same type of product equalled to or exceeded 50% of the client's net worth or asset under MICBC's management, whichever is higher which would then be considered an over-concentrated transactions.

3. Salespersons were required to document their rationale for recommending the product to the client.

The SFC found the following deficiencies in the procedures:-

- The post October 2014 assessments were not applied to fund switching transactions and subscriptions for regular savings funds.

- MICBC did not require salespersons to document the rationale underlying their investment recommendations made to the clients in respect of fund switching transactions.
- The concentration assessment was performed only when the client indicated in the CRPQ that his/her investment amount accounted for 35% or more of his/her total assets.
- Among a total of 523 fund transactions conducted between October 2014 and July 2015, there were 233 over-concentrated transactions.
- The product checklist was not completed for 156 over-concentrated transactions involving fund switching or regular savings plans.
- For the remaining 77 over-concentrated transactions where a checklist had been completed, 55% were not identified as an over-concentrated transaction in the checklist.
- Funds which could be redeemed freely at any time by the clients' requests were considered by MICBC to be suitable for any investment horizon.
- Although the investment objective of certain funds was stated in the product fact sheets to be "long term capital growth", they were sold to clients who had selected the shortest period (i.e. less than 3 years) as their investment horizon in the CRPQ.
- There is no record to show that the salespersons had considered the funds' investment objective in performing the suitability assessment and documented the reasons as to why such funds were considered to be suitable for the clients having regard to the clients' investment horizon.
- There was no guideline on the handling and approval of transactions with multiple mismatches/exceptions in different aspects, including the clients' risk tolerance level, investment objective, investment horizon and/or asset concentration level.
- The executive officer of MICBC was not required to document any justification for approving the mismatch transactions or multiple mismatches transactions).
- Whilst salespersons were required to document the reasons as to why a particular mismatch transaction should proceed, a sample review of the multiple mismatches transactions showed that most of the explanations provided were general and did not sufficiently justify why the intended transactions were considered to be suitable for the clients despite the risk mismatch and high asset concentration risk.
- In some cases, the salesperson input "the client specifically requested for the relevant product" as one of the reasons for recommending the mismatch product to the client when the transaction was in fact not initiated by the client.

Product Due Diligence Failures

MICBC relied on the PDD performed by its head office on the Head Office Funds. Apart from checking whether the head office funds were authorized by the SFC, MICBC did not conduct any independent assessment on the adequacy and quality of the product due diligence performed by its head office having regard to the regulatory requirements in Hong Kong.

MICBC adopted a product risk rating methodology whereby a risk rating would be assigned to each of the funds distributed by it. However, MICBC only considered a limited number of factors during the risk rating exercise. Relevant factors such a price volatility, market segment and certain product features which might directly or indirectly impact on the risk return profiles of the funds were not taken into account in the risk rating exercise.

MICBC did not establish any policies or procedures for assessing and identifying funds which might constitute derivative products in breach of the SFC Circular of 23 April 2012.

MICBC were fined HK$7 million over these failures. As well as the Circulars and FAQs mentioned above, the SFC considered that MICBC has breached:-

- General Principle 2 (diligence), 3 (capabilities) and 7 (compliance) of the the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct); and
- Paragraphs 3.4 (advice to clients), 4.3 (internal controls), 5.1(a) (KYC), 5.1A (investor categorization), 5.2 (reasonable advice) and 12.1 (compliance) of the Code of Conduct.

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