Good practices for sale of In-house Products

It is a common market practice that financial intermediaries (i.e. registered institutions and licensed corporations) (the "**FIs**") under the same group may manufacture and manage their own financial products (including structured products and investment funds) (the **"In-house Products"**) and distribute them to clients. Whilst such practice is not prohibited, it may trigger conflict of interest issue. This explanatory note is minded to alert the FIs (i) to follow the good practices observed by the regulators; and (ii) implement appropriate policies and procedures to meet the regulator's expected standards.

With respect to the good practices for and regulator's expected standards on dealing in the In-house Products, reference is made to the joint reviews by the Securities and Futures Commission and the Hong Kong Monetary Authority on managing conflicts of interest in financial groups published in a circular dated 24 November 2017 (the **"Joint Reviews"**). The Joint Reviews demonstrated the good practices by dividing into 4 different areas as well as the regulator's expected standards which are summarised as follows:-

1. Order execution and related disclosures

Good practices	Regulators' expected standards
(1) The FIs make sufficient disclosure to clients when they transact structured products with client by selecting their related entities as counterparties.	(1) The FIs should execute client orders on the best available terms in accordance with paragraph 3.2 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commissions (the **"Code of Conduct"**).
(2) The FIs require their staff to obtain quotes from different market participants when they execute orders of the In-house Products to ensure orders are executed at better prevailing prices.	(2) The FIs should disclose to clients any monetary or non-monetary benefits and affiliation with the product issuer in accordance with paragraph 8.3 of the Code of Conduct.
(3) The FIs ensure staff to compare in-house quotes with those of other market participants.	(3) The FIs should disclose material interests in a transaction with or for a client in accordance with paragraph 10.1 of the Code of Conduct.
(4) The effectiveness of implementation of conflict of interest policies are reviewed by an independent unit of the FIs.	(4) The FIs should implement effective controls and policies to require staff to obtain and compare quotes from external market participants. If no external quote is available, the FIs should sufficiently disclose to clients in respect thereof.
	(5) Effective controls should be in place to ensure sufficient disclosure to client in relation to conflict of interest arising from sale of the In-house Products.
	(6) The FIs should provide training and guidance to staff with respect to disclosure requirements under the Code of Conduct.

2. Product due diligence

Good practices	Regulators' expected standards
(1) The FIs implement sufficient policies and procedures governing the assessment of conflicts of interest in relation to sale of the In-house Products.	(1) The FIs should have thorough understanding of the In-house Products before recommending to, or soliciting investments from, clients.
	(2) The FIs may take into account the due diligence work of their related entities provided that the FIs have established policies and procedures to ensure that assessment is sufficiently and independently conducted.
	(3) The due diligence work should include the assessment of due consideration of actual or potential conflicts of interest, such as taking into account the relationship between the product issuers and the distributors as well as the benefits received for distributing the In-house Products.
	(4) The conclusion of the due diligence work should be approved by senior management of the FIs.
	(5) The FIs should maintain proper documentation of the product due diligence.

3. Selling process and discretionary portfolio management

Good practices	Regulators' expected standards
(1) The FIs properly disclose to clients about their preference for internally managed strategies and provide clients with a choice to exclude certain investment products managed or issued by the FIs' related entities.	(1) The FIs should establish policies and procedures to ensure clients are fairly treated and actual or potential conflicts of interest in the sale of, and investment in, the In-house Products by discretionary accounts are properly addressed.
(2) The FIs demonstrate their material interest in relevant transactions to clients by way of disclosure in clients' monthly statements about the percentage split of the investment allocation between in-house managed and third-party managed strategies.	(2) The FIs should ensure charges, mark-ups or fees in the general course of dealing or advising a client should be fair and reasonable pursuant to paragraph 2.2 of the Code of Conduct.

(3) In relation to advisory models, the FIs should have regard to all relevant information about the clients available to the FIs before recommending the In-house Products to, or soliciting investment thereon from, clients.

(4) In relation to discretionary models, the FIs should ensure the choice of the In-house Products matches with the clients' investment strategies and risk expectations. Also, such choice should be made in accordance with the clients' personal circumstances.

4. Management supervision, and controls and monitoring

Good practices

(1) The FIs establish guidance to staff about conflicts of interest with examples in order to assist staff to identify actual and potential conflicts of interest.

(2) Risk assessments are conducted annually to ensure the effectiveness of tracking and assessing risk in business activities with potential conflicts of interest.

Regulators' expected standards

(1) The FIs should implement effective management supervision and controls and monitoring which cover issues arising from the distribution of the In-house Products (e.g. conflicts of interest).

(2) The FIs should review their internal controls and guidance regularly and to enhance their practices and controls as follows:
- (i) establishing proper policies and procedures with regard to conflicts of interest arising from the sale of the In-house Products;
- (ii) reviewing the scope and frequency of monitoring carried out by compliance and internal audit to assess whether conflicts of interest are properly addressed; and
- (iii) providing regular staff training to ensure staff have sufficient skills and knowledge to handle conflicts of interest arising from sale of the In-house Products.

This explanatory summary is not, and should not be regarded as, a legal advice. Should you have any enquiries, please seek specific advice from legal advisers.

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