ETHICAL SELLING GUIDELINES

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Introduction

In terms of ethical selling, a critical aspect of it is whether the customer needs the product and the facts of the product including its risk and performance is duly informed to the customers. In this regard, there are specific requirements in different jurisdictions that call for a risk assessment of the customer to assess suitability of the investment. Besides complete and latest available performance information about the nature of the fund should be given to the customer. It is necessary for sales person to carefully consider all the pros and cons of his/her fund's performance including suitability and based on these factors, a decision to sell should be made.

Considering its importance and underlying investors' rights, there has been specific requirements on ethical selling in all regulated jurisdictions i.e. MiFID II and MiFIR applicable in the European Union as adopted by its parliament as well as US SEC mandated FINRA requirements that also talk of suitability with an aim to protect investors and making financial markets transparent. We aim to summarize the ethical selling and profiling requirements in Pakistan, India, Hong Kong and Singapore as enforced by the respective Regulators in their respective jurisdictions and the best practices that can be applied in addition to the existing regulatory requirements.

Pakistan

Mutual funds are regulated under NBFC Regulations 2008 issued by Securities and Exchange Commission of Pakistan (SECP).

As per the regulatory requirements, an AMC shall not be involved either directly or indirectly in mis-selling, making false or misleading statement, concealing or omitting material facts of CIS, and concealing risk factors associated with the CIS.

In addition, any performance reporting / presentation is required to be accompanied by all explanations, qualifications, limitations and other statements that are necessary to prevent such information from misleading investors. AMCs are also required to ensure that promotional materials do not contain untrue statements or omit to state facts that are necessary in order to prevent the statements from being misleading, false or deceptive. In this regard, SECP has also specified risk profile and risk of principal erosion of different Funds based on their investment policies and it requires confirmation of investments in higher risk funds through CBC/ email etc. based on the risk appetite of the customer.

To elaborate, following requirements should be followed by AMCs for the prevention of mis-selling:

Sales person's Responsibility

It is necessary for the sales staff to understand as to what constitutes mis-selling and deal with all their customers in an ethical and responsible way. Sales staff should put the customers' interest above their own interest and ensure that any investment product offered to the customers are as per their investment requirements and risk appetite.

Advertisement

It should be ensured that misrepresentation does not occur in any marketing material. Further, all the advertisement material should be prepared on the guidelines provided by the SECP.

Communication of Returns

It should be ensured that disclosure of returns for any CIS is as per the requirement specified by the SECP and comparison for the same has been made with Funds' relevant benchmark.

Risk Profile Form

Risk profiling is a process for finding the optimal level of investment risk for your investor considering various factors (age, objective, investment horizon, risk/return required, etc.) and suggesting investment solution accordingly. Risk Profile Forms are mandatory part of Account Opening Forms and should be duly filled and signed by the investors. Sales person has responsibility to ensure that all the required details of the Form are correctly filled and explained to investors.

Communication of Incorrect Information

In order to avoid presentation and communication of any incorrect information to the investors, sales staff should only use the advertisement material provided by the company and should not prepare or draft their own sales/ marketing material for investors.

Communication of Guaranteed and Predicted Returns

Sales staff should not under any circumstances communicate any guaranteed and predicted returns to the investors. Only the returns provided by the company in the past should be used for communication to the investors. Use of words like minimum profit, commitment of no losses etc. should be avoided.

Disclosure Requirement

It should be ensured that all the advertisement pertaining to the CIS contains the necessary risk disclosure as specified by SECP or any other disclosures as per the best practice.

Further, sales staff should ensure that complete disclosures of all the applicable charges at the time of investment including front end sales load, back end load and any other applicable taxes and charges have been communicated to the investors.

Additionally, investors should be encouraged to carefully read the disclosures provided in the advertisement material, account opening forms, investment forms as well as the relevant sections of the Offering Documents of the Funds.

Ethical Selling Guidelines by MUFAP

Besides the regulatory requirements stated above, Mutual Funds Association of Pakistan (MUFAP) which is the representative body of mutual funds has also suggested the following measures for the purpose of ethical selling.

- Minimum Qualification criteria of Sales personnel and supervision of newly hired staff under a senior person for selling high risk products.
- Selling process including Account opening form and investment form to be filled in by the customer.
- Appropriate Commission structure to discourage sales of only high-risk products.

International Practices

India

The ethical selling requirements in India varies depending on the distribution channel, as well as target investors. For fee-only registered investment advisors, Securities and Exchange Board of India ("SEBI") investment advisor regulations places obligations on risk profiling and suitability. But investment advisors are smaller community compared to distributors, who need to be registered by AMFI (Association of Mutual Funds of India). AMFI lays down a code of conduct for distributors against mis-selling and evaluate suitability although there are challenges in its enforcement. The largest distributors are banks, where sales people are compensated for selling products of its own asset management stable.

There are no suitability requirements for alternative products such as Alternative Investment Funds (AIFs) and Portfolio management services (PMS) aimed at HNI and institutional clients, where definition of accredited investors are based on minimum investment ticket-sizes rather than on wealth (assets / income thresholds), like it is in many jurisdictions; middle class retirees could potentially meet these thresholds for high fee-exotic products without adequate suitability safeguards.

Hong Kong

According to Securities and Futures Commission (SFC) in Hong Kong, licensed or registered persons should:

(i) Know their clients;
(ii) Understand the investment products they recommend to clients (Product due diligence);
(iii) Provide reasonably suitable recommendations by matching the risk return profile of each Investment product with the personal circumstances of each client to whom it is recommended;
(iv) Provide all relevant material information to clients and help them make informed investment decisions;
(v) Employ competent staff and provide appropriate training;
(vi) Document and retain the reasons for each investment recommendation made to each client.

Furthermore, a March 2020 SFC Circular requires a registered person to fulfil their suitability obligations under the Code of Conduct covering the due diligence of investment products, giving due to consideration to all relevant circumstance related to client including risk tolerance, investment horizon, liquidity needs etc.

Singapore

Singapore also recommends a conflicts of interest disclosure for the advice.

- Monetary Authority of Singapore (MAS) requires licensed financial advisers to have a reasonable basis for any recommendation made, with respect to any investment product, to a person who may reasonably be expected to rely on the recommendation, in particular, the licensed financial adviser shall give due consideration to the person's investment objectives, financial situation and particular needs.

- Where the investment product recommended is a Specified Investment Product, the financial adviser shall also give due consideration to the person's knowledge or experience in the Specified Investment Product.

- A financial adviser who is involved in making recommendations on investment products to clients shall comply with the requirements set out in this Notice in relation to the following aspects:

  (a) know your client;
  (b) needs analysis; and
  (c) documentation and record keeping.

Opting Out

In case of Singapore, the regulatory requirement provides an option of opting out where a client does not want:

(i) To provide any information requested by the financial adviser; or
(ii) To accept the recommendation of the financial adviser and chooses to proceed with the transaction in another investment product which is not recommended by the financial adviser, the financial adviser may proceed with the client's request, but it shall document the decision of the client and highlight to the client in writing that it is the client's responsibility to ensure the suitability of the product selected.
(iii) Where a client chooses not to receive any recommendation from a financial adviser, the financial adviser shall ensure that there is proper documentation to demonstrate that fact.

Balanced Scorecard approach

Singapore implemented a balanced scorecard approach for advisors for determining remuneration for front-line staff that combines monetary with non-monetary KPIs, which is seen as a positive influence in the way they approach clients.

> *Under the balanced scorecard framework, non-sales KPIs are assessed based on whether the adviser (i) understood the client's needs, (ii) recommended suitable products, (iii) made adequate disclosures, and (iv) upheld standards of professionalism and ethical conduct in providing financial advisory services. These non-sales KPIs reflect the due diligence requirements captured in the various MAS conduct rules, guidelines, and notices to better align the interests of client-facing advisers and their supervisors with those of customers and to minimize conflicts of interest inherent in volume-based remuneration arrangements*

Steps for Implementing Ethical Selling

In addition to the requirement specified by SECP and MUFAP, AMCs can consider the following additional measures to encourage and promote ethical selling:

Assessment of Client's Attitude towards Risk

There may be different ways for AMCs to assess a client's attitude towards risk for the purpose of suitability assessments. For example, there may be verbal discussions with clients that can be supplemented by questionnaires with a risk-scoring mechanism. However, while using a risk-scoring questionnaire to support their assessment, particular attention should be given to the design of the questions and the underlying scoring mechanism.

Suitability of Recommendations

Suitability involves matching the risk return profile of each recommended investment product with each client's personal circumstances. Therefore, AMCs should use their professional judgement to assess diligently whether the characteristics and risk exposures of each recommended investment product are actually suitable for the client and are in the best interests of the client considering the client's investment objectives, investment horizon, investment knowledge and experience, risk tolerance, and financial situation, etc. AMCs should consider all the relevant circumstances of a client when performing the suitability assessments. Hence, for registered persons that have assigned risk ratings to products, merely mechanically matching a product's risk rating with a client's risk tolerance level assessed by the registered persons shall not be sufficient to discharge their obligation.

Lastly, AMCs should exercise extra care when making recommendations to elderly or unsophisticated clients and their liquidity needs or those who may not be able to make independent investment decisions on complex investment products and rely on sales person for recommendation, particularly when these clients invest in investment products with long maturity periods and those which will attract hefty penalty charges upon early redemption or withdrawal.

Commission

Where AMCs or their related companies will receive commission rebates or other benefits for transacting in particular investment products for clients, sales persons must not take such commission rebates or other benefits as the primary basis for recommending particular investment products to clients. Also, where the sales persons only recommend investment products which are issued by their related companies, they should disclose this limited availability of products to each client.

Documentation Standards

AMCs should maintain records documenting the rationale underlying investment recommendations made to the client and provide a copy of the rationale for the recommendations to the client upon his or her request. To demonstrate compliance with regulatory requirements, sales persons should document and record contemporaneously the information given to each client, including any material queries raised by the client and the responses given by them. In addition, sales person should keep sufficient documentation on all client transactions including orders placed to product providers. Sales persons may choose to fulfil the documentation requirement by maintaining a written record or an audio record having regard to their mode of operations. These have minimum record retention requirements.

Interactive Communication between sales person and client that triggers suitability obligations

Interactive communications between AMCs and their clients about investment products may occur in different forms (e.g., face to face communication, phone conversation and electronic communication or a combination of any such forms). Whether an interactive communication between a sales person and a client about an investment product triggers the suitability obligations would depend on whether there is solicitation or recommendation having regard to the facts and circumstances of each case.

In this regard below extract of CFAI Sales Inducement report speaks of Hong Kong experience.

> *One of the central tenets of the suitability concept is risk matching. Put simply, risk-adverse clients would be shown relatively safe products, whereas relatively risky products would be shown only to those clients who have a risk appetite and experience with such products, as well as the capital to withstand potential losses. This means that intermediaries need to spend time on understanding a client's profile, including their investment objectives, horizon, return expectations, tolerance and appetite for risk, and ability to take losses. More important, they have to document such profiles, assign a risk rating to clients and keep their profiles and risk ratings up to date. Records of conversations (call reports) along with product recommendations are made for supervisory and audit purposes. Furthermore, at the point of sale, many retail banks ask clients a list of questions to confirm the client's understanding of the trade in question, including the product's key features and risk profiles. Without such documentation, it would be difficult for banks and distributors to defend their recommendations in the event of a client complaint or when an investigation calls for further scrutiny. Banks and other intermediaries are encouraged to perform self-assessment, review their policies and processes, and self-report, if weaknesses are detected.*
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> *Risk matching is not the only factor, however. The Securities and Futures Commission (SFC) has also indicated that the consideration of suitability is not merely on the basis of matching a product's risk rating with client's risk tolerance level - a wholesale consideration of all relevant circumstances needs to be demonstrated as well.*

Given the stronger conflicts of interest for an AMC than an intermediary to push its products, AMCs certainly need to put in place a stronger incentive mechanism to make sure client interests come first.

Online Platforms

Considering the availability of online platforms for account opening and distribution of mutual funds, as part of its existing obligation to discharge the Suitability Requirement, Platform. AMC should ensure to match the risk return profile of the investment product selected by a client with the personal circumstances of that client.

> This may involve an Online Platform assessing a client's risk tolerance level and risk profile and accordingly risk profiling the client,and the Platform Operator conducting product due diligence to ascertain the risk return profile of an investment product and accordingly risk profiling the investment product. It should be noted, however, that merely mechanically matching an investment product's risk rating with a client's risk tolerance level may not be sufficient to discharge the Suitability Requirement.
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> An AMC offering online investment should ensure that in assigning risk profiles to investment products, its risk profiling methodology is properly designed to consider both quantitative and qualitative factors and consider all risks involved, including credit risk, liquidity risk, counter party risk, use of leverage, etc. Platform Operators should have appropriate processes in place to periodically review the risk profiling methodology and mechanism for investment products. Further, it is imperative for the AMCs to ensure all the requirement relating to ethical selling is adhered to in offering online services to the investors.

In the above article, we have captured the local requirements as well as international best practices of regional and developed markets and these should be leveraged by Asset Management Companies to ensure ethical selling and to increase the trust of the investors. If properly followed, these would go a long way in increasing the base of mutual fund industry in Pakistan which is abysmally low presently even in comparison to the regional markets.