SFC reprimands and fines Noah Holdings (Hong Kong) Limited HK$5 million for regulatory breaches

29 May 2018

The Securities and Futures Commission (SFC) has publicly reprimanded and fined Noah Holdings (Hong Kong) Limited (Noah HK) HK$5 million over Noah HK's internal system and control failures in its sale and distribution of investment products.

In particular, Noah HK had failed to comply with various regulatory requirements on know-your-client, product due diligence, suitability assessment, information for clients, and sales supervision and controls (Note 1).

The SFC's disciplinary action followed an SFC inspection and an independent review jointly agreed by the SFC and Noah HK, which found that between January 2014 and June 2016 (Note 2):

- Noah HK's risk profiling questionnaires for assessing clients' risk appetite and risk tolerance level were defective in certain areas;
- Noah HK failed to ensure the features and risks of certain investment products were sufficiently considered when assigning a risk rating to the product as part of the product due diligence process;
- Noah HK had sold clients potentially unsuitable investment products as a result of its deficient risk profiling questionnaires and product risk rating framework (Note 3);
- Noah HK did not require its sales staff to document the rationale underlying the investment advice or recommendations prior to March 2016, nor did it require them to provide clients with copies of such information; and
- Noah HK did not have an adequate supervision and control mechanism in place for monitoring the sale of investment products.

In reaching this resolution, the SFC took into account all relevant circumstances, including that Noah HK:

- engaged an independent reviewer to conduct an independent review to address the SFC's regulatory concerns and review its internal systems and controls;
- agreed to reimburse the affected clients (Note 4);
- took remedial actions to strengthen its internal systems and controls and proactively engaged an external consultant to assist in the process;
- undertook to provide the SFC with a report prepared by an independent reviewer within 12 months confirming that all the identified concerns have been properly rectified;
- cooperated with the SFC in resolving its concerns; and
- has no disciplinary record with the SFC.

End

Notes:

1. Noah HK is licensed under the Securities and Futures Ordinance (SFO) to carry on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.
2. The SFC conducted an inspection into Noah HK's business activities in March 2016 and identified a number of concerns regarding the adequacy and effectiveness of its internal controls and systems. In January 2017, the SFC and Noah HK jointly engaged an independent reviewer to review Noah HK's internal control framework in relation to its sale and distribution of investment products during the period between 1 January 2014 and 30 June 2016, and assess the financial impact on clients arising from the concerns identified by the SFC and the independent reviewer.
3. The independent reviewer identified that a total of 1,243 transactions worth about US$523 million, involving 757 clients, were affected by the identified concerns. All of these affected clients were classified by Noah HK as "professional investors" as defined in the SFO and its subsidiary legislation.
4. In respect of each affected client who had redeemed the investment with a net realised loss or who is still holding the investment, Noah HK agrees to reimburse the client for the realised loss and/or make an offer to redeem or sell the client's holding and reimburse the client for any loss resulting from the redemption or sale (as the case may be).

A copy of the Statement of Disciplinary Action is available on the SFC website

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STATEMENT OF DISCIPLINARY ACTION

The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded Noah Holdings (Hong Kong) Limited (**Noah HK**)[1] and fined it HK$5,000,000 pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).

2. The disciplinary action is taken according to an agreement pursuant to section 201 of the SFO dated 24 May 2018 in respect of Noah HK's internal control failures in relation to its investment product selling practices.

Summary of facts

Background

3. In or around March 2016, the SFC conducted an inspection into the business activities of Noah HK. During the inspection, the SFC identified a number of concerns regarding the adequacy and effectiveness of Noah HK's internal systems and controls in the following 5 areas:

   (a) know your client;

   (b) product due diligence;

   (c) suitability assessment;

   (d) information for clients; and

   (e) sales supervision and controls.

4. In January 2017, the SFC and Noah HK jointly engaged an independent reviewer to review Noah HK's internal control framework in respect of its sale and distribution of investment products during the period from 1 January 2014 to 30 June 2016 (**Relevant Period**), focusing on the 5 areas of concerns set out in paragraph 3 above (**Independent Review**). The independent reviewer was also instructed to assess the financial impact on clients arising from the concerns identified by the SFC and the independent reviewer.

Know your client

5. During the Relevant Period, Noah HK used four different versions of risk profiling questionnaires (**RPQs**) to gather client information such as the clients' financial position, risk appetite and investment objective, knowledge and experience. Clients were categorised into one of five risk profiles[2] based on the ultimate scores of their answers to the RPQs.

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[1] Noah HK is licensed under the SFO to carry on Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities.

[2] The five risk profiles were "Low", "Low to Medium", "Medium", "Medium to High" and "High".

6. The design of the RPQs was defective and failed to establish the clients' risk profiles fairly and accurately:

   (a) The scoring mechanism adopted by Noah HK permitted clients with low risk appetite and/or low risk tolerance to attain a high risk score under the RPQs, leading to the potential recommendation of high risk products to clients with low risk appetite.

   (b) The formula used for calculating the client risk score in version 2 of the RPQs was wrong.

   (c) 704 RPQs were not fully completed by the clients. When the risk scores were recalculated by assigning a zero score to the incomplete answers, 319 RPQs yielded a risk score lower than that assigned by Noah HK, of which 93 should have led to the assignment of a lower client risk profile.

   (d) Noah HK did not have controls in place to assess contradictory answers in the RPQs. The Independent Review observed a total of 585 RPQs with contradictory answers.

7. The Independent Review also revealed various deficiencies in Noah HK's account opening and know your client procedures during the Relevant Period:

   (a) Noah HK did not have proper procedures in place to assess its clients' knowledge of derivatives.

   (b) Various exceptions such as missing client signatures and incomplete client information were noted in 66 out of 120 samples of account opening documents reviewed.

   (c) Prior to 24 March 2016, Noah HK had no policies or procedures governing the validity period of the PRQs. In 898 transactions, the clients' RPQs were completed more than one year prior to the time of the transactions.

Product due diligence

8. During the Relevant Period, Noah HK adopted a product risk rating (**PRR**) framework and assigned one of five risk ratings[3] to each product based on the risk score assigned to the product.

9. Noah HK's product managers, who are responsible for performing product due diligence, would assess the features and risk factors of each product and assign a risk score to the product using Noah HK's product risk score template.

10. Under the risk score template, a standard score would be assigned to a product based on the product asset class. Adjustment scores would then be added to or subtracted from the standard score depending on the product manager's assessment of the product risk factors.

[3] The five product risk ratings were "Low", "Below average", "Average", "Above average" and "High".

11. The Independent Review found that:

(a) The PRR framework was subjective and did not adequately cater for features and risk factors applicable to the products sold by Noah HK.

(b) Noah HK failed to give sufficient consideration to certain product features and risk factors and thereby incorrectly assessed the risk rating of 9 products.

(c) 89 exceptions such as incorrect calculation of risk score, incorrect adjustment applied on risk factors, and lack of explanations to justify the risk adjustment made were noted in the samples reviewed.

Suitability assessment and information for clients

12. During the Relevant Period, Noah HK performed suitability assessment by matching the product risk rating with the client risk profile. If the product risk rating did not match the client's risk profile, an additional suitability assessment form was required to be completed and approved by Noah HK's responsible officer before the product could be sold to the client.

13. The deficiencies set out above regarding the design of the RPQs and the PRR framework mean that there could be executed transactions where the investment products sold were potentially unsuitable for the clients (**Potential Risk Mismatch Transactions**) but were not identified as such during Noah HK's suitability assessment.

14. Based on the impact analysis performed by the independent reviewer, there were 1,243 Potential Risk Mismatch Transactions during the Relevant Period, involving a total investment amount of about US$523 million.

15. In addition, the Independent Review found the following irregularities in relation to Noah HK's systems and controls regarding suitability assessment and information for clients:

(a) Certain risk mismatch transactions were confirmed and executed before the completion of the required process for mismatch transactions.

(b) The lock-up period of 1,326 transactions traded during the Relevant Period was longer than the clients' maximum acceptable maturity as stated in the RPQs.

(c) Prior to March 2016, Noah HK did not require the sales staff to document and provide a copy of the underlying investment rationale to clients.

Sales supervision and controls

16. The Independent Review identified the following weaknesses in Noah HK's supervision and controls framework for monitoring the sale of investment products:

(a) Noah HK did not have any exception reports to facilitate effective management oversight on irregular and high risk transactions.

(b) Noah HK's compliance monitoring program lacked a sampling methodology and a detailed timeline for the compliance review.

(c) Although Noah HK had provided product training to its sales staff, it did not perform assessment on the sales staff to ensure that they fully understood the products.

Our concerns

17. The conduct of Noah HK as set out in paragraphs 5 to 16 constitutes a breach of:

(a) General Principle 2 (Diligence) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**), which requires a licensed person, in conducting its business activities, to act with due skill, care and diligence, in the best interests of its clients and the integrity of the market;

(b) paragraph 5.1 (Know your client: in general) of the Code of Conduct, which requires a licensed person to take all reasonable steps to establish the true and full identity of each of its clients, and of each client's financial situation, investment experience and investment objectives;

(c) paragraph 5.1A (Know your client: investor characterization) of the Code of Conduct, which requires a licensed person, as part of the know your client procedures, to assess the client's knowledge of derivative and characterize the client based on his knowledge of derivatives;

(d) paragraph 3.4 (Advice to clients: due skill, care and diligence) of the Code of Conduct, which requires a licensed person to act diligently and carefully in providing advice to a client and ensure that its advice and recommendations are based on thorough analysis and take into account available alternatives; and paragraph 5.2 of the Code of Conduct (Know your client: reasonable advice), which requires a licensed person, having regarding to information about the client of which it is or should be aware through the exercise of due diligence, to ensure the suitability of its recommendation or solicitation for the client is reasonable in all the circumstances;

(e) paragraph 3 of Appendix A of the Management, Supervision and Internal Control Guidelines for persons licensed by or registered with the Securities and Futures Commission, which requires a licensed person to implement special procedures to document and provide a copy to the client the rationale underlying investment advice rendered or recommended;

(f) paragraph 4.2 (Staff supervision) of the Code of Conduct, which requires a licensed person to ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed or appointed by it to conduct business on its behalf;

(g) paragraph 4.3 (Internal control, financial and operational resources) of the Code of Conduct, which requires a licensed person to have internal control procedures which can be reasonably expected to protect its operations and its clients from financial loss arising from theft, fraud, and other dishonest acts, professional misconduct or omissions; and

(h) General Principle 7 (Compliance) and paragraph 12.1 (Compliance: in general) of the Code of Conduct, which require a licensed person to comply with, and implement and maintain measures appropriate to ensure compliance with, relevant regulatory requirements.

Conclusion

18. Having considered all the circumstances, the SFC is of the opinion that it is in the interest of the investing public and in the public interest to resolve the above concerns with Noah HK and take the disciplinary action as set out in paragraph 1.

19. In deciding the disciplinary sanctions, the SFC has taken into account that Noah HK:

    (a) engaged an independent reviewer to conduct the Independent Review;

    (b) agreed to reimburse the affected clients;

    (c) took remedial actions to strengthen its internal systems and controls and proactively engaged an external consultant to assist in the process;

    (d) undertook to provide the SFC with a report prepared by an independent reviewer within 12 months confirming that all the identified concerns have been properly rectified;

    (e) cooperated with the SFC in resolving its concerns; and

    (f) has no disciplinary record with the SFC.