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# SFC reprimands and fines Phillip Securities (Hong Kong) Limited \$1 million over mis-selling of investment product

16 Jun 2015

The Securities and Futures Commission (SFC) has reprimanded and fined Phillip Securities (Hong Kong) Limited (Phillip Securities) \$1 million for failings over its sale of a fund to four clients (Note 1).

Phillip Securities has also agreed to repurchase the fund from the clients at the principal amount less dividends plus interest if the amount had been invested in a 12-month fixed term deposit over the same period of time (Note 2).

An SFC investigation revealed that Phillip Securities sold the American Pegasus Fixed Income Fund – Series II Segregated Portfolio to the four clients around August 2004, involving transaction amount of approximately \$819,000. The fund was liquidated in July 2011 and the clients have not been able to recover their investment (Note 3).

The SFC found that Phillip Securities failed to:

- conduct adequate due diligence on the fund before selling it to clients;
- provide adequate training and/or sufficient product information to its sales staff to ensure they fully understand the nature of the fund, the risks involved, and for which types of investors the fund would have been suitable; and
- implement sufficient measures to ensure that its sales staff had assessed the suitability of the fund to clients, and to monitor and review the selling process.

In deciding the sanction, the SFC took into account that Phillip Securities has co-operated with the SFC in resolving the disciplinary proceedings.

End

Notes:

1. Phillip Securities is licensed under the Securities and Futures Ordinance to carry on Type 1 (dealing in securities), Type 4 (advising on securities), Type 7 (providing automated trading services) and Type 9 (asset management) regulated activities.
2. The repurchase agreement is made under section 201 of the Securities and Futures Ordinance.
3. The American Pegasus Fixed Income Fund – Series II Segregated Portfolio is a viatical settlement which invested in senior life settlement insurance policies issued by investment grade insurance companies in the United States. It is not a product authorized by the SFC. In June 2010, investors were notified that the fund would be wound up as it did not have sufficient value to continue to pay life insurance policy premiums until the expected maturity of the life settlement policies held by it. The fund was placed into official liquidation under Cayman Islands law in July 2011.

[A copy of the Statement of Disciplinary Action is available on the SFC website](#)

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## STATEMENT OF DISCIPLINARY ACTION

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### The Disciplinary Action

1. The Securities and Futures Commission (**SFC**) has publicly reprimanded Phillip Securities (Hong Kong) Limited<sup>1</sup> (**Phillip Securities**) and fined it \$1 million pursuant to section 194 of the Securities and Futures Ordinance (**SFO**).
2. The disciplinary action relates to failings of Phillip Securities concerning its sale of the American Pegasus Fixed Income Fund – Series II Segregated Portfolio (**Fund**) to clients. The SFC found that Phillip Securities has failed to:
  - (a) conduct adequate due diligence on the Fund before selling it to clients;
  - (b) provide adequate training and/or sufficient product information to its sales staff to ensure that they fully understand the nature of the Fund, the risks involved, and for which types of investors the Fund would have been suitable; and
  - (c) implement sufficient measures to ensure that its sales staff had assessed the suitability of the Fund to clients, and to monitor and review the selling processin breach of General Principles 2 (diligence), 5 (information for clients) and 7 (compliance) and paragraphs 3.4 (advice to clients), 4.2 (staff supervision), 4.3 (internal control, financial and operational resources), 5.2 (know your client: reasonable advice) and 12.1 (compliance: in general) of the Code of Conduct<sup>2</sup>.
3. Phillip Securities has agreed to repurchase the Fund from the four clients who bought the Fund in a resolution made under section 201 of the Securities and Futures Ordinance.<sup>3</sup>

### Summary of facts

4. Phillip Securities sold the Fund to four clients in around August 2004, involving transaction amount of approximately \$819,000. The Fund is a viatical settlement which invested in senior life settlement insurance policies issued

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<sup>1</sup> Phillip Securities is licensed under the Securities and Futures Ordinance (SFO) to carry on Type 1 (dealing in securities), Type 4 (advising on securities), Type 7 (providing automated trading services) and Type 9 (asset management) regulated activities.

<sup>2</sup> Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission

<sup>3</sup> The repurchase amount will be calculated by reference to the principal amount invested by the clients, less any dividends received. It will include an additional amount representing the interest that would have been earned if the amount invested in the Fund, taking into account the dividends received, had been invested on a US dollar 12-month fixed term deposit.

by investment grade insurance companies in the United States. It is not a product authorized by the SFC.

5. In June 2010, investors were notified that the Fund would be wound up as it did not have sufficient value to continue to pay life insurance policy premiums until the expected maturity of the life settlement policies held by it. The Fund was placed into official liquidation under Cayman Islands law in July 2011. The four clients have not been able to recover the principal sums they invested in the Fund.
6. A client complained to the SFC alleging that Phillip Securities had mis-sold the Fund to her. An SFC investigation revealed a number of deficiencies in the selling of the Fund by Phillip Securities to its clients.

#### Product due diligence

7. General Principle 2 (diligence) and 5 (information for clients), paragraphs 3.4 (advice to clients: due skill, care and diligence) and 5.2 (know your client: reasonable advice) of the Code of Conduct require licensed corporations to ensure that, through the exercise of due diligence, their investment recommendations to clients are based on thorough analysis and are reasonable in all the circumstances, and relevant material information was disclosed to clients.
8. In order to fulfil that obligation, licensed corporations must fully understand the nature and risks involved in the products that they recommend to their clients, so that they can determine for which types of clients the products are suitable, and what kinds of details and risk should be emphasized to the clients. They must therefore conduct thorough due diligence and independent enquiries to understand and assess the products in question.
9. The SFC found that Phillip Securities had failed to conduct proper and adequate due diligence on the Fund before selling it to its clients. There is no record of Phillip Securities assigning a risk level to the Fund. Further, it did not have any written guidelines or policy on how product due diligence should be conducted at the time and/or how its products should be assessed and evaluated.

#### Training and guidance to sales staff

10. The SFC also found that Phillip Securities failed to provide any and/or sufficient training on the Fund to its sales staff, and did not have any measures to ensure that its sales staff understood the structure and risks of the Fund before selling the Fund to its clients.
11. Given that no due diligence and no risk assessment was performed by Phillip Securities in respect of the Fund, it is difficult to see how any of its sales staff could have acquired sufficient understanding of the structure and nature of, and the risks involved in, the Fund. Sales staff were left to assess and reach their own personal view on the risk level of the Fund.
12. Without any training and guidance from the firm, it is questionable whether the sales staff were capable of evaluating the risks of the Fund appropriately. If the sales staff could not fully understand the nature and risks associated with the Fund, they would not have been able to know whether the Fund was suitable for their clients and to ensure that the clients understood the product.

13. The lack of training to sales staff and the lack of risk assessment of the Fund could lead to inconsistent advice given by different sales staff to different clients as different staff might have different understanding and different evaluation of the risks of the Fund. This is borne out by the evidence of the clients which suggests that they received different advice as to the risk level of the Fund. Three clients were told that the Fund involved low risks (two of these clients were told that the product was principal protected), and one client was aware that the risk of the Fund might be higher, but he did not know how high the risk was.

Monitoring and supervision of sale process

14. General Principle 7 (compliance) and paragraphs 4.3 (internal control, financial and operational resources) and 12.1 (compliance: in general) of the Code of Conduct require licensed corporations to implement and maintain measures appropriate to ensuring compliance with relevant regulatory requirements and internal control procedures to protect their clients from financial losses arising from professional misconduct or omissions.
15. Paragraph 4.2 (staff supervision) of the Code of Conduct requires a licensed corporation to ensure that it has adequate resources to supervise diligently and does supervise diligently persons employed by it to conduct business on its behalf.
16. Phillip Securities as a licensed corporation should monitor and supervise its sales staff to ensure that advice given to clients is suitable, taking into account the clients' specific personal circumstances.
17. Phillip Securities breached these regulatory requirements in that it failed to establish and implement proper and adequate internal control measures to monitor and review the process on the sale of the Fund by its staff. Evidence shows that:
  - (a) Phillip Securities did not have any written policy or guidelines for sales staff regarding the selling of funds to clients at the time.
  - (b) Although its management claimed that it considered the Fund to be high risk and sales staff were not allowed to market it to clients, there were no controls to prevent this from happening:
    - Three clients had signed a declaration confirming that their decision to invest was not a consequence of any direct marketing by Phillip Securities, and that they were aware of the associated risks of the relevant investment. Phillip Securities relied on the declaration as evidence that the purchase of the Fund was self-initiated by the clients.
    - However, evidence shows that all the clients bought the Fund as a result of the recommendation of its sales staff, and three out of them were told that the Fund was a low risk product.
    - It was also recorded in an internal documentation that the reason for introducing the Fund to a client was that it had "comparatively low risk", but this inconsistency with management's alleged assessment was not identified by Phillip Securities.
  - (c) There were no procedures in place to enable management to know if the products sold were recommended by sales staff or requested by clients.

- (d) Although Phillip Securities claimed that it had provided verbal guidance to its sales staff, requiring them to ensure that the risks associated with the Fund had to be highlighted to clients, and that the clients had read the prospectus carefully before investing in the Fund, it did not appear to have any controls in place to ensure that its sales staff followed the guidance:
- Phillip Securities did not require its sales staff to keep records of the advice they gave to clients and/or the documents they had provided to clients regarding the product they sold to clients. There was no means by which it could independently monitor whether the offering memorandum of the Fund was in fact provided and explained to the clients.
  - Evidence of the clients suggests that the offering memorandum might not have been provided and/or explained to them before they decided to invest in the Fund. In the circumstances, the clients could only rely on the oral representations of the sales staff without the benefit of reading the terms and conditions before deciding whether or not to invest in the Fund.

### **Conclusion**

18. Phillip Securities failed to discharge its suitability and disclosure obligations owed to its clients when selling the Fund, and clients suffered losses as a result of their investment in the Fund. Its system for distributing the Fund and giving investment advice to its clients was seriously deficient and non-compliant with relevant regulatory requirements.