

Annex

Supplementary commentary on principles regarding licensed insurance broker company's referral business models focused on long term business and Mainland China Visitors ("MCV")

Whilst there is no prohibition on licensed insurance broker companies accepting introductions of clients (i.e. referrals) from persons who are not licensed, it is imperative that this is done in a compliant manner. A licensed insurance broker company that seeks to rely on referrers (without the requisite licence) to refer prospective clients to the broker company, must ensure that the referral model adopted aligns with the following three self-evident principles:

Principle 1 – Unlicensed referrers¹ must not give any regulated advice to clients and must not carry on any regulated activities or sales activities

Firstly, if a licensed insurance broker company seeks to rely on a referrer which does not have the requisite licence under the IO to carry on regulated activities on behalf of the broker company, then in sourcing, dealing with and referring clients to the broker company, the referrer must not give any regulated advice and must not carry on any regulated activities or sales activities.

Limits referrers must stay within

This means that a referrer must **not** provide any advice or recommendations to clients on any specific insurance protections or products, must not introduce or seek to explain any specific insurance products when dealing with clients and must not seek to persuade clients to buy specific insurance products. Rather, a referrer must limit its role only to introducing clients to the broker company. The referrer should explain to a prospective client that he/she is the referrer and whilst he/she can arrange to introduce the client to the broker company in Hong Kong, any advice on insurance matters or specific insurance products from authorized insurers in Hong Kong, would need to be provided to the client by the broker company (through its technical representatives) in Hong Kong and the broker company would assist the client with any application for insurance the client may wish to make in Hong Kong.

Referrers must stay within these limitations. If the referrer does provide any regulated advice or carries on any regulated activities (and is rewarded for doing so by the broker company), not only does the referrer risk committing a criminal offence under the IO and partaking in unlicensed selling in Mainland China, but also the broker company risks having conspired with the referrer to commit such offences.

Due Diligence on referrers

If a broker company wishes to enter into such referral arrangements, it must implement sufficient controls to ensure the unlicensed referrers it engages, only introduce clients, but do not carry on

¹ In this context, an "unlicensed referrer" in relation a licensed insurance broker company means a person who is not a technical representative (broker) appointed by the broker company to carry on regulated activities on its behalf.

any regulated activities. Prior to entering into any arrangement with a referrer, the broker company should perform due diligence on the referrer (and keep records to demonstrate the work done) to understand where its source of clients to be referred to the broker company would come from, to ensure this is consistent with the referrer only introducing clients to the broker company and not carrying on any regulated activities itself as part of this process.

By way of example, individuals or companies which do not hold the requisite licence under the IO, but run other businesses that give them access to an existing client base or network of potential clients, may be positioned to introduce clients to the broker company without having to carry on insurance sales activities to actively source such clients. This type of scenario would be consistent with a referral model where the referrer is positioned only to effect introductions of its clients to the broker company, with lower levels of risk of it having to carry on regulated activities in doing this (albeit the broker company would still need to ensure that the referrer understands the imperative of not carrying on regulated activities).

By contrast if a referrer has no separate business or no apparent existing network of potential clients and is looking to the referrals it makes to the broker company as a principal activity or source of income (rather like a client focused technical representative), then this would carry high risk of the referrer having to carry out unlicensed selling and regulated activities to source clients. The broker company should avoid such types of arrangements (and either look to appoint the individual as its technical representative (broker), which would mean the individual obtaining a licence and becoming subject to the broker company's governance, controls and process, or not do any business with the individual).

Ongoing controls and processes to ensure referrers are compliant

Broker companies must also establish controls and processes to ensure referrers act in a compliant manner and do not carry on regulated activities or offer prohibited rebates to clients. We have already outlined some suggested controls in our circular of 30 November 2022 such as:

- written referral agreements stating clearly the limited activities the referrer can perform;
- clear “Do’s and Don’ts” provided to referrers (see above “Limits referrers must stay within”);
- spot-check enquiries of clients, doing client surveys or obtaining feedback from clients on how referrers dealt with clients;
- periodic reminders to referrers about not carrying on regulated activities or unlicensed selling;
- “red flags” which identify where unlicensed regulated advice may have been given by the referrer and then following up with the client to make enquiries; and
- providing referred clients with the disclosure statements in clear format as required by Standard and Practice 5.5 of Part C of the Code of Conduct for Licensed Insurance Brokers and taking clients through these so they understand.

Broker companies should be particularly alert if referrers visit the broker company's office and attend the meeting between the client and the technical representative(s) of the broker company. Technical representatives should ascertain why the referrer needs to be present at their meeting

with the client (given that the meeting may involve the client disclosing personal data and information). Technical representatives must report to the responsible officer of the broker company any regulated advice given by the referrer to the client in the meeting, or which it is clearly evident has been given by the referrer prior to the meeting. Broker companies should in turn self-report this to the IA and consider terminating the referrer.

As stated, these controls and processes are not a prescribed set of “one-size fits all”, minimum controls which, provided the broker company has them in place, enable it otherwise to ignore any unlicensed selling or regulated activities that referrers are evidently performing to refer clients. The referral model being operated is part of the broker company’s business operation. The duty is on the broker company (its responsible officer and its technical representatives) to ensure its business operation is compliant.

Principle 2 – The broker company (and its technical representatives) must give all regulated advice to the client and carry on all regulated activities needed to arrange insurance policies for the client to the minimum standards required in the Insurance Regulatory Framework

Secondly, for any MCV client who is referred to a licensed insurance broker company, the broker company must ensure that it (and its technical representatives) provides regulated advice to the client directly and carry on all regulated activities to the minimum standards required under the Insurance Regulatory Framework. Any technical representative who simply relies on the referrer to have performed the selling and advising activities and simply signs the application forms and related documents as a “rubber stamp” (as per the non-compliant business model cited in the circular), can expect to be the target of enforcement action by the IA and other law enforcement agencies. The same would be the case for responsible officers, directors, controllers and senior management of the broker company, if they allow this to happen. Such erosion of standards of conduct in the market will not be tolerated.

All licensed insurance broker companies, their responsible officers and their technical representatives must be fully cognizant of the standards and practices laid down in the Insurance Regulatory Framework and conduct their regulated activities with clients in accordance with these requirements. These requirements underpin the substance of the role that an insurance broker performs, particularly in the context of long term insurance policies, namely:

- helping clients ascertain and assess their insurance needs and the type of insurance protections that would meet those needs based on what clients can afford;
- recommending suitable insurance policies from a range of insurers based on an objective and impartial analysis and explaining how these products work in a way clients would understand;
- assisting clients in making a fully informed decision on whether or not to proceed with an insurance purchase;
- if clients decide to proceed, representing them in arranging the insurance policy(ies) with the insurer; and
- continuing to serve and advise clients on matters arising on the insurance policy(ies) arranged.

In explaining any insurance products being recommended that are available from Hong Kong insurers, the technical representative may need to spend additional effort dispelling any wrong pre-conceptions the client from another jurisdiction may have about such insurance products (which may have been gleaned, for example, from social media or internet posts that give an incomplete picture). Putting the client in a position where he or she can make a fully informed decision, is precisely the role that licensed insurance intermediaries serve (and the service that clients coming to buy from the Hong Kong insurance market, are entitled to expect from Hong Kong licensed insurance intermediaries).

The non-compliant business models identified in this circular, indicate that certain broker companies have forgotten the fundamental role that insurance brokers are licensed to perform. Those who abuse their licences in this manner, can expect enforcement action in the form of suspension or revocation of licence or other penalties such as fine and public reprimand.

Principle 3 – If any payments are to be offered to referrers by the broker company for introducing clients, such payments should be calibrated to be consistent with (i) the referrers not carrying on regulated activities (and not being incentivized to do so); and (ii) the broker company being properly resourced to provide regulated advice and perform regulated activities for the clients being introduced

This third principle is essential to prevent any resurrection of the non-compliant business model identified in this circular, where the referral fees being offered by the infringing broker companies appear to have been so inordinately high that referrers were obviously incentivized to carry on regulated activities, whilst the resources of the broker company were so constrained that its technical representatives were not providing substantive regulated advice or regulated activities themselves (as per Principle 2).

In the same way that it is not for the IA to specify a set of “one-size fits all” controls and processes, it is also not for the IA to specify maximum rates for referral fees or place specific limits on the amount of such payments (this remains, for the most part, a commercial decision and judgement that a broker company will need to make). It is also recognized that the level of payment may differ depending on the specific referral arrangement. However, it is the responsibility of the broker company to justify that any payment to unlicensed referrers accords with this Principle 3 and consideration must be given to this when deciding the level of payment to be offered.

If a broker company is calibrating the level of referral fee as a percentage of commission to be received, it should give consideration to the sufficiency of the portion to be retained based on the resources it would need to ensure its technical representatives perform adequate regulated activities and give regulated advice to the clients referred (as per Principle 2). It should also take account of post-sales and ongoing servicing that will need to be provided by the broker company. Similarly, referral payments should be calibrated on the basis of the referrer carrying on **no** regulated activities and simply introducing the client (as per Principle 1), albeit broker companies may take account of the referrer’s work in establishing its client base (from which introductions will be made) through, for example, the referrer’s principal non-insurance business (which would have involved no regulated activities).

The IA takes a common sense, “substance-over-form” approach in assessing whether there has been a possible breach of the Insurance Regulatory Framework that requires investigation or heightened regulatory scrutiny. Each matter is assessed on its own facts.

For example, a referrer may be a regulated financial services provider (albeit not in insurance) and the referral arrangement involves the referrer introducing its clients from its existing client base to the broker company when those clients may have insurance needs. In this situation, the level of referral payment may reflect the time, work and costs that the referrer has incurred in building its client base and establishing client relations (to which the broker company is gaining access and does not need to do itself). Further, the referrer (as well as commercially taking a referral fee) will have an interest in the broker company serving the clients referred to the requisite standards in the Insurance Regulatory Framework. Such arrangement would generally not appear to attract the need for additional regulatory scrutiny.

Contrast this with a situation where a licensed insurance broker company is receiving multiple referrals from an unlicensed referrer where the referrals appear to be a principal activity or source of income for the unlicensed referrer, the referrer has no apparent existing client base or network established from any other principal business from which clients are being introduced, and the broker company is paying a majority of its commission received on successful sales to the referrer. The combination of these red flags (suggesting that the referrer may be carrying on unlicensed selling and the broker company is not sufficiently resourcing itself to carry on the necessary regulated activities) would make it likely that immediate regulatory scrutiny and investigative action need to be deployed by the IA.

We provide the above as examples but emphasize again that every case will depend on its own specific facts.

Intermediary management control functions in authorized insurers

Licensed insurance broker companies generally act for potential policy holders, not insurers. In the parlance of the insurance market, however, insurers and broker companies are often referred to (and they often refer to each other) as “business partners”. The IO reflects this in practical terms by requiring the intermediary management function of an insurer to put in place adequate controls and processes to ensure that licensed insurance broker companies submitting business to the insurer have arrangements in place to comply with the Insurance Regulatory Framework. This reflects the fact that, as business partners, the manner in which licensed insurance broker companies source and deal with clients who become policy holders of the insurer, will impact the reputation of the insurer for treating customers fairly (or otherwise) and the level of positive (or negative) outcomes for policy holders of the insurer.

In the training sessions we have carried out for Key Persons in the Intermediary Management Control Functions and Directors of authorized insurers (through The Hong Kong Federation of Insurers), we have indicated the type of controls and processes an intermediary management function of an insurer may consider implementing in respect of the licensed insurance broker companies which place insurance policies with it. These include due diligence, agreements or documentation to make clear their respective roles and obligations, offering training, providing

up to date product information, carrying out periodic assessments and handling complaints. We have also emphasized the need for these controls and processes to be enhanced on licensed insurance broker companies that rely on referrals to offer long term insurance products to MCV clients (particularly to identify and prevent the spread of the non-compliant business model cited in this circular).

Below we provide further guidance in the context of the three principles. However, the onus remains on the insurer to design controls and processes suitable to its operations, which are effective to address the objective of the three principles. The IA will continue, in its conduct inspections, to assess the effectiveness of controls and processes of insurers using a “substance over form” approach.

(a) Enhanced Due Diligence

The minimum levels of due diligence an authorized insurer should perform on any broker company before entering into business dealings with it, would include verifying its licensing status, obtaining information on the broker company’s experience, knowledge, capacity and track-record to carry out regulated activities in respect of the type of products offered by the insurer, and understanding the business model of the broker company in sourcing and serving clients.

If the broker company’s business model relies on sourcing of MCV clients, and this is to be done using unlicensed referrers, the insurer’s due diligence must be enhanced to ascertain that the business model aligns with the three principles stated above. Below is a list of best practices to consider in carrying out such enhanced due diligence:

- Conduct a formal meeting with the responsible officer(s) of the broker company to seek to understand its business model and how it complies with the three principles;
- Ascertain the specific controls the broker company has established to ensure that its referrers are not carrying on unlicensed selling (e.g. no distribution of marketing material, no conducting sales illustrations, etc.);
- Visit the broker company’s offices regularly to assess whether its capacity and operation (and number and quality of technical representatives) can support the business it is submitting to the insurer;
- Obtain audited financial statements (and other financial metrics) from the broker company and ascertain whether its financial metrics are consistent with a business model aligned to the three principles (e.g. volume of commission income versus number of technical representatives);
- Obtain information on the broker company’s referral fee structure and amount to understand the proportion of commission received by the broker company and referral fee paid out to its referrers;
- Understand the type and number of referrers the broker company engages and how they perform due diligence on such referrers;
- Understand how much of the broker company’s business is sourced from MCV clients;
- Speak to technical representatives to understand how they work and provide quality advice;

- Understand the background and perform checks on ultimate controllers of the broker company;
- Conduct online search against the broker company to ascertain if there is adverse news or red flags indicating non-compliant practices; and
- Keep records and document findings on the above.

These are precisely the types of information that “business partners” would share and they can be disclosed under the auspices of a confidentiality agreement. Similarly, broker companies can (as part of assessing the insurer) seek to obtain the insurer’s audited financial statements.

Insurers should fully document their due diligence assessments of such broker companies and keep adequate records, for example, for the IA’s inspection to demonstrate compliance.

(b) Role and obligations

The respective roles and obligations of the insurer and the broker company in their business dealings should be established and documented, whether by way of written agreement or otherwise. As well as recording the relationship and indicating who is responsible for what roles (e.g. delivery of policies, handling of claims, delivery of renewal notices etc. and, also, of course to record the commission terms), this can also include audit clauses and obligations for the broker company to provide ongoing provision of information (such as audited financial statements) to allow the insurer to continue to assess the business model and the level of risk of accepting submissions through the broker company. Again, true “business partners” would be transparent about this information.

(c) Training

The insurer may consider offering training to the responsible officers and technical representatives of relevant broker companies which can focus on the three principles. In our inspections we have witnessed best practices, whereby insurers offer this type of training on an annual basis and take attendance. Completion of the training is taken into account on an annual basis, in deciding whether or not to continue accepting business from the broker company. As well as controlling conduct risk, this can assist with attainment of Continuing Professional Development hours.

(d) Periodic ongoing assessments

An insurer should periodically revisit its due diligence on the broker company (annually or longer periods can be considered, depending on the business volume produced) to ensure it is still comfortable with the business model being used by the broker company aligning with the three principles and the continued suitability of the broker company as a trusted business partner.

An insurer should monitor the submissions from the broker company for “red flags” where unlicensed referrers may be conducting regulated activities rather than the licensed technical

representatives of the broker company (for example, large volumes of submissions versus a small number of technical representatives, or a larger volume of submissions from a single technical representative in a short period).

Other best practices we have seen in the market include post-sales calls to clients to assess how the policy was sold (in terms of quality and compliance). For the same reason, mystery shopping is also another good practice to be employed and encouraged. Intelligence gathering, through monitoring of social media and obvious non-compliant practices (e.g. menus of unchecked rebates on offer, unofficial webinars on how to become a referrer). This type of information should be followed up on and, if necessary, self-reported to the IA.

Insurers should document their ongoing assessments and keep adequate records, for example, for the IA's inspection to demonstrate compliance.

(e) Commission structures

As stated in the main body of the circular, per GL15 and GL16 authorized insurers must ensure that their remuneration structures on long-term insurance products do not create misaligned incentives for intermediaries to engage in mis-selling and aggressive selling, but are aligned with the “treating customers fairly” principle.

The IA has observed in our conduct inspections that a number of authorized insurers take the “treating customers fairly” principle into account in commission on long term medical policies by structuring commission payments relatively evenly over a policy period to reflect the servicing that these types of policies entail. By contrast “following the market” appears to be the dominant consideration in designing commission structures for long term policies with savings and investment elements (particularly those falling within the scope of GL16), which has resulted in commission being skewed to the first year of the policy (not just for insurance broker companies but also for insurance agents), with apparently limited consideration being given to ongoing servicing needs to policy holders in terms of premium collection, answering questions or giving explanations on annual statements, changes of beneficiaries or policy ownership, making claims and accessing benefits under the policy etc. This seems to create the heightened conduct risk of over-prioritizing new sales at the expense of servicing existing insurance policies.

Since the level of upfront commission has also been an enabler for the level of referral fees and prohibited rebates that characterize the non-compliant business model cited in this circular, these are matters to which we shall be giving increasing focus in our supervision of long-term authorized insurers going forward in seeking to ascertain how they justify alignment of their distribution remuneration with the “treating customers fairly” principle. We expect long-term authorized insurers to be able to justify based on appropriate documented analysis, how their remuneration structures for insurance intermediaries are fair, equitable and reasonable in terms of promoting the interests of policy holders (in obtaining impartial and objective advice and ongoing servicing from insurance intermediaries in respect of insurance policies which deliver the positive policy holder outcomes for which policy holders are paying and which address

their circumstances) whilst providing fair and balanced (and not aggressive) remuneration to insurance intermediaries.

From time to time, we also get asked by insurers whether the circular dated 10 April 2006 which outlined certain principles on remuneration offered by insurers to licensed insurance broker companies is still applicable. The answer is, it is. Licensed insurance broker companies represent and serve as agents of policy holders and the basics of agency law apply to this. Accordingly, to quote that circular: *“any incentive or inducement provided by an insurer to seek to influence an insurance broker to place more business with it would jeopardise the independence of the insurance broker and is a serious market conduct issue. These prohibited practices include specifically (but not limited to) an insurer entering into a contract or agreement (exclusive or otherwise) with a view to inducing an insurance broker to place business with it by offering commission level based on volume or requiring an insurance broker to meet certain annual business target.”* Insurers should keep this in view, when setting commission structures for broker companies (and not seek to circumvent the principles in the quoted circular with levels of commission or allowances tied to volume/meeting annual business targets).