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Latest Revision of the HK SFC Code of Conduct

A discussion on the proposed amendments to the HK SFC Code of Conduct (the “Code”) and implications following the release of a recent consultation conclusion from the HK SFC on 16 November 2017.

Background

On 16 November 2017, the HK SFC released the Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts (the “Consultation Conclusions”). The Consultation Conclusions can be viewed at:

<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=16CP5>.

Despite the focus of the Consultation Conclusions is on amendments to the Fund Manager Code of Conduct which we covered in our last issue of CP Insights, it also stipulated amendments to Paragraph 1 (Interpretation and application), Paragraph 8.3 (Disclosure of monetary and non-monetary benefits), Paragraph 8.3A (Disclosure of transaction related information), Paragraph 10 (Conflicts of interest) and Schedule 9 (Disclosure statement in respect of an intermediary’s independent status) of the Code which will become effective on 17 September 2018.

This article aims to discuss the main proposed changes to the Code and their implications to industry practitioners especially investment product distributors.

Application of the Code

Prior to the revision of the Code, Paragraph 1.4 described the Code does not apply to the licensed or registered person who acts in the capacity of a management company in relation to the discretionary management of collective investment schemes and they shall be subject to the Fund Manager Code of Conduct.

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Under the regulatory regime of the revised Code, HK SFC has deleted the relevant paragraph and has extended the coverage of the Code to the abovementioned licensed and registered persons.

Implication:

While most Fund Managers also try to meet the requirements as set out in the Fund Manager Code of Conduct and the Code, Fund Managers cannot use Paragraph 1.4 of the Code as defense for non-compliance in provisions of the Code.

1. Restriction on the use of the term “independence” by investment product distributors

After the global financial crisis, regulatory bodies around the world keep strengthening their rules and policies to increase the transparency so as to better address the inherent conflict of interest. The HK SFC is mindful about the international standard and has proposed two-pronged approach to lift its standard in addressing the issue of potential conflict of interest in the sale of investment products. One of the approaches is to govern the use of the term “independence”.

(a) Links or other legal or economic relationships

From the Consultation Conclusions, HK SFC revised Paragraph 10.2 (b) of the Code, adding the word “close” in front of the word “links”, stating that “if a licensed or registered person wants to represent itself as being independent when distributing any investment products, it should not have any close links or other legal or economic relationships with the product issuer”.

Implication:

Under the revised regime, intermediaries should ensure they do not have any close links or other legal or economic relationships with product issuer before they use the term independent to represent themselves. It is targeted to some existing financial advisers with title of “Independent Financial Adviser” but subject to remuneration received from product issuers. The HK SFC is concerned whether such links or other legal or economic relationships will impair the independence of the intermediary that the intermediary may favour a particular investment product or product issuers. While intermediaries should understand that the assessment of independence is principles-based and is dependent on the facts and circumstances of the links or other legal or economic relationship.

(b) Disclosure of non-independence

With the revision of the concept of “independence” to the Code, an intermediary is required to provide clear disclosure even if it claims non-independence. The licensed or registered person

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should deliver the following disclosure to the client **prior to or at the point of entering** into the transaction:

“We are NOT an independent intermediary because:

1. we receive fees, commissions, or other monetary benefits from other parties (which may include product issuers) in relation to our distribution of investment products to you. For details, you should refer to our disclosure on monetary benefits which we are required to deliver to you prior to or at the point of entering into any transaction in investment products;

and/or

2. we receive non-monetary benefits from other parties, or have close links or other legal or economic relationships with issuers of products that we may distribute to you.”

Implication:

Under the regulatory regime of the revised Code, an intermediary is required to provide clear disclosure of whether or not it is independent and the bases for such determination. Disclosure of the status and reason for non-independency allows investors to understand why an intermediary is not independent when deciding whether to engage the services of the intermediary.

It is optional for the Intermediaries to decide whether to provide a description of the close links or other legal or economic relationships with product issuers which render them non-independent.

(2) Enhancing disclosure by investment product distributors

Another approach that HK SFC adopted to further address the issue of inherent conflict of interest is to enhance the disclosure arrangement.

(a) Disclosure of transaction related information

The HK SFC clarifies that in regards to the disclosure of transaction related information, including the disclosure of independence/non-independence, a One-off Disclosure is acceptable.

Where there are subsequent changes to the One-off Disclosure, either (1) an updated One-off Disclosure, or (2) individual disclosure for each transaction where the information for which deviates from the information in the One-off Disclosure, must be provided to the client prior to or at the point of entering into a transaction.

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Implication:

The proposal is to make, at a minimum, a one-off disclosure prior to or at the point of entering into a transaction, but intermediaries must inform clients of any changes. The disclosure of the changes could take the form of an update, or a specific disclosure for each transaction where there is a change from the one-off disclosure.

(b) Receipt of monetary benefits

The terms “non-monetary” has been removed under Paragraph 10.2 (a) of the revised Code, stating that to claim independence when distributing an investment product, an intermediary should not receive fees, commissions, or any monetary benefits, paid or provided (whether directly or indirectly) by any party in relation to the distribution of the investment product.

Implication:

The HK SFC is in the view that any fees, commissions or monetary benefits received by a distributor may give rise to potential conflict of interest which in turns may undermine the independence of the distributor. For instance, if a distributor is remunerated for selling a particular issuer’s product, HK SFC will consider such arrangement as likely to undermine independence. As a result, distributor under such arrangement cannot claim itself as being independent.

(c) Receipt of non-monetary benefits

Under the revised Code of Conduct regime, Paragraph 10.2 (b) has been revised to include also the “non-monetary benefits”, if an intermediary wants to represent itself as being independent, it should not have received any non-monetary benefits from any party.

Implication:

Under the revision, the HK SFC stressed on the fact that the whether non-monetary benefits would render an intermediary “non-independent” would depend on whether the non-monetary benefits are likely to induce the intermediary to favour a particular investment product or product issuer and hence impairing their independence. Intermediary would need to pay attention on it.

(d) Other changes

Currently, only disclosure of received monetary benefits are required to be disclosed by the intermediaries. Under the revised Code, both monetary benefits received and receivable prior to

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or at the point of entering into a transaction must be disclosed. The HK SFC has provided separate terms for quantifiable and non-quantifiable monetary benefits in Paragraph 8.3 Part A of the Code.

For monetary benefits received or receivable from a product issuer (directly or indirectly) for distributing an investment product that are not quantifiable prior to or at the point of entering into a transaction, the intermediary should disclose the existence and nature of such monetary benefits and the maximum percentage of such monetary benefits, and the maximum percentage of such monetary benefits receivable per year. This disclosure should be made on a transaction basis.

Implication:

The HK SFC has enhanced the disclosure requirement to enable investors to make better informed decisions and increase transparency to detect potential conflicts of interest. The increase in coverage and further classification of benefits inevitably renders the rules more complicated and onerous to comply. Intermediaries should pay close attention when engaging in point-of-sale transactions.

Conclusion

Amendments to the revised Code mainly aim to enhance point-of-sale transparency and to better address the potential conflicts of interest in the sale of investment products by adopting a two-pronged approach:

- (a) governing the conduct of intermediaries when representing themselves as “independent” or as providing “independent advice”; and
- (b) enhancing the disclosure of monetary benefits received or receivable that are not quantifiable prior to or at the point of entering into a transaction.

Intermediaries should note that the amendments to the Code will become effective 9 months (instead of the 12 months for Revised Fund Manager Code of Conduct) from gazettal.

Therefore, intermediaries shall start determining the form of disclosure, the marketing and client onboarding procedures and related documents preparation e.g. client agreement to see how to incorporate the above requirements as appropriate.

CompliancePlus will continue to keep in view any updates from the HK SFC with regards to the present Consultation Conclusions.

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If you have any further questions regarding this issue of CP insights or have any topic you would like us to cover, please submit your response here <https://goo.gl/forms/gDLVThTmxGvMI4r12>.

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