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Submission to Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms

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Executive Summary

The Securities and Futures Commission (the “**SFC**” or “**Commission**”) has issued a Consultation Paper on proposed Guidelines on Online Distribution and Advisory Platforms (the “**Consultation Paper**”) on 5 May 2017.

This submission is made in response to the Consultation Paper with our comments and suggestions set out below. Terms defined or given a particular construction in the Consultation Paper have the same meaning in this Response unless a contrary indication appears.

We appreciated the SFC’s intention of preparing the Proposed Guidelines to offer guidance to the Platform Operators in light of recent development of online sales platform. Still, there are several areas of improvement required on the Proposed Guidelines as elaborated below.

Differences between the online and offline sales processes

- 1. Do you agree with the factors relevant to online platforms identified above?
Please explain your view.*

It is noted that 3 factors relevant to online platforms were identified in Section II of the Consultation Paper, which include the lack of human interaction, a greater influence on customers as opposed to offline investment companies and the issue of questionable appropriateness or suitability of investment products listed on online platforms.

Under the assumption that the relevant factors are justifications for the SFC to implement regulations on online platforms, we are of the view that the first two factors are appropriate justifications that online platforms shall be subject to additional regulatory requirements.

The lack of human interaction indicates that additional procedures and mechanisms should be put in place for online platforms to replace the human element in securing appropriateness of investment advice and distribution.

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Further, the fact that online platforms having a greater impact on customers who wholly rely on materials made available on them for investment products suggests that additional regulations should be implemented.

However, we do not entirely agree with the third factor. Under offline sales environment, investors can also gain access to information of various investment products through the prospectuses and fund factsheets under some physical retail bank branches, instead of merely through the representative recommendation.

Nevertheless, investors should be aware that only a limited number of investment products would be provided on Online Platforms, due to the fact that various factors influence the provision of information to investors, which include advertisements of the product at the platform, as well as personal preferences and investment knowledge of the particular investor.

Therefore, we believe that the Proposed Guidelines should not focus on Factor 3. Rather, the Proposed Guidelines should emphasize the suitability requirements when the relevant obligation is triggered by the Platform Operators.

2. Are there any factors that the SFC has not identified? Are these covered by existing conduct requirements? If not, do you have any suggestions about how they can be addressed through specific requirements? Please explain your view.

We believe that threats to cybersecurity and data protection posed by online investment platforms constitute an important factor that should be taken into account in the formulation of regulations.

While the relevant Circulars issued by the SFC has addressed relevant cybersecurity issues such as the Circular to Licensed Corporations - Mitigating Cybersecurity Risks, the SFC should also consider the particular cybersecurity risk arising from the inherent weaknesses of online platform systems.

We recommend the SFC to recognize such risks based on paragraph 33 of the Consultation Paper.

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Yet, Section II of the Consultation Paper did not highlight it as a major difference between online and offline sales processes when it in fact is a major one with significant implications on tailored regulations, given that, unlike offline platforms, online platforms base its operation wholly online. Therefore, we recommend putting stronger emphasis with details on the aspects of cyber security and data protection rather than just briefly mentioning it.

The SFC should also require online platform operators to secure insurance coverage to offer protection to investors if they suffer any loss. It has to be noted that there may not be a fair term on investor protections in cybersecurity incident as all the related terms are standard and are widely drafted in favor of online platform operators.

Another key factor not identified by the SFC is the connection and linkage of online platform services to other online financial facilities or services such as online bank accounts, online financing and lending services that transactions can be completed swiftly that investors may easily make impulsive and not well-thought investment decisions online.

To address this issue, the SFC can require online platform operators to provide clear “Message Box”, “Pop-up warning” or “Confirmation” buttons for investors to accept and acknowledge investment risks before completion of transactions.

With the assistance of online technology, online platform operators should provide real-time and well-designed investment tools or gain/loss impact calculations/ analyses to facilitate investors to make informed and well-thought investment decisions that may not be easily or swiftly done in offline environment.

Proposed Guidelines

A. Core Principles for the operation of online platforms

- 3. Do you have any comments on the Core Principles in the Proposed Guidelines as outlined above? Are there any other areas which you think the Proposed Guidelines should cover? Please explain your view.*

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Whilst it would be impractical for the SFC to list out every detail or step to be followed by guideline users in operating their robo-advisor platforms, we suggest further elaborations as below:

Core Principle 2: Information for Clients

The Core Principle as mentioned in the Proposed Guidelines is appropriate and in line with existing international regulatory standard. Yet, in order to further ensure the investors can make informed decisions when choosing Platform Operators, we suggest the Proposed Guidelines to require Platform Operators to consider the timing of disclosure.

In particular, for the requirements as stated in paragraph 2.3 (v), we recommend the Platform Operators should disclose the scope and limitation of services such as asset classes of the products provided, whether rebalancing or discretionary trading services are in place for robo-advisors, before investors signing up, where applicable.

It also helps to protect investors' privacy for any unnecessary personal information to be disclosed to the Platform Operators during the sign up process when the investors finally did not make investment through the corresponding platform. This is similar as the requirements set up in IM Guidance Update No. 2017-02 issued by the U.S. SEC.

Core Principle 3: Risk Management

As identified in Response 2 above, cybersecurity is a real concern in the usage of online investment platforms.

In paragraph 2.4 of the Proposed Guidelines it is suggested that "a Platform Operator should ensure the reliability and security of its online platform" and it has to do so by testing before deployment and regularly reviewing the platform given in Note (i) under paragraph 2.4, but it is ambiguous as to how regular should the review take place and how should a platform operator define its platform as "reliable" and "secure" while the SFC's standards are also unclear.

In particular, when the Proposed Guidelines also require the Platform Operators to ensure system reliability, we believe the SFC also has responsibility to mitigate the

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risk of system unreliability of the Platform Operators during the licensing stage. Rather than raising questions to check the internal policies or requesting the Platform Operators to confirm that they need to comply with the Proposed Guidelines, the SFC can take a further step to run a mock system test to further ensure the system reliability or requesting them to provide the system test results.

Core Principle 4: Governance, Capabilities and Resources

In order to ensure compliance with the SFC's guidelines and reliability of all online platforms, we agree that it is necessary for platform operators to publish and implement their own internal policies. We hereby suggest a refinement to note (i) under paragraph 2.5 of the Proposed Guidelines by requiring "the responsible officer or executive officer responsible" stated therein to be "a competent person who has sufficient knowledge or experience regarding the operation of online investment platforms," so that the overall management and supervision of the platforms could be more sensibly assured and efficient.

B. Robo-advice

4. *Are there any other areas relating to robo-advice which you think the Proposed Guidelines should cover? Please explain your view.*

The Proposed Guidelines have covered most critical areas of robo-advisors, but we would like to raise some potential issues and areas of robo-advisors that the SFC should consider them when preparing the Proposed Guidelines.

The first issue is proper and best trade execution. It is not enough for the robo-advisors to merely comply with paragraph 18 (Electronic Trading) of and Schedule 7 to the SFC Code of Conduct for the robo-advisors with discretion over clients' accounts when carrying Type 1 regulated activity. Proper order management including fair allocation and order execution should also be ensured to meet the investors' interests.

The second issue is the distressed arrangement. When the market is experiencing volatility, some robo-advisors will have its own practices to address this. For example, some robo-advisors will simply suspend trading during the Brexit times.

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Whatever which tools to be used, robo-advisors should also disclose such arrangement to the investors before entering into service arrangement to ensure the investors to make informed decisions when choosing robo-advisors and understanding the relevant risks of such arrangement.

5. *What are your views on the shortcomings of robo-advice? How can the Proposed Guidelines be further enhanced to address these issues?*

We believe robo-advisors have 3 major shortcomings when compared with human financial advisors.

Firstly, robo-advisors may not understand clients' financial circumstances and objectives as comprehensively as traditional human advisors do, and thus being less capable of giving the most suitable investment advice (Ramnani, 2015).

This shows the importance of investment questionnaire design of the robo-advisors. Despite paragraphs 4.5 to 4.7 stressed the robo-advisors need to ensure proper design of the client profiling questionnaire, the SFC should further provide further guidance to facilitate implementation, which may include types of information to be obtained, design of scoring system, and also requirement of plain language to be used in the questionnaire.

Secondly, certain robo-advisors, especially fully automated ones, generally relies on algorithms. These algorithms help robo-advisors to offer advice based on various assumptions such as the generally accepted investment theories or past investment history.

When the market movement is difficult to be predicted, the algorithms may not work accurately as time goes by. Therefore, the robo-advisors need to consider the reasonableness and appropriateness of algorithms. The SFC has addressed this issue under paragraphs 4.2, 4.8, 4.9 and 4.13, but some of them may require updates and revision.

In particular, the term "suitably qualified person" is not appropriate to be incorporated in paragraph 4.9 (d), (e) and (g) as various parties should also take the responsibility

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to test the reasonableness and appropriateness of the algorithms, which are listed below:

- (i) Technician or the system developer: He/ she should ensure the program is running properly without program errors;
- (ii) Investment Managers/ Advisors: He/ she should ensure the assumptions in algorithms are not contradictory with current market situation by running mock tests; and
- (iii) Compliance personnel: He/ she should challenge the reasonableness of the algorithms by raising queries to the Investment Managers and check whether it fulfills the relevant requirements and guidelines such as this Proposed Guidelines.

Due to the diversified requirements for different personnel as demonstrated above, we suggest the SFC to further elaborate the requirements enlisted under paragraph 4.9 rather than using the single term “suitably qualified person” as this term by itself does not bear any guidance value to industry participants. Further, we believe that the responsibility of testing and control of algorithms should be clearly defined.

Thirdly, cybersecurity and data protection is another shortcoming of robo-advisors as most of the sensitive client information is stored online or even in cloud systems. This will increase the risk of data leakage in absence of appropriate safeguard measures.

The Proposed Guidelines attempted to cover cybersecurity and data protection issues, but we suggest the SFC to consider any particular controls are required to be incorporated by the robo-advisors such as data encryption, cybersecurity insurance, indemnification to investors, disclosure and notifications to investors of any related cybersecurity incidents.

C. Application and discharge of the Suitability Requirement in the online context

6. *Do you have any comments on the guidance on the Suitability Requirement to be provided in the Proposed Guidelines?*

We agree to the guidance on suitability requirement as provided in the Proposed Guidelines, which is in line with the existing guidelines in determining whether there is recommendation or solicitation which triggers the suitability requirement pursuant to paragraph 5.2 of the Code of Conduct.

7. *Do you have any comments on how the design and overall impression created by an online platform's content could trigger the Suitability Requirement?*

Despite paragraph 5.2 of the Code of Conduct being equally applicable for online and offline platforms, given the difference in nature and the manner of which information is presented to investors such as with “pop up message” and “click” icons, we agree that it is easier for online platforms to give an impression of making recommendations or solicitations which trigger suitability requirement.

As illustrated in the *Circular to Intermediaries – Frequently Asked Questions on Triggering of Suitability Obligations* dated 23 December 2016, in determining whether the acts on the part of licensed or registered persons amount to making of recommendation or solicitation, it is largely a question of fact, taking into account the communications with clients and the environment in which the acts are performed.

As the assessment is to be made on the point of sale of advice, suitability obligations may not be triggered even when materials like research reports and marketing materials are provided to investors.

Nevertheless, this circular may not be entirely applicable to online platforms where there is lack of human involvements and absence of a distinguishable point of sale or advice process. One can only look at the information that are available to investors on the platform to determine objectively whether such materials or information constitute recommendation or solicitation to investors in general.

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We are of the view that the design and overall impression created by an online platform's content would logically be regarded as a point of sale or advice process, thus it is correct that all posting of materials that are not factual, fair or balanced on online platforms shall trigger suitability requirement.

8. Do you have any comments on the above examples of when the posting of materials on online platforms would or would not amount to a solicitation or recommendation?

We agree with the examples of when the posting of materials on online platforms would or would not amount to a solicitation or recommendation.

9. Are there any examples not mentioned above that may suggest that the content or presentation of materials would amount to a solicitation or recommendation? Please explain your view.

For the examples of which suitability requirement is triggered, we suggest that the Commission could mention the advertisements or materials which promote the performance of investment products and those that include contents such as recommendations by other users or investors.

In case of updates to the examples or the main elements of the suitability requirement, we urge the Commission to keep the industry notified about the updates through issuance of circulars and FAQs which outline the key rationale of the regulatory regime.

10. Do you have any view on how risk analysis assessments and client profiling should be conducted and the quantitative and qualitative factors that any risk methodology should take into account?

For client profiling, the SFC should consider the factors as explained in Response 5.

For risk analysis assessments of product offered to investors, the Proposed Guidelines should mention that Platform Operators should ensure the following factors are considered when assessing the risk scoring of the product:

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- (i) The standard deviation of the product price;
- (ii) Asset class of investment product (derivative or non-derivative);
- (iii) Credit rating of product;
- (iv) Whether margin financing arrangement applies; and
- (v) Liquidity of the product.

We would like to emphasize that the above factors are non-exhaustive and the SFC should update it from time to time as appropriate.

D. Sale of complex products on online platforms on an unsolicited basis

11. Do you have any comments on the definition of a complex product, and the considerations that should be taken into account in determining whether a product is complex?

When it is difficult to draw a clear line between complex products and non-complex products by local regulator's own effort, we believe that it is appropriate to adopt the IOSCO's definition so as to align with international regulatory standards.

In particular, the factors mentioned in paragraph 104 of the Consultation Paper meet IOSCO's definition. Therefore, we do not oppose the suggestion that consideration shall be taken into account in determining whether a product is complex.

However, please note that the SFC should consider the nature of product on a totality of fact basis instead of simple "checkbox" approach towards the factors as mentioned in paragraph 104.

We also want to draw the SFC's attention that while the risk classifications of complex and non-complex products are important and part of the consultation focus of this consultation paper, the SFC should pay attention to the offer of financial services that are not in products form online.

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For example, the online platforms can offer financial services that are not in products form such as financing, margin, securities lending or borrowing and other facilities that also demand for investors' protections.

The SFC should demand Online Platform operators to show clear and prominent messages such as "pop up box" and "acceptance" button for investors to click or to accept or to acknowledge that whether they realise that any such services are offered and by whom and whether any linkage or connection to bank accounts of the investors or any online payment or online financing or facilities are to be triggered or used.

12. Do you have any comments on the list of investment products that are considered to be "non-complex"?

Based on the definition of "complex product" under IOSCO and factors to be considered as "complex product" as proposed in paragraph 104 of Consultation Paper, we believe it is inappropriate to classify SFC-authorized REITs and other SFC-authorized funds without FDIs for investment or non-hedging purposes as "non-complex products".

In Hong Kong, SFC-authorized REITs only include the REITs listed in the HKEx. We recommend the SFC to additionally include REITs listed in overseas stock exchange market and other authorized funds overseas without FDIs for investment or non-hedging purposes with information available in English and Chinese languages.

Whilst these authorized products overseas have similar product nature with SFC-authorized products with sufficient liquidity and transparency as required by the overseas stock exchange and securities authorities with the languages that are commonly understandable by Hong Kong retail investors, they should be considered as "non-complex product" based on the consideration of "complex product" under paragraph 104 of Consultation Paper.

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13. Do you have any comments on the list of examples of investment products that are considered to be “complex”? Please explain your view.

Based on the definition of “complex product” under IOSCO and factors to be considered as “complex product” as proposed in paragraph 104 of Consultation Paper, we believe the coverage of “complex product” is sufficient enough. However, to have a clearer identification of “complex product”, we suggest the SFC to include the products as listed below.

Name of Proposed Complex Product	Description*
Swaps	A swap is a derivative contract through which two parties exchange financial instruments.
Forwards	A forward contract is a customized contract between two parties to buy or sell an asset at a specified price on a future date.
Hybrid Securities	A single financial security that combines two or more different financial instruments.
Contract for differences	A contract for differences is an arrangement made in a futures contract whereby differences in settlement are made through cash payments, rather than by the delivery of physical goods or securities.

*Note: The description offered is based on Investopedia and is a general idea of the above proposed complex products.

In addition, from Response 12 above, we believed not all of the collective investment schemes not authorized by the SFC should be treated as “complex products”. The SFC should not consider overseas authorized funds without FDIs for investment or non-hedging purposes as “complex products”.

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14. In the online environment, do you think that risks arising from the sale of complex products should be addressed by requiring Platform Operators to ensure transactions in complex products are suitable for clients? Please explain your view.

We agree that complex products involve higher risks that may bring harm to investors if they are not aware of such risks.

In addition, we understand that because the retail clients may not have sufficient knowledge on these complex products. Compared with non-complex products, mere disclosure of fair, factual and balanced information of the complex products are normally insufficient for retail investors to make well informed and suitable investment judgment based on their own financial situations and client profile.

Therefore, we agree that the Platform Operators need to ensure product suitability of complex products for clients even the information they posted is fair, factual and balanced.

15. As the SFC's concern arises from the sale of complex products, do you agree that the same requirement to ensure suitability should also apply to offline sales of complex products? Please explain your view.

We believe the same requirement to ensure suitability should not be applied to offline sales of complex product due to the inherence difference in nature between online and offline sales processes.

For online sales process of complex products, there is a risk of selling unsuitable complex products to retail investors due to lack of relevant knowledge and investors solely relying on the materials posted online when making investment decisions. Therefore, more due care should be exercised by advisers/ sellers in online sales environment.

However, it is unusual for investors to solely rely on the factual, fair and balanced information of complex products in making investment decisions. Under offline environment, retail investors will generally seek financial advisors' opinions when they are aware of the relevant information of "complex product".

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Alternatively, the retail investors will normally be aware of particular complex product from the recommendation from the financial advisors.

Therefore, we believe the offline sales suitability of complex product should be consistent with the relevant requirements in the Circular to Intermediaries - Frequently Asked Questions on Triggering of Suitability Obligations. It means only direct client communication for the complex product involved will trigger the suitability requirements.

16. Are there any other additional or alternative protective measures that should be introduced for the sale of complex products online?

The SFC should consider requiring the online platforms to provide information below to the investors PRIOR to the completion of the online sale of complex products to facilitate investors making informed investment decisions:

- Gain/loss impact analysis
- Risks analysis
- Scenario analysis

17. Are there any types of investment products (e.g., accumulators) that should not be made available on online platforms even where the Platform Operator is required to ensure suitability?

We believe that there is no reason for Platform Operator to be restricted from selling any particular investment products.

As suggested from the Consultation Paper and the Proposed Guidelines, extra protection will be required from the Platform Operators in achieving investor protection in the online environment. Given the enhanced regime in strengthening the regulatory regime for online platforms, we do not see any necessity in imposing restrictions to the scope of business that Platform Operators may perform.

Products like accumulators had raised public attention due to the lack of sufficient and appropriate investor protection from authorities in the past, which is no longer a major issue in the present times. We believe that as long as financial intermediaries have

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endeavored to ensure product suitability, sales of these similar products should be allowed given that the regulatory requirements have been adequately complied with.

Another measure is client segmentation that certain classes of investors can be allowed to have access to complex products

18. Do you think the items of minimum information set out in Appendix 4 are sufficient and appropriate? Please explain your view.

We agree with the information set out in Appendix 4 of the Consultation Paper is appropriate in terms of information disclosure to the investors. However, this will increase the presentation burden of some Platform Operator when they have a large number of complex products to be distributed.

Therefore, such minimum information disclosure requirement should be lied on Product issuers. Third party product distributors only need to ensure the disclosure requirements of Product issuers meet the requirements as set in Proposed Guidelines.

19. Do you have any comments on the proposed warning statements set out in Appendix 4 that should be made on an online platform?

According to Paragraphs 104 and 105 of the Consultation Paper, the characteristics of “complex products” include difficult to understand the product nature and risk of losing more than amount invested. In particular, when the corresponding guideline will cover the complex product to be sold in retail market, the standard of warning statement should be referred to the relevant standard.

Therefore, we believe the warning statements as stated in Appendix 4 are not enough to address the above.

Refer to current Advertising Guidelines Applicable to Collective Investment Schemes Authorized under the Product Codes as issued by the SFC, we believe the warning statements should also include:

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- the offering document should be read for further details including the risk factors of the complex product; and
- you may lose more than the amount you invested

In addition, the SFC should require online platform operators to provide a gain/loss or risk impact analyses to investors before they make investment decisions. Merely showing warning statements do not facilitate investors making informed investment decisions.

Implementation timeline

20. Do you think a 12-month transition period is appropriate? If not, what do you think would be an appropriate transition period? Please set out your reasons.

We believe 12-month transition period is appropriate. However, the SFC needs to ensure guidance shall be provided to licensed intermediaries at earlier stages, preferably after issuance of the conclusions to this Consultation Paper, to keep the industry informed with the updates and be better prepared for the relevant operation transitional arrangements, by issuance of circulars, guidelines and Frequently Asked Questions and organizing briefings to provide implementation directions such as system restructuring of the platform operators and robo advisors.

Conclusion

To conclude, the SFC should consider the relevant factors as mentioned above in particular the Suitability requirements for complex product and non-complex product under online sales environment and pay attention to online platform operators to offer financial services that are not in products as that may be loopholes of the Proposed Guidelines.

The SFC may need to keep track development of other countries' regulation and guidance towards the Platform Operators like Australia and the United States to catch up with rapid growth and fast paced development of online distributions and advisory platforms relating to financial services and products.

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