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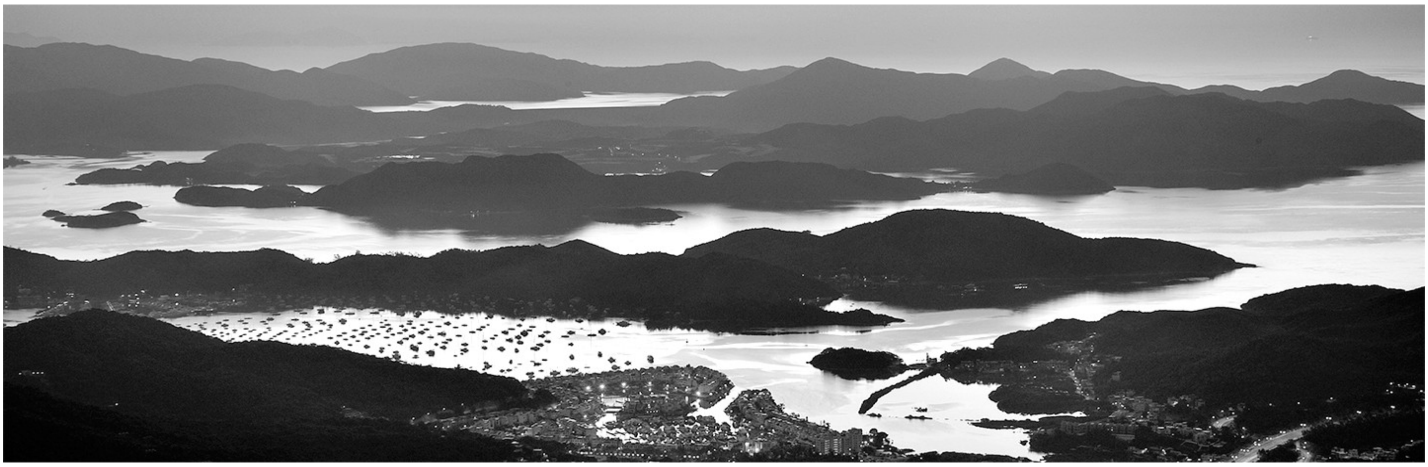

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New Report Sets Out Proposals to Boost Hong Kong as a Fund Distribution Centre

Introduction

The Financial Services Development Council (**FSDC**) published a paper entitled 'Strengthening Hong Kong as a Retail Fund Distribution Centre'[1] in December 2015. The objectives of the paper are for Hong Kong to become the leading fund distribution centre in the Asia Pacific Region in the medium term, and globally in the longer term. There are various challenges to this objective which the paper seeks to address.

There are many opportunities for the expansion of Hong Kong's financial services sector by virtue of its location in the Asia-Pacific region. It is anticipated that there will be new and substantial money flows into Asian capital markets, which will be boosted by the increased internationalisation of the Renminbi. It is expected that assets under management will grow faster in Asia than in the developed world over the next ten years, propelled by a shift in economic power to the East, growing pension funds and an increasing percentage of High Net Worth Individuals living in Asia. Given technological developments and innovation, Hong Kong also has the opportunity to develop a highly efficient, customer needs focused and regulatory compliant industry.

In order for Hong Kong to position itself as a leading regional fund distribution centre, it must address various obstacles. In comparison to other global markets, Hong Kong's fund distribution channels are highly concentrated in a small number of banks in the banking sector. With a market size of 7 million people, Hong Kong must rely on overseas investors, which in 2014 constituted 70% of Hong Kong's fund sales. Current industry practice concerning taking on new clients (on-boarding) is unnecessarily burdensome and costly, thereby discouraging investors. This includes the industry's face-to-face identification requirement, which has resulted in online fund platforms being slow to take-off in Hong Kong. There are also major inefficiencies in the financial service industry's Know Your Client (**KYC**) and Anti-Money Laundering (**AML**) procedures, with significant costs incurred by financial institutions building their own systems and processes.

The FSDC has made four recommendations: encouraging the diversification of fund distribution and innovation, issuing additional guidance on suitability requirements, streamlining the KYC process, and developing and participating in new cross-border initiatives. These recommendations are discussed in detail below.

Recent Market Developments and Positioning of Hong Kong

In the latest Global Financial Centres Index survey, Hong Kong was ranked third in terms of competitiveness for its asset management after New York and London. As at December 2014, Hong Kong's total fund management business was USD 2.3 trillion, the highest on record. Hong Kong's strength as a fund management centre is intimately linked to its reputation as a strong adherent to the rule of law and its effective regulatory system, as well as its geographic location and close relationship with China. Hong Kong's growth has also been propelled by

1 Financial Services Development Council, 'Strengthening Hong Kong as a Retail Fund Distribution Centre', FSDC Paper No. 19, December 2015, http://www.fsdc.org.hk/sites/default/files/Fund%20Paper%20-%20Eng-No.19.pdf.

both Mainland China's and Hong Kong's regulatory authorities' policy initiatives aimed towards the liberalisation of China's financial market.

Initiatives Relating to Mainland China

The liberalisation of China's capital market has facilitated Hong Kong's growth in the asset management industry. Excluding Mainland China, Hong Kong is the world's leading provider of RMB products, which has significantly contributed towards the growth of its fund management business. There have been various unilateral and bilateral initiatives which have facilitated and encouraged investment between Hong Kong and Mainland China. In particular, the Mainland and Hong Kong Mutual Recognition of Funds Scheme (**MRF**), which was implemented on 1 July 2015, is considered to be a significant breakthrough for the funds industry. Under the MRF, Hong Kong funds can now be sold into China and vice versa. The MRF provides a building block for increased financial and regulatory ties between the two jurisdictions, resulting in further integration of their asset management industries. Under the MRF, the China Securities Regulatory Commission (**CSRC**) and Hong Kong's Securities and Futures Commission (**SFC**) authorise Mainland and Hong Kong funds that meet the eligibility requirements to be subject to a streamlined authorised process for offering to retail investors in each other's market. The MRF allows investors to choose from a greater diversity of fund investment products, and increases the business opportunities for the financial services industry in Hong Kong. It is expected that as a result of the MRF initiative, Hong Kong's position as a domicile, investment management, distribution and sales centre for the asset management business will rapidly expand.

Other Initiatives Relating to Passporting of Funds

The Asian wealth management industry outside of China will continue to expand, and this will be facilitated by initiatives such as the ASEAN Framework for Cross-Border Offering of Funds, as well as the Asian Regional Fund Passport (**ARFP**). The ARFP permits mutual funds established and regulated in one member state to be offered to investors in other member states. Although Hong Kong is not yet an ARFP signatory, it is expected that it will consider participating in the future.

The FSDC recommends that the Hong Kong government should continue to develop new cross-border initiatives so as to expand Hong Kong's fund distribution business in Asia. The initial focus should be on the development and expansion of the MRF in order to ensure that Hong Kong is the preferred location for fund managers both selling investments in China and distributing funds from China. In the long term, Hong Kong should also aim to become a fund distribution gateway for the rest of Asia, for example by participating in the development of the ARFP.

Fund Distribution Landscape

Hong Kong Fund Distribution Landscape

The banking sector dominates fund distribution in Hong Kong, distributing 78% of retail funds. While insurance companies, e-platforms, fund of funds and master trusts make up 19% of the fund distribution market, brokers, agents, independent financial advisors and distribution companies make up the remaining 3%.

A major advantage of the market dominance of banks has been the banks' substantial investment in developing user-friendly and regulatory compliant distribution platforms. However, this market dominance has enabled banks to control both the fees and the type and range of products available to investors.

Under the current system, managers are charged high fees by distributors, while new market entrants face high entry barriers and major difficulties in developing new distribution channels. Investors have limited means of comparing competing funds, are subject to a limited product range and face opaque cost structures. There is also an issue that distributors are incentivised by asset managers so that their interest may not always be aligned to that of investors when providing advice.

The FSDC considers that there should be a greater diversification of distribution channels in Hong Kong so as to decrease dependency on the banks, and greater regulatory clarity as to how the suitability requirements are expected to be implemented across different distribution channels.

Comparison with Other Markets

The level of concentration and principal distribution channels in funds management vary across Asia. In China, on-line fund platforms have changed the distribution landscape. For example, Ali Baba Group started Yu'e Bao in June 2013, which automatically invests in the Tianhong Zengliabo Money Management Fund. The fund grew from the then 50th largest asset manager in China to the now largest in China. Other companies have launched similar services following Yu'e Bao's success.

Emerging Trends in Fund Distribution Channels

Technological developments have allowed disruptors to challenge the status quo and increase competition to meet the needs of investors. Demand for investment products has increased with Asia's growing middle class requiring more retail investment products and the ageing populations of advanced countries (including Hong Kong) requiring more post-retirement products and investment solutions. An increasing portion of the population has grown up with modern technology and the internet, and the asset management industry, including advisors and distributors, must service this investor base through modern technologies.

Online Fund Platforms

Fund platforms are internet-based services used by intermediaries to view and administer investments. These fund platforms generally provide various tools which allow advisers and clients to view and analyse portfolios. Fund platforms arrange transactions and may arrange custody for clients' assets. Investment managers generally pay fund platforms rebates in exchange for the right to list their products on a platform.

New entrants include non-financial intermediaries who provide online fund platforms which sell fund products. These non-financial intermediaries have grown significantly over the past year, although they started from a low point. Companies with a strong online presence, such as Ali Baba, have used their reputation in distributing commercial goods to create new money market fund services.

Online fund platforms provide a customer friendly and accessible method of investing in a variety of funds, and may enhance investors' understanding of a fund and its fee structure though clear presentation of information on each fund.

However, there are a number of challenges, including an absence of full transparency concerning fees and product bias with large fund managers paying higher rebates, thereby gaining greater prominence on online fund platforms. The UK sought to resolve some of these challenges through regulatory rules which break the links between fund managers and the companies who showcase their products.

Fund platforms operated by non-bank intermediaries have grown at a slower pace in Hong Kong as compared to other global markets. The emergence of independently operated online fund platforms may result in increased fee competition and lower entry barriers for new funds.

Exchange Based Distribution Platforms

Through exchange based distribution platforms, unlisted fund products are transacted and/or settled via stock exchanges and their associated clearing and settlement systems. An example of an exchange based distribution platform is the Australian Stock Exchange's mFund.

Hong Kong does not presently have an exchange based distribution platform for funds, but the Hong Kong Exchange's capacity to provide such a service should be explored. The advantages of such a platform include increased distribution channels, higher visibility and brand recognition to a much broader range of funds, and support of data analytics to facilitate investors' comparison of fund performance and fees. Up to now, Hong Kong retail investors have relied on banks for advice, but under an exchange based distribution platform investors would act in a more self-directed fashion. This may require greater investor education and awareness.

Industry Owned Platforms

The emergence of Industry owned platforms, such as Korea's web based 'Fund Supermarket Korea' launched in 2014, allows investors to have access to a wider range of products offered by numerous fund providers.

The FSDC recommends that Hong Kong policy makers actively encourage and develop the establishment of more diversified distribution channels in Hong Kong, especially through new online fund platforms and possibly exchange platforms.

Regulatory Framework

The FSDC has found that firms have inconsistently applied their regulatory obligations, especially in relation to suitability requirements, with some firms being overly restrictive, and others being potentially non-compliant. There are other challenges in relation to the KYC requirements and the product approval process.

Suitability Requirements

The aim of suitability requirements is to ensure that firms obtain sufficient information about their customers so that any recommendation or solicitation is appropriate to the customer's circumstances. The primary requirement regarding the suitability of investments for clients is set out in the Securities and Futures Commission's (**SFC**) Code of Conduct.[2] Suitability requirements in Hong Kong apply to personal recommendations as well as to solicitations (even though no advice is being given).

Following the global financial crisis and the large scale mis-selling of mini-bonds, the SFC and the Hong Kong Monetary Authority have prioritised compliance by licensed and registered persons with their suitability obligations. The 2008 Report to the Financial Secretary on the Mini-Bonds Crisis[3] resulted in tighter regulation, including additional suitability obligations in relation to derivative products. The SFC in its 2014 consultation paper[4] on professional investors decided not to allow intermediaries to be exempt from suitability requirements or rely on other existing Code exemptions when serving Individual Professional Investors.

In response to these regulatory developments, firms have enacted more stringent internal controls, especially in relation to the suitability assessment procedures. The FSDC considers that some firms have imposed requirements in excess of the regulatory standards, which has resulted in investors being deprived of informed access to investment products. The industry does not fully understand the elements of the suitability process, and there is a lack of guidance by regulators on this issue. There is also uncertainty as to the impact of the Code of Conduct on unsolicited and non-advised transactions under specific client instructions.

The FSDC does not support relaxing the requirement that advice be suitable, because it considers that it is important that investors are not sold investment products that are misaligned with their risk profile. However, the FSDC does recommend a review of the current risk appetite rating system for funds.

The FSDC recommends that the SFC publish clear guidance so that firms can better understand their suitability obligations and what is acceptable practice by the industry across different distribution channels. Clarification of regulation would assist the accessibility of Hong Kong's fund market to investors. Other recommendations include a clear definition of how a risk based approach can be applied to SFC authorised mutual funds, which would offer a smoother on-boarding process to retail investors. This would facilitate the introduction of new business models in funds management with lower transaction costs to investors.

KYC and AML Requirements

Various customer due diligence and record-keeping requirements are imposed on financial institutions under the Anti-Money Laundering Ordinance. The institutions must consider additional risks posed by non-face-to-face businesses, but presently there is a lack of regulatory guidance on such risks. This has resulted in institutions taking a cautious approach; for example there has been a tendency to require face-to-face customer due diligence for customers wishing to invest in mutual funds. The face-to-face practice is incompatible with Hong Kong's objective to be a competitive funds distribution centre. The FSDC noted that in countries such as the UK and the US, a significant percentage of funds are distributed online, because there is greater legal certainty arising from prescriptive rules issued by the regulatory authorities. Regulatory guidance and legal clarity also enable firms to adopt a practical approach to conducting KYC and AML checks on clients.

The FSDC recommends that in relation to both KYC/AML and suitability requirements, the SFC consider consolidating and updating its guidance by publishing clear and detailed guidance for the industry which provides certainty around client on-boarding processes and ongoing AML and suitability requirements.

2 Securities and Futures Commission Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission Paragraph 5.2: Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.

3 Securities and Futures Commission, 'Issues Raised by the Lehmans Minibonds crisis Report to the Financial Secretary', December 2008 http://www.sfc.hk/web/doc/EN/general/general/lehman/Review%20Report/Review%20Report.pdf.

4 Securities and Futures Commission, 'Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements', 25 September 2014, http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=13CP1.

KYC Registration Agencies

The current administrative processes for investment account opening are burdensome because of the practice of customers being required to present their identification documents in person. An alternative approach is the centralisation of customer due diligence in a central registration database, which would reduce account-opening documentation requirements. This approach has been adopted by the Securities Board of India (**SEBI**), with the objective that the due diligence process would be completed only once and all market intermediaries could access it.

The SEBI system has had teething problems in that many brokerages are also worried that the information is not up-to-date and thus go through the KYC process themselves. Another concern is that due to inconsistency across market participants, there is difficulty in replicating documentation for additional or specialised services provided by brokerages.

The FSDC recommends that Hong Kong should consider creating a central repository for effecting KYC and AML procedures comparable to those in India. This would not only increase efficiencies across the financial services industry, but also facilitate improved AML supervision by regulators. Such a system would need further development and adaptation to iron out problems experienced in SEBI's system, for example to ensure consistency in documentation.

Product Approval Process

In order for interests in a fund to be marketed to the public in Hong Kong, the fund must be authorised by the SFC under section 104 of the Securities and Futures Ordinance (**SFO**). Further, under section 105 of the SFO, any invitation to the public to acquire shares in the fund must be authorised by the SFC.

Investment funds that seek to be authorised in Hong Kong must comply with the SFC's Handbook for Unit Trusts and Mutual Funds. Generally, in order to obtain authorisation in Hong Kong, overseas investment funds need to satisfy the SFC as to the suitability of their structural and operational requirements, investment restrictions, and the suitability of their key operators. Where an investment fund is domiciled and authorised in certain jurisdictions (e.g. the UK and the US), it may qualify as a Recognised Jurisdiction Scheme, and is thereby deemed to comply with material provisions of the SFC's Code on Unit Trusts and Mutual Funds.

Difficulties encountered by product providers regarding authorisation of their scheme under the current regulation in Hong Kong include time to market issues, high costs, additional disclosure requirements, approval of investment managers, and the approval process of subsequent changes post SFC authorisation.

The time taken to approve a fund in Hong Kong is less favourable than its competitors. The FSDC welcomes the SFC's initiative to enact a two-stream process whereby standard applications would have a target authorisation time of 4-8 weeks, and non-standard applications' authorisation time would be approximately 8-12 weeks. If the SFC initiative is implemented, the time to market for fund authorisations in Hong Kong would be reduced, and would be similar to its competitors.

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