

LEGAL UPDATE

**SFC Consultation Paper on the Proposed Guidelines  
on Online Distribution and Advisory Platforms**

On 5 May 2017 the Securities and Futures Commission (“SFC”) issued the ‘Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms’ (“**Proposed Guidelines**”).

In view of the increasing use of electronic distribution channels, the use of algorithms to construct investment portfolios and to provide investment advice (e.g. automated portfolio construction or model portfolios based on a client’s personal circumstances) (commonly referred to as “**robo-advice**”), SFC issued the Proposed Guidelines to (1) provide guidance and control on the design and operation of online platforms; (2) clarify how suitability requirements would be triggered in terms of online trading; and (3) provide additional safeguard proposed for the sale of complex products on online platforms on an unsolicited basis.

The Proposed Guidelines will be applicable to all SFC licensed or registered persons when conducting their regulated activities in providing order execution, distribution and advisory (including discretionary and automated) services in respect of investment products via online platforms (“**Platform Operators**”).

We would urge asset management companies to take a closer look to the Proposed Guidelines and provide necessary feedback before the end of the consultation period (4 August 2017) since there is a growing trend for fund houses to develop their own trading platform, and provision of robo-advice. These activities will be caught under the Proposed Guidelines. It would also be helpful to be aware of these requirements when fund houses select distributors and assess whether they are compliant with such requirements. Lastly, fund houses may wish to take a closer look at the proposed definition of ‘Complex Products’ as set out in the Proposed Guidelines as this will likely impact fund distribution and product design.

(I) **Design and Operation of Online Platforms**

SFC takes the view that the online sales process differs from the offline sales process mainly in the absence of interactive face to face communication, and also that in online platforms, investors can often view and have access to a wider range of investment products without specific recommendation from a sales representative. In this context, the Proposed Guidelines set out certain core principles which the SFC suggests should be applicable to the operation of online platforms and provided examples on compliance:

1. **Proper Design** – A Platform Operator should ensure that its online platform is operated with due skill, care and diligence when selecting and posting information and materials on investment products, is also properly designed to contain the appropriate access rights and controls so that retail clients will not invest in or view investment products in circumstances that would constitute a breach of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) or Part IV of the Securities and Futures Ordinance (Cap. 571) (the “SFO”).
2. **Information for clients** – While ensuring that all information is communicated in an easily comprehensible manner, a Platform Operator should make clear and adequate disclosure of relevant material information on its online platform to clients including up-to-date product offering documents and information of relevant investments as soon as reasonably possible, as well as the scope and limitation of other available services and products.

3. **Risk Management** – A Platform Operator should ensure the reliability and security (including data protection and cyber security) of the online platform, which includes a requirement to conduct continuous testing of its online platform and any modifications before launching, and having in place an appropriate contingency plan which should also be periodically tested.
4. **Governance, capabilities and resources** – A Platform Operator should ensure there are robust governance arrangements for overseeing the operation of its online platform as well as adequate human, technology and financial resources to ensure that all operations are carried out properly.
5. **Review and monitoring** – As part of its ongoing supervision and monitoring obligation, a Platform Operator should review, both on regular and ad hoc basis, all activities conducted on its online platform and exercise due skill, care and diligence in the selection, appointment and monitoring of any function which has been outsourced to third-party service provider(s).
6. **Record keeping** – For a period of not less than two (2) years or for such period as may be required under related guidance issued by the SFC, a Platform Operator should maintain proper records in respect of its online platform, which may consist of comprehensive documentation on platform design, operational process and risk management controls, as well as a proper audit trail of activities and transactions conducted on the online platform. Audit trail and records relating to suitability assessment should be retained for at least two (2) years for exchange traded products and at least seven (7) years for other investment products.

## (II) Suitability Requirement in the online context

### *What is the Suitability Requirement? –*

According to paragraph 5.2 of the “Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission” (“**Code of Conduct**”), a SFC licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstances 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. This requirement as set out under the Code of Conduct (referred to as the ‘**Suitability Requirement**’) is principle based, and is applicable to both offline and online context.

### *Robo Advice and when will the Suitability Requirement be triggered? -*

The Proposed Guidelines clarified that the posting of factual, fair and balanced materials on online platforms should not, in itself, trigger the Suitability Requirement. The Proposed Guidelines has drawn the analogy of posting factual, fair and balanced materials online to an offline publication of an advertisement for an investment product in newspapers, or by the wide dissemination of research reports.

With reference to paragraph 5.2 of the Code of Conduct, the Suitability Requirement will be triggered by a ‘solicitation’ or a ‘recommendation’. In an online context, robo-advice constitutes a solicitation and/or a recommendation, thus triggering the Suitability Requirement.

The Proposed Guidelines continue by providing certain examples where Suitability Requirement is not triggered, such as the provision of objective filters for self-directed research on funds (e.g. geographical location, underlying assets, performance data, risk categories and third party or in-house risk ratings), or the posting of non-product specific information such as market news or updates, industry and sector trends.

The Proposed Guidelines also provided certain examples where Suitability Requirement would be triggered, including presenting a specific list of investment products accompanied by statements such as “product of risk rating X or below may suit you or match your risk tolerance level” or “these products may suit you or match your risk tolerance level” to clients immediately after the online platform conducts a risk profiling of clients; or, upon a client’s completion of the know-your client process or provision of information through a client profiling tool or upon a client providing updates to his or her information, generating a specific model portfolio with a list of investment products or generating a list of selected investment products which may be perceived to be based on a consideration of the information provided by the client.

Subject to the consultation, these examples may be mentioned in the SFC’s FAQ for further guidance.

*What should Platform Operators do to discharge the Suitability Requirement? -*

When the Suitability Requirement is triggered, such obligation should be discharged at the point of sale or advice, in accordance with the existing requirements under the Code of Conduct. To sufficiently discharge the Suitability Requirement obligation, Platform Operators should refrain from mechanically matching a product’s risk rating with a client’s risk tolerance level, nor should they use algorithms programmed to direct clients towards particular investment products with high commissions. They should instead, as a minimum, make an assessment of a client’s risk tolerance and risk profile, conduct product due diligence to ascertain the risk return profile of an investment product, take into account similar but less costly products, and not consider commission rebates or other benefits as the primary basis for making such recommendations. In designing the risk profiling methodology, it should take into account credit risk, liquidity risk, counterparty risk and use of leverage. Relevant information, such as accurate description of the scope of advice, limitations, risks and key components of the service should also be disclosed in a comprehensible manner.

Apart from determining how to deal with their respective clients, the Suitability Requirement also requires Platform Operators to periodically review their internal mechanisms and methodology for risk profiling both clients and investment products. Where appropriate, updates to clients’ information and risk tolerance should be carried out on a regular basis. Online platforms should also disclose to the clients how clients’ risk profiles and/or product risk ratings are determined.

It should be noted that the SFC also proposed to consolidate all the relevant materials relating to the Suitability Requirement.

**(III) Suitability requirement extended to online transactions of Complex Products on an unsolicited basis**

Under the Proposed Guidelines, ‘**Complex Products**’ refer to products that contain the below factors:

1. whether the product is a derivative product;
2. whether a secondary market is available for the product at publicly available prices;
3. whether there is adequate and transparent information on the product available to retail investors;
4. whether there is a risk of losing more than the amount invested;

5. whether any features or terms of the product could fundamentally alter the nature or risk of the investment or the pay-out profile or which include multiple variables or complicated formulas to determine the return; and
6. whether any features or terms of the product might render the investment illiquid.

*According to the international Organization of Securities Commissions (IOSCO), Complex Products are defined as products with terms, features and risks which are not reasonably likely to be understood by a retail investor because of their complex structure, and which are difficult to value.*

SFC has set out examples of non-complex and complex products in Appendix 3 of the Proposed Guidelines. It should be noted that whilst bonds are generally considered as low risk investments, it is suggested that complex bonds should be considered as complex products, and complex bonds refer to bonds with special features (including, inter alia, subordinated bonds). This reflects SFC's view that complex product does not necessarily mean such product is high risk, though complexity may make it difficult for investors to understand a product thus requiring additional measures.

If an investment product is considered as a Complex Product, then:

- (i) Platform Operators should ensure transaction of such product is suitable for the client in all circumstances as if it were under the obligation to discharge the Suitability Requirement. This is applicable regardless of whether there are any solicitation or recommendation.
- (ii) With respect to Corporate Professional Investor clients, this requirement may be exempt but not for Individual Professional Investors. (For details relating to the Professional Investors regime, please refer to our previous [update](#).)
- (iii) Platform Operators should ensure that there are minimum information and warning statements.

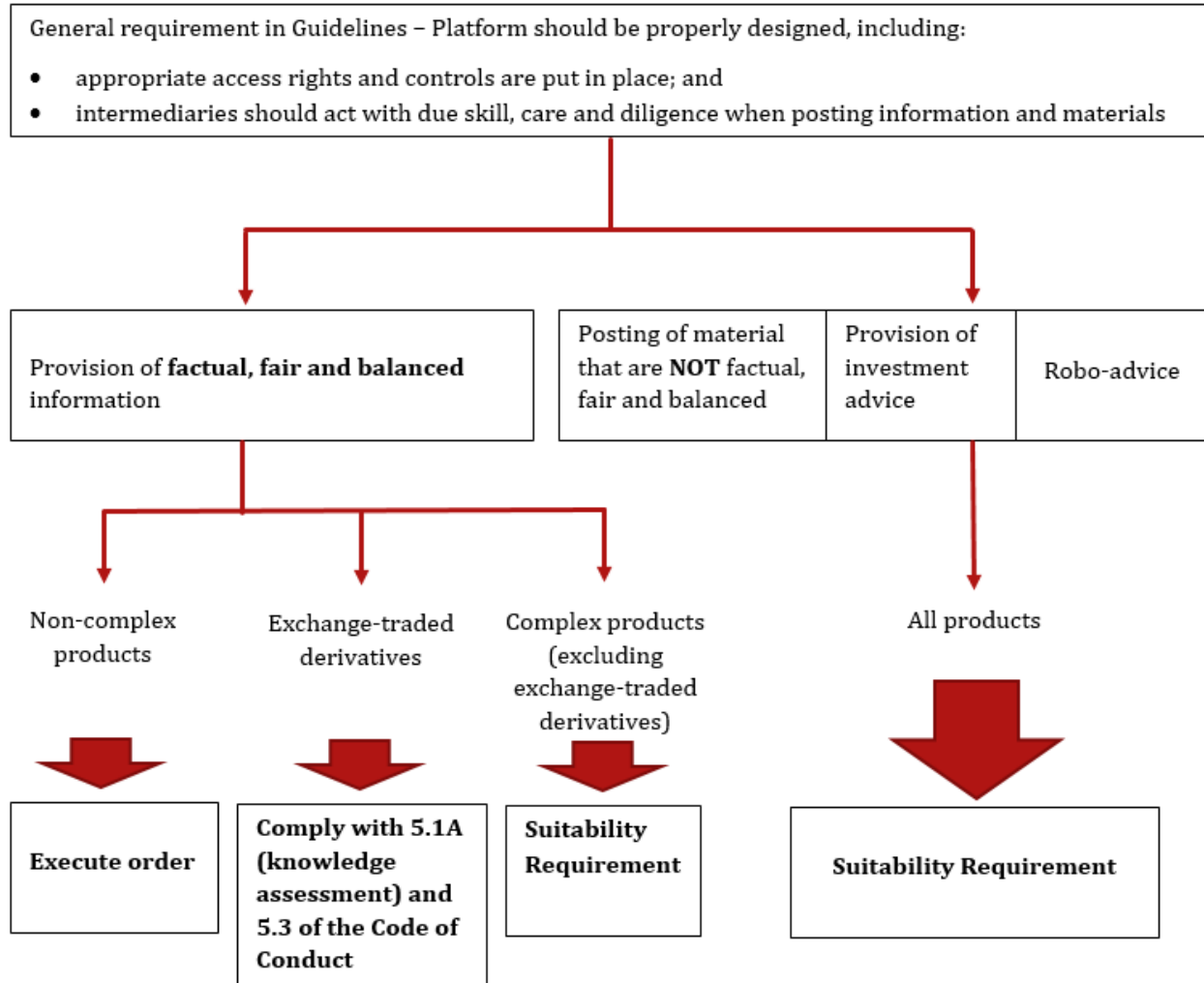
While exchange-traded derivative products, by definition, are considered as complex products, regulations and requirements are already in place under the Code of Conduct<sup>1</sup> for the sale of these products on an unsolicited basis. As such, these existing additional requirements are considered by the SFC as being adequate, meaning that Platform Operators need only comply with the current practice. The SFC is, however, proposing additional safeguards should apply to the sale of all other complex products via online platforms on an unsolicited basis.

To summarize the proposals set out in the Proposed Guidelines for the sale of investment products on online platforms, the following flowchart was provided within the Proposed Guidelines as guidance to when Platform Operators will need to consider specific requirements:

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<sup>1</sup> Paragraphs 5.1A and 5.3 of the Code of Conduct

### Online Distribution and Advisory Platform



As mentioned in the beginning of this update, fund houses should review the Proposed Guidelines and consider whether the above suggested measures are feasible. Subject to feedback, the impact of these proposed changes might be quite far reaching, e.g. the definition of complex products may be extended to offline sales transactions of complex products, and also may impact the design of investment products in the long run. This said, depending ultimately on whether these proposals are implemented, the SFC may also consider amending the Code of conduct, subject to further consultation if appropriate.

Starting from **5 May 2017** (the date of issue), this consultation paper is subject to a three-month public consultation, ending 4 August 2017, whereupon the SFC will consider all comments provided by respondents who have reviewed the paper. Thereafter, a consultation conclusion paper, along with the final version of the Proposed Guidelines, will be issued and given effect through gazette.

The SFC acknowledges that it may take time for the industry to align the current system with, what will then be, the final Proposed Guidelines. Therefore, the SFC has initially proposed a 12-month transition period which, in itself, is also for consultation.

For further details on these proposals relating to online distribution and advisory platforms, a full copy of the Proposed Guidelines is available on the SFC's website (in English and Chinese version):

- [Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms](#)
- [有關建議的《網上分銷及投資諮詢平台指引》諮詢文件](#)

#### **Contact Details**

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual contact at our firm.

**Vivien Teu**  
**Partner**  
**Vivien Teu & Co LLP**  
Tel: (852) 2969 5316  
vivien.teu@vteu.co

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