What's next for robo-advice?

The SFC consults on the proposed guidelines on online distribution and advisory platforms

June 2017

Hogan Lovells

What's next for robo-advice? The SFC consults on the proposed guidelines on online distribution and advisory platforms

With the rapid development of technology, there is an increasing trend of intermediaries providing investment services and distributing investment products over the internet. Whilst the Securities and Futures Commission ("**SFC**") has published regulations which govern the conduct of intermediaries registered or licensed with the SFC, these regulations were drafted to cater for offline situations. In light of the increasing reliance on online platforms for sale and distribution of investment products, and the additional risks involved with these new business models, the SFC proposes to introduce a set of guidelines applicable to all persons licensed or registered with the SFC in conducting regulated activities, including order execution, distribution and provision of advisory services. On 5 May 2017, it launched a three-month consultation period on the proposed *Guidelines on Online Distribution and Advisory Platform* ("**Guidelines**").

The proposed Guidelines provide guidance and clarity on existing business conduct and suitability requirements which apply to persons licensed by or registered with the SFC, and compliance with these requirements in an online context. It also contains new proposed requirements in respect of complex products for further protection of investors. The Guidelines include a three-stage requirement which online platform providers licensed or registered with the SFC are required to consider:

1. General requirements which all online platform providers should take into account and comply with;
2. Suitability requirements (the "**Suitability Requirements**") under the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (the "**Code of Conduct**") which will be triggered if there is "recommendation" or "solicitation" by intermediaries, and how suitability obligations may be discharged; and
3. New suitability requirements applicable to "complex products" even if there is no "recommendation" or "solicitation" by intermediaries.

The SFC explains in the consultation paper its view that the complexity of products does not directly correlate with the level of risk involved. That is, simple products can be risky whilst complex products might not. Rather than proposing to introduce additional regulatory requirements in relation to online distribution of simple investment products, the SFC is placing its focus on ensuring that investors have the means to fully understand the nature and risks of complex investment products through appropriate disclosures, in the online context where there investors will not have the benefit of face-to-face communication with intermediaries.

General core principles

There are six core principles which are proposed to be included in the Guidelines. These core principles apply to all licensed or registered persons when conducting regulated activities in providing order execution, distribution and advisory services online.

a) **Proper design**: such as restricting retail clients to access information relating to exchange-traded funds not authorised by the SFC, and operating the online platform with due skill, care and diligence;

b) **Information for clients**: such as providing clear and up-to-date product offering documents and disclosure as to the scope and limitations of services and commission, fees and charges;

c) **Risk management**: such as testing and monitoring the systems regularly, having a contingency plan to deal with emergencies and cybersecurity;

d) **Governance, capabilities and resources**: such as adequate resources to oversee and manage the operations of the online platform;

e) **Review and monitoring**: such as on-going supervision and monitoring of the online platform; and

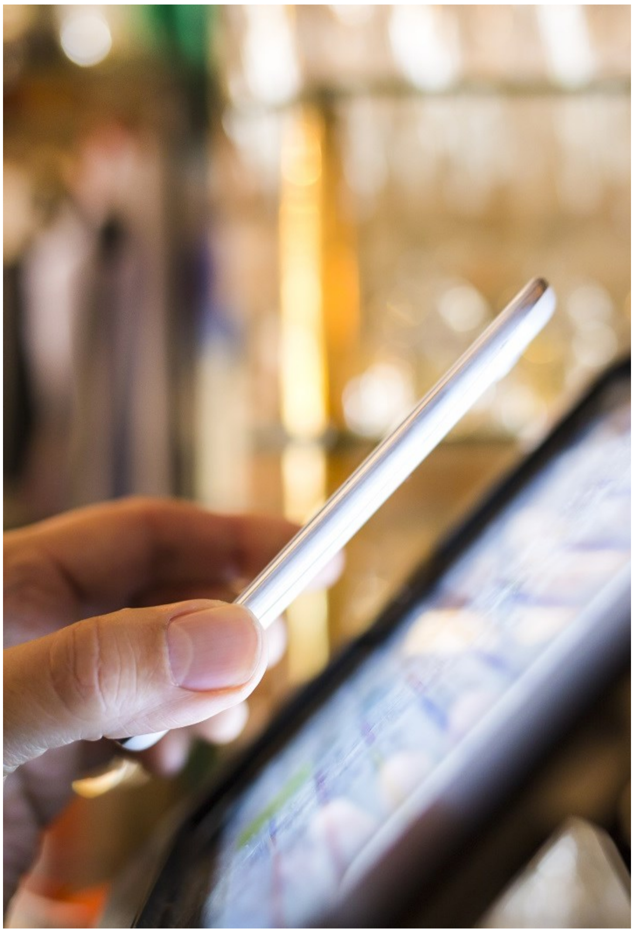
f) **Record keeping**: including documentation on the platform design, operations, tests and reviews, which should be retained for at least two years after the online platform ceases to operate, and audit trails of transactions, to be retained for at least seven years for non-exchange traded products and two years for exchange traded products.

The Guidelines will contain a section on the general requirements of business conduct of licensed or registered persons in accordance with the Code of Conduct and other codes, guidelines and circulars published by the SFC. These requirements are the same as those which apply in an offline environment, such as the usual know-your-customer requirements, the requirement to ensure best execution and the requirement to disclose monetary and non-monetary benefits. This section is a clarification of the general obligations of licensed or registered individuals in the context of an online environment, but does not impose new requirements.

The Guidelines will also contain a separate section which discusses specifically the application of the current general conduct requirements and the Suitability Requirements in the context of robo-advisory services, i.e. provision of financial advice through online platforms using algorithms and other technology. Under this section, accurate description of investment products and easily comprehensible disclosures must be provided to enable investors to make informed decisions. Licensed or registered intermediaries will also be required to ensure client profiling tools are properly designed (for example designs to ensure sufficient information is obtained and inconsistencies in such information are identified and reconciled), algorithms properly programmed, appropriate on-going testing and supervision is performed, and adequate resources are deployed to maintain and develop the systems.

Suitability Requirements

Under the Code of Conduct, the Suitability Requirement is the obligation to ensure the suitability of a recommendation or solicitation that is made by a licensed or registered person to a client. Whether an intermediary has "recommended" or "solicited" is a question of fact. The Suitability Requirements apply the same way to both online and offline regulated activities. The use of an online platform will not deem an intermediary to have recommended or solicited any products. Nonetheless, provision of robo-advice would normally trigger the Suitability Requirements.



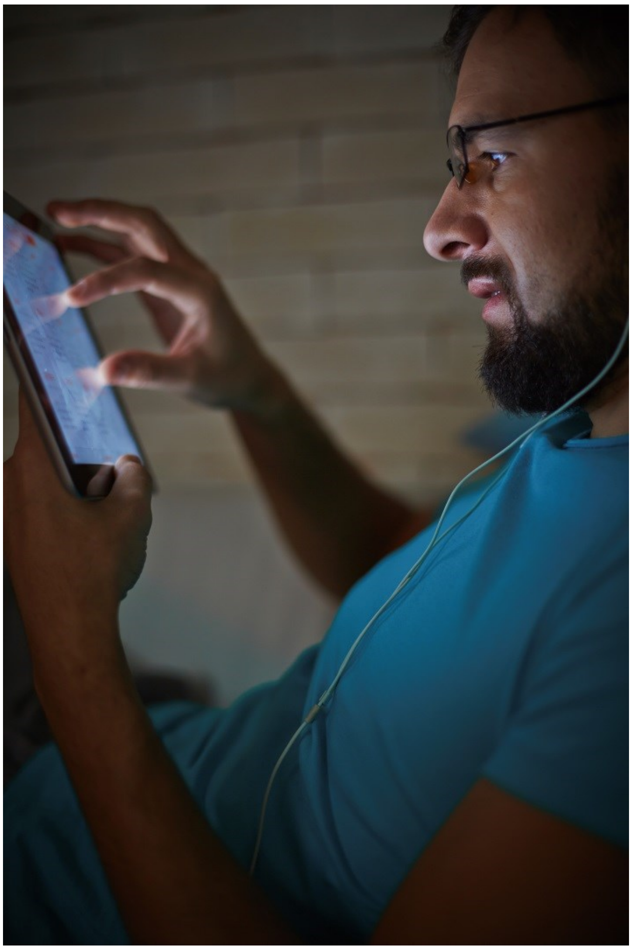
The principles regarding suitability discussed in the SFC's consultation paper do not impose new obligations, but are only clarifications of the existing requirements under the Code of Conduct as they are applied to the online context. The discussions focus mainly on (i) when the Suitability Requirements are triggered and (ii) the discharge of suitability obligations.

In determining whether there is "solicitation" or "recommendation", the context and content of product-specific materials posted on an online platform coupled with the design and overall impression created by the platform content should be considered. Whether the materials posted are factual, fair and balanced, and whether there is influence on investors to purchase a particular product are key factors. The SFC proposes to include certain examples of situations when and when not the Suitability Requirements will be triggered. For example, posting of general market news or updates, or product-specific materials which are factual, fair and balanced will not in itself trigger the Suitability Requirements, neither would the posting of lists of investment products that are selected using objective criteria (for example performance data, sales figures and research data). On the other hand, posting of advertisements with product-specific incentives for any transactions in a specific investment product, or the generation of a list of investment products following a client's query through a client profiling tool, will trigger the Suitability Requirements.

With respect to discharging obligations when the Suitability Requirements are triggered, the SFC emphasised that mere mechanical matching of a product's risk rating with a customer's risk tolerance level may not be sufficient. The SFC expects online platform providers to at a minimum make an assessment of a customer's risk tolerance and risk profile, and conduct product due diligence to ascertain the risk return profile of an investment product. The SFC proposes to consolidate all SFC guidance materials on the Suitability Requirements (including the FAQs published in December 2016) into one page on the SFC's website for ease of reference.

New requirements for complex products

On the basis that it may be more difficult for investors to understand complex products in an online environment, the SFC proposes to extend the suitability requirements to "complex products" even in situations where there is no solicitation or recommendation. Intermediaries may be exempt from this requirement in respect of Corporate Professional Investors provided that certain steps are taken, but exemption will not be applicable to Individual Professional Investors.



The proposed Guidelines set out factors which will be considered in determining whether product is "complex". These are, for example, whether the product is a derivative product, whether there is a risk of losing more than the amount invested, and whether there are features which may render the investment illiquid. The SFC proposes to publish a non-exhaustive list of examples of "complex" and "non-complex" products to assist intermediaries with their classification. For example, futures contracts, synthetic ETFs and funds or other structured products which are not authorised by the SFC are proposed to be classified as "complex" products.

In addition to extending the Suitability Requirements to complex products, the SFC also proposes the requirement for platform providers to provide warning statements and basic and key information on complex products at the minimum. The proposed Guidelines include an appendix setting out a non-exhaustive list of examples of minimum information and warning statements which must be provided in relation to complex products on online platforms. These are, for example, the product nature, key terms and features, whether the product is principal protected or not, and whether there are penalties for early exit.

Conclusions

The SFC will publish a consultation conclusion after the end of the consultation period (the consultation period will end on 4 August 2017) together with the final form Guidelines, which will come into effect upon gazettal. The SFC proposes a12-month transition period after the finalised Guidelines coming into effect for intermediaries to update their systems and controls. The public and industry participants are invited to submit their comments on the consultation paper to the SFC.

The consultation represents an important reaction to a significant shift in the market for financial services in Hong Kong and elsewhere, as investors seek the convenience and speed of online transacting and greater choice in terms of how they receive financial services. The SFC, in line with the other principal Hong Kong financial regulators, has established a Fintech Contact Point that is meant to encourage greater engagement with fintechs and recently entered into a fintech cooperation agreement with the UK Financial Conduct Authority, the UK regulator being seen as a leader in regulatory innovation on this front. The SFC has clearly been undertaking a broader review of its compliance requirements in light of Hong Kong's fintech surge. It is also interesting to see the SFC has taken the view that additional requirements should be imposed with respect to the sale of complex investment products, which echoes the concern of the Insurance Authority, who in its guidance note (*GN16 – Guidance Note on Underwriting Long Term Insurance Business (Other Than Class C Business)*) stated that products with complex features may not be suitable for distribution through online channels, as advice cannot be given to customers during the sale process. With these reference points in mind, the SFC clearly sees fintech innovation as an opportunity for Hong Kong but also recognises the importance of a measured approach to re-adjusting risk allocations in order to protect investors.

Contacts

Mark Parsons
Partner, Hong Kong
mark.parsons@hoganlovells.com

Katherine Tsang
Associate, Hong Kong
katherine.tsang@hoganlovells.com

Alicante
Amsterdam
Baltimore
Beijing
Brussels
Budapest
Caracas
Colorado Springs
Denver
Dubai
Dusseldorf
Frankfurt
Hamburg
Hanoi
Ho Chi Minh City
Hong Kong
Houston
Jakarta
Johannesburg
London
Los Angeles
Louisville
Luxembourg
Madrid
Mexico City
Miami
Milan
Minneapolis
Monterrey
Moscow
Munich
New York
Northern Virginia
Paris
Perth
Philadelphia
Rio de Janeiro
Rome
San Francisco
São Paulo
Shanghai
Shanghai FTZ
Silicon Valley
Singapore
Sydney
Tokyo
Ulaanbaatar
Warsaw
Washington, D.C.
Zagreb

Our offices
Associated offices

www.hoganlovells.com