



## CONSULTATION ON THE PROPOSED GUIDELINES ON ONLINE DISTRIBUTION AND ADVISORY PLATFORMS

### THE LAW SOCIETY'S SUBMISSIONS

The Law Society has studied a paper released by the Securities and Futures Commission ("the SFC") in May 2017, with the title "*Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms*".

#### CONSULTATION QUESTIONS

In reply to those questions posed in the Consultation Paper, we have the following responses.

#### *Initial considerations*

*Naturally, the proposed guidelines would only cover the activities of licensed or registered persons. It is important to ensure consistency across the piece in relation to the regulation of unlicensed/unregistered persons' online activities targeting the Hong Kong market, in particular in the context of the operation of section 115 of the Securities and Futures Ordinance in relation to offshore online platforms. The overlap of the issues concerning respectively solicitation/recommendation and active marketing need to be regulated in as seamless a manner as possible.*

***Question 1:** Do you agree with the factors relevant to online platforms identified [in the Consultation Paper]? Please explain your view.*

#### **Law Society's response:**

*As a starting point, it is in our view fundamental to the Hong Kong regulatory system that as far as possible the technological neutrality of regulation is maintained, in other words, to ensure that the rules are consistently applied regardless of whether technology is involved in the delivery of the service. This is so as to avoid potentially arbitrary outcomes or the creation of possible arbitrage in the regulation of the industry.*

We agree that the principal area of differentiation between online and offline sales processes at their core, concerns, not surprisingly, the absence of interactive face-to-face communication with clients in the online environment. That results in a more [inflexible]/[restrictive sales] process for a client where there is virtually complete reliance upon the materials appearing on the platform to provide relevant information to consider in the context of a potential purchase of an investment product. In an offline – face-to-face – environment, there is the potential for additional clarification and information to be sought by a client from the representative.

We regard, overall, that the additional practical regulatory requirements and considerations proposed under the guidelines reasonably address the online issues without derogating from the technologically neutral approach referred to above.

The potential access to a very wide range of investment products is also an appropriate factor to bear in mind, and accordingly we agree that in an online environment it is not practicable to ensure that every investment product listed on a platform is appropriate or suitable for all clients who may be able to access the platform. The critical issue arising from that is that it becomes more important to ensure that (where required) the suitability of an investment product is appropriate or suitable not at the *time of access*, but at the *point of sale/point of delivery of advice*. That is consistent with the current regime, but appropriately nuanced for the online environment.

***Question 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.*

**Law Society's response:**

We have not identified at this stage any additional online-specific factors. To the extent that any prove to be relevant, we consider that the framework of core code of conduct provisions (including the General Principles) and related guidelines in this area should provide a sound basis for investor protection pending any later enhancements that may be required.

***Question 3:** Do you have any comments on the Core Principles in the Proposed Guidelines as outlined [in the Consultation Paper]? Are there any other areas which you think the Proposed Guidelines should cover? Please explain your view.*

**Law Society's response:**

CP 1 – no comment.

CP 2 - A Platform Operator should make clear and adequate disclosure of relevant

material information on its Online Platform as soon as reasonably appropriate.

The suggested amendment is designed to provide a degree of flexibility as regards when the information should be provided (which should in any event be sufficiently in advance of the point of sale/delivery of advice to allow the client to take it fully into account) but without any need for immediate provision of e.g. offering materials, so as to cater for different arrangements on a platform for access to the product.

CP 3 - A Platform Operator should ensure the reliability and security (including data protection and cybersecurity) of its Online Platform.

In terms of system reliability, we consider that in the light of recent market events it would be helpful to include guidance that there is an expectation on licensed/registered persons that they will keep their anti-virus software up to date and otherwise take advantage of patches published by manufacturers and other official providers to ensure proper current levels of protection.

CP 4 – no comment.

CP 5 – no comment.

CP 6 – no comment.

Where we have no comment, we consider the CP appropriately targets online activities while remaining appropriately consistent with other existing regulatory requirements under the regime.

***Question 4:** Are there any other areas relating to “robo-advice” [as referred to in the Consultation Paper] which you think the Proposed Guidelines should cover? Please explain your view.*

**Law Society’s response:**

No. We view the proposed CPs 1 and 3 (as well as 4) as being the principal areas of focus in relation to robo-advice.

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

**Law Society’s response:**

In our view, the principal shortcoming of robo-advice stems from, for now, the lack of sophistication, granularity and flexibility of robo-advice, in short leading to a real or potential gap between what is offered by intermediaries to their clients and what can actually be delivered under the current levels of technology.

A similar and potentially dangerous gap is between the expectations of clients for what can be delivered and the capability of intermediaries to deliver against those expectations. That should be addressed by investor education, as discussed in the consultation paper, and the need for intermediaries to ensure that their materials in particular sufficiently clearly explain the limits of their services – we note paragraph 4.3 of the Proposed Guidelines.

The above is a function of still relatively early technology in this area. That should be capable of being addressed more effectively over time, hence it being appropriate at this early stage to tackle some of the regulatory issues arising from this phase of development and tackling the wider issues of principle that will become increasingly important.

***Question 6:** Do you have any comments on the guidance on the Suitability Requirement [as referred to in the Consultation Paper] to be provided in the Proposed Guidelines?*

**Law Society’s response:**

Paragraph 5.8(c) of the Proposed Guidelines is a helpful illustration of the need for an intermediary’s systems to be viewed holistically to ensure that all relevant information collected from a client as part of an online transaction, as well as all relevant information held by the intermediary elsewhere in relation to that client, is appropriately assessed, and records are where appropriate updated.

In our view it would be helpful for that to be made more explicit to intermediaries to avoid any doubt on that issue.

***Question 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?*

**Law Society’s response:**

We welcome the confirmation that *the posting of factual, fair and balanced product-specific materials would not in itself amount to a solicitation or recommendation and will thus not trigger the Suitability Requirement in principle.*

We note that the design and overall impression of any material, whether online or offline, inevitably affects the case by case determination of whether the Suitability Requirement is triggered, and this is illustrated in Example (4) of “Examples of when the Suitability Requirement is triggered” set out in Paragraph 91 of the Consultation Paper.

Overall, we do not disagree with the SFC’s approach in that regard to online activities.

*Question 8: Do you have any comments on the [examples set out in the Consultation Paper] of when the posting of materials on online platforms would or would not amount to a solicitation or recommendation?*

**Law Society's response:**

No. See above. We consider the examples provided to be useful illustrations to market participants on when the Suitability Requirement is (or is not) triggered. Whilst useful, we assume they are not exclusive, but a selection of possible illustrations.

*Question 9: Are there any examples not mentioned [in the Consultation Paper] that may suggest that the content or presentation of materials would amount to a solicitation or recommendation? Please explain your view.*

**Law Society's response:**

We consider the examples to be useful illustrations of the principle, and they will no doubt be refined and as necessary updated in due course.

In Item (6) of “Examples of when the Suitability Requirement is NOT triggered”, it would be appropriate to include asset classes (from an educational perspective) and geographical areas as additional examples of non-product specific information that would not trigger the Suitability Requirement.

*Question 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?*

**Law Society's response:**

Firstly, we agree that a merely mechanical approach to risk analysis and client profiling would not normally suffice to discharge the regulatory requirements.

We agree that relevant factors in relation to risk profiling should include credit risk, liquidity risk, counterparty risk and use of leverage. Age, concentration risk and, where relevant, foreign investment/exchange risk should also be factored in for individual clients to reflect their personal circumstances.

We consider it appropriate, and important, not to be made overly prescriptive for intermediaries in relation to these issues as regards design and scoring mechanisms, but rather keep to a principles-based approach so as to accommodate multiple methodologies.

*Note: We would suggest further consideration of the role of a portfolio-based approach as being desirable in relation to risk-profiling for clients and investment*

*products, not only in a discretionary account or private banking context, but also more widely, so as to permit a reasonable degree of flexibility for intermediaries in client account management. This would allow, subject to the intermediary in question collating and appropriately processing sufficient details in relation to the client's overall portfolio, to include higher and lower risk products, as appropriate, within the portfolio where they do not materially alter the overall risk profile, but potentially provide portfolio management advantages for the client (where that may reasonably contribute to satisfying the client's investment objectives and is consistent with the client's overall personal circumstances). Any such variations in the individual constituents of the portfolio would need to be carefully scrutinized and justified before being introduced to the client in the context of the wider know-your-client requirements.*

**Question 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?*

**Law Society's response:**

We have reproduced below the definition of complex products, for ease of reference, marked with our suggested amendments.

*Definition of a complex product*

6.1 A complex product is an investment product whose terms and conditions, features and risks are not reasonably likely to be understood by a retail investor because of its complex structure [~~deleted text~~].

Note: Set out below are factors to determine whether an investment product is complex or not:

- (i) whether the investment product is a derivative product;
- (ii) whether a secondary market is available for the investment product at publicly available prices;
- (iii) whether there is adequate and transparent information on the investment product available to retail investors;
- (iv) whether there is a risk of losing more than the amount invested;
- (v) whether any features or terms of the investment product could fundamentally alter the nature or risk of the investment or pay-out profile or include multiple variables or complicated formulas to determine the return; and

Note: This would include, for example, investments that incorporate a right for the investment product issuer to convert the instrument into a different investment.

- (vi) whether any features or terms and conditions of the investment product might render the investment illiquid and/or difficult to value.

6.2 A Platform Operator should refer to the examples of investment products that the SFC considers are not complex, and examples of complex products, which are published on the SFC website.

We submit that the main provision needs to be amended as follows:

A complex product is an investment product whose terms and conditions, features and risks are individually or collectively not reasonably likely to be adequately understood by a retail investor because of its complex structure.

*Commentary:*

Our suggested amendments to paragraph 6.1 and sub-paragraph (vi) of the Proposed Guidance are merely designed to highlight the test for complexity while continuing - in sub-paragraph (vi) - to reflect the importance of valuation in the context of an investment product's complexity. The deletion from paragraph 6.1 of the reference to valuation removes the potential for confusion that an investment product, to be classed as a "complex product", would need to satisfy the test and be difficult to value.

We regard sub-paragraph 6.1(v) and (vi) to be the core factors determining whether an investment product is a "complex product". The remaining elements are arguably merely examples of where those sub-paragraphs would be triggered (in the case of (iii) the lack of adequate information does not of itself make the underlying investment product "complex"), although we appreciate that the articulation of those points in the guidance is helpful as a general matter.

The reference to overall and individual features, etc. in the definition is designed to cater for investment products which either as a whole should properly be viewed as complex by their very nature (CBBCs being a helpful example) or individually should be viewed as complex as a result of the inclusion of a particular feature that renders an otherwise non-complex product reasonably difficult to be understood by a retail investor (in some respects, the latter is the more potentially troublesome for investor protection purposes).

In relation to paragraph 6.2 of the Proposed Guidance, we note that a *Platform Operator should refer to the examples of investment products that the SFC considers are not complex, and examples of complex products, which are published on the SFC website*. It is important that these examples are as clearly set out as

possible to avoid any doubt in the market. We consider that the list of “complex” investment products is helpful. Our comments on “non-complex products” are set out below in our response to Question 12.

***Question 12:** Do you have any comments on the list of investment products that are considered to be “non-complex”?*

**Law Society’s response:**

We agree with the products referred to in (i), (iii) and (iv) in Appendix 3.

In relation to (2) – non-complex bonds – our comment is that it will be important to monitor the efficacy of that definition as a practical matter to ensure that the boundary of complex and non-complex bonds is sufficiently clearly marked. We recognize that for the most part it will be relatively straightforward to determine whether a bond falls into the “complex” category, but there may be instances where the line is less clear, potentially creating the need for additional guidance.

Note: We consider that the relevant reference should be to complex bonds, notes and equivalent instruments to ensure as far as possible that the substance of this type of investment product is clearly covered rather than the strict legal form.

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

**Law Society’s response:**

Please see above.

***Question 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.*

**Law Society’s response:**

Paragraph 117 of the Consultation Paper, and the Proposed Guidance, do indeed propose “a new basis for triggering the Suitability Requirement”, keyed to the *complexity* of the investment product rather than whether there has been or is any *solicitation or recommendation* by an intermediary in respect of the transaction.

We recognize the investor protection driver behind this proposal, and its origins in previous IOSCO pronouncements on this area.

Imposition of the Suitability Requirement to complex products on an unsolicited basis would of course effectively amount to ensuring that intermediaries subject to

that requirement safeguard the investor when he is trying to source an investment product even though the intermediary would have taken no part in the decision-making process leading to the purchase.

Given the contractual obligation placed on an intermediary under its client agreement, insofar as the Suitability Requirement applies, we consider that such a change would fundamentally affect the “execution-only” market in relation to complex products. It would create potential liability, or at least potentially lead to claims from investors, stemming from the investor’s own decision simply to source a selected product from a chosen intermediary, without any interaction with that intermediary other than – for example – to view some balanced and factual material in respect of the product on the intermediary’s web-site.

While we appreciate the intention to ensure that Hong Kong consistently meets international standards in relation to the regulation of its markets, and recognize the investor protection advantages, we strongly consider that the imposition of a contractual obligation in this regard goes too far.

*We submit that, insofar as the SFC ultimately decides to adopt this approach, the Suitability Obligation would be carved out of client agreements in the context of complex products.*

***Question 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.*

**Law Society’s response:**

Given our above-mentioned support for continuing technology-neutral regulation, provisionally we would support such an extension, subject to specific further consultation on the issue given the potential ramifications for the execution-only part of the market.

Given that online activities are in starker relief than offline, there would need to be potential modifications made to the offline requirements which, while not inconsistent with the overall mapping over of that requirement, would take into account the practical differences between online and offline.

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

**Law Society’s response:**

We consider that, if adopted in the proposed form, the introduction of the Suitability Requirement in respect of online transactions and activities concerning complex products would be a major change to the Hong Kong market and no

further protections would be required in that regard given the lack of solicitation and recommendations.

***Question 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?*

**Law Society's response:**

We do not consider that product bans are an appropriate regulatory tool. The overall regulatory requirements in respect of investment product sales, including any extension of the Suitability Requirement, structured product regulation and the overarching need for intermediaries to ensure appropriate risk management (including legal, regulatory and reputational risk) should suffice to regulate online platform sales appropriately. We would expect intermediaries to adopt an appropriate assessment of this type of product, in the light of the overall regulatory regime, before permitting online sales. In the light of the SFC's stated intention to adopt a more pro-active stance to head off potential market issues, the likely increased scrutiny in relation to what have become seen as high complexity and high risk products should also act as a practical check and balance.

***Question 18:** Do you think the items of minimum information set out in Appendix 4 [of the Consultation Paper] are sufficient and appropriate? Please explain your view.*

**Law Society's response:**

Paragraphs 2 and 4 (key terms/features and risks) of Appendix 4 give rise to the main practical issues. We would observe that there will need to be a granular approach to the minimum information required in order to head off as far as possible any doubt or confusion in the market as to what is required. Prescribed templates prepared by the SFC in separate consultation with market participants would be a useful approach in that regard.

There would need to be a proportionate approach, taking into account for example key facts documentation requirements in relation to structured products.

It can be seen from the above that the proposed approach to unsolicited sales of complex products would create a significant and detailed raft of new prescriptive regulation in this area of the investment products market, which needs to be carefully assessed in the cost-benefit context.

***Question 19:** Do you have any comments on the proposed warning statements set out in Appendix 4 [of the Consultation Paper] that should be made on an online platform?*

**Law Society's response:**

We have no comment on the warning statements, which are proportionate and reasonable. See above in relation to our comments on for example the proposed minimum information requirements.

*Question 20: Do you think a 12-month transition period [before the full implementation of the Proposed Guidelines] is appropriate? If not, what do you think would be an appropriate transition period? Please set out your reasons.*

**Law Society's response:**

The suggested period is the absolute minimum that should be implemented.

**The Indicative Draft of the Proposed Guidelines on Online Distribution and Advisory Platforms (Appendix 2 of the Consultation Paper)**

We have not reviewed the proposed guidelines at this stage and recommend that the proposed guidelines be subject to a further consultation exercise until after the substantive principles have been settled.

**The Law Society of Hong Kong  
18 July 2017**