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Distributors and financial advisers: Are you prepared for the enhanced point-of-sale transparency requirements?

Introduction

The Securities and Futures Commission (SFC) published its *Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts* ("**Conclusions**") in November last year, which adopted important proposals to strengthen Hong Kong's fund manager supervisory regime.

In addition to making extensive changes to the *Fund Manager Code of Conduct*, the SFC has adopted amendments to the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* ("**Code of Conduct**") which will come into effect on **17 August 2018.** The changes, which encompass enhanced disclosures and restrictions on use of the term 'independent', aim to improve point-of-sale transparency and better address potential conflicts of interest in the sale of investment products. The SFC has also provided further guidance in the form of FAQs on its expectations in these areas.

Separately, in respect of non-SFC-regulated products (such as currency-linked or interest rate-linked products), the Hong Kong Monetary Authority (HKMA) has also notified Authorised Institutions (AIs) of the application of the enhanced disclosure and independence requirements when distributing such non-SFC-regulated products. AIs are expected to implement these enhanced requirements **before the end of 2018**.

With only a few months to go before the amendments take effect, distributors and financial advisers should act now to ensure that necessary measures are put in place.

Key Actions

1. *Assess if you are "independent" of product issuers*

The revised Code of Conduct restricts the circumstances in which intermediaries may represent themselves as "independent" or as providing "independent advice". "Independent" in this context includes other similar terms, such as "independent financial advisers" / "IFA", "independent financial planners", "impartial", "neutral", "objective" and "unbiased".

The new test for 'independence' relies on the intermediary:

- not receiving fees, commissions, or any monetary benefits paid or provided (whether directly or indirectly) by any party in relation to the distribution of investment products to clients
- not having close links or other legal or economic relationships with product issuers, or receiving any non-monetary benefits from any party, which are likely to impair its independence to favour a particular investment product, a class of investment products or a product issuer

The assessment of independence is principles-based and a question of fact, however the SFC has provided some examples of the meaning of "close links" which include:

- The intermediary has a parent company and subsidiary relationship with a product issuer, or is in a controlling entity relationship with the product issuer.
- The intermediary and product provider have an exclusivity arrangement whereby the intermediary may only distribute that product provider's investment products.

2. *Review and revise documentation to comply with enhanced disclosure requirements*

<u>Disclosure of independence and non-independence</u>

Disclosure must be made regardless of whether an intermediary is independent or not, and must also include the bases for the determination. The SFC expects intermediaries to make (at least) a one-off disclosure before or at the point of sale, as well as ongoing updates of any changes to the information.

The amended Code of Conduct contains a form of disclosure statement relating to the status of independence that an intermediary is expected to communicate to its clients. This is set out in the new Schedule 9.

Importantly, if independence cannot be established on the basis of the test set out above, an intermediary will not be allowed to describe itself as being independent (or words to that effect) in any of its communications with clients.

<u>Disclosure of non-quantifiable monetary benefits</u>

Where monetary benefits received or receivable from a product issuer (directly or indirectly) for distributing an investment product are not quantifiable prior to or at the point of entering into a transaction, in addition to disclosing the existence and nature of the monetary benefits, an intermediary must now also disclose the maximum percentage receivable per year. This disclosure is expected to be made on a transaction basis.

By way of illustration, if an intermediary will receive trailer fees for distribution of Fund A, the SFC has provided the following sample disclosure for distribution of Fund A: "We will receive from *[the product issuer's name]* up to 60% of Fund A's annual management fees as ongoing commission every year throughout the term of your investment".

The SFC has given some additional feedback in the Conclusions relating to the application of this disclosure requirement in various scenarios. The key objective is to ensure that the disclosure is sufficient to highlight conflicts of interest (if any) and to facilitate easy comparison of fees for investors.

3. Take steps

We recommend that distributors and financial advisers consider taking the following steps to ensure that they are in a position to comply with the revised Code of Conduct by 17 August 2018 (and in relation to AIs' distribution of non-SFC-regulated products, by the end of December 2018):

- *Assess benefits*: put in place measures to calculate maximum percentage of monetary benefits on an annualised basis if applicable.
- *Disclosure documents*: review and amend disclosure documents to: (i) incorporate prescribed form of disclosure statement on independence; and (ii) include disclosure of maximum percentage of monetary benefits if applicable.
- *Client documents*: review and revise standard client documentation to ensure references to independence correspond with actual arrangements.

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