

# SFC PUBLISHES CONSULTATION CONCLUSIONS ON ENHANCING REGULATION OF ASSET MANAGEMENT INDUSTRY AND POINT-OF-SALE TRANSPARENCY AND LAUNCHES FURTHER CONSULTATION

17 November 2017 | Hong Kong  
Legal Briefings - By **Hannah Cassidy**

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Yesterday, the Securities and Futures Commission (**SFC**) published its [consultation conclusions](#) on proposals to enhance asset management regulation and point-of-sale transparency (the **Proposals**) (please see [here](#) for our e-bulletin on the SFC's consultation). The SFC has also launched a further consultation on disclosure requirements applicable to discretionary accounts.

The SFC received 38 written submissions from key players in the asset management industry and, as the majority of respondents supported the Proposals, the SFC has largely adopted them and the proposed changes to the *Fund Manager Code of Conduct (FMCC)* and the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct)*, with certain modifications or clarifications of the regulatory intent. The SFC will also provide further guidance to the industry by way of a set of Frequently Asked Questions (**FAQs**), which will be updated from time to time.

## **KEY ELEMENTS OF THE NEW ASSET MANAGEMENT FRAMEWORK**

### ***TIMETABLE***

- **17 November 2017** - The revised FMCC and the amendments to the Code of Conduct are gazetted.
- **17 August 2018** - The amendments to the Code of Conduct become effective.
- **17 November 2018** - The revised FMCC becomes effective.

The SFC is conducting a further consultation on the disclosure requirements applicable to discretionary accounts under the Code of Conduct. The deadline for submitting written comments is **15 January 2018**.

If you wish to discuss the new requirements or the SFC's further consultation, please contact [William Hallatt](#), [Hannah Cassidy](#), [Jeremy Birch](#) or your usual Herbert Smith Freehills contact.

The SFC took on board comments that a 12-month transition period (rather than the original 6-month) would be more appropriate. However, firms should not underestimate the amount of work which will be required to comply with the new FMCC and Code of Conduct requirements. Changes to the FMCC are wide ranging and firms should consider whether amendments to offering documentation will be necessary, as well as the potential impact on systems, controls, procedures, and delegates (both intra group and third party).

### ***Meaning of "responsible for the overall operation of the fund"***

Certain enhancements to the FMCC will only be applicable to fund managers that are "responsible for the overall operation of a fund", which is in line with relevant IOSCO principles. All references to the concept of "de facto control" have been removed.

However, the SFC stresses that the intended scope of a "fund manager that is responsible for the overall operation of the fund" remains unchanged. A fund manager would not be able to cite the existence of a governing body to conclude that it is not "responsible for the overall operation of the fund" just because it does not formally make final decisions or enter into legal agreements.

The SFC will issue further FAQs from time to time to illustrate when a fund manager may be considered to be "responsible for the overall operation of a fund". The SFC also agrees that a fund manager may not always have control over its affiliates, especially where the affiliate is its parent company or a sister company. They have therefore revised the example such that where the representatives of the fund manager or its subsidiaries constitute a majority of the fund board, then the fund manager may be considered to be responsible for the overall operation of the fund.

### ***Persons to whom the FMCC applies***

The SFC has clarified that the FMCC applies to the business activities carried out by fund managers which would include the management of discretionary accounts. This clarification was broadly supported given the similarity between the business activities of fund management and discretionary account management.

However, to address concerns about the selection and appointment of a custodian, the SFC reiterates that where a discretionary account client has selected and appointed its own custodian and the discretionary account manager is not involved in this process, the discretionary account manager will not be required to observe the relevant principles and requirements.

### ***Other modifications***

Modifications have also been made to the revised FMCC including in the areas of custodian/safe custody of assets and disclosure requirements for securities lending and repurchase agreements. For example, the SFC has taken into account the EU regulations on Securities Financing Transactions and Reuse, and has aligned the disclosure requirements with the relevant Financial Stability Board recommendations, which have now been set out in the FMCC.

## ***Point-of-sale transparency in the Code of Conduct***

### *Adoption of a pay-for-advice model*

Respondents generally agreed that Hong Kong is not yet ready to adopt a pay-for-advice model (ie, banning of commissions) and supported the proposed two-pronged approach to address the conflicts of interest arising from intermediaries receiving benefits from other parties in the sale of investment products. The SFC will, however, keep under active consideration the merits of pay-for-advice models taking into account local and international market and regulatory developments.

The SFC also noted that recent enhancements to intermediaries' selling practices, such as the new client agreement clause to require intermediaries to ensure the suitability of any solicited or recommended investment product as well as their clarification of and guidance on the suitability requirements, also complement the Proposals (please see here for our e-bulletins dated [28 September 2016](#) and [6 January 2017](#) on these developments).

The SFC will also closely monitor the growth of online distribution and advisory platforms, which may have a material effect on distribution channels, access to advice and fee structures. The SFC noted that it will shortly provide specific guidance on the design and operation of online platforms (please see [here](#) for our e-bulletin on this topic). The SFC will also continue thematic inspections of the selling practices of licensed corporations.

### *Restriction on the use of the term "independent"*

The new Code of Conduct restricts intermediaries from representing themselves as being "independent" if they receive monetary benefits from other parties and requires disclosure of their independence or non-independence. The SFC has clarified the definition of "independence" and also provided more guidance.

### *Enhancing disclosure*

Intermediaries must also now disclose the maximum percentage receivable in terms of monetary benefits and the disclosure would need to be made prior to or at the point of entering into the transaction. This approach was deemed to be the most appropriate, taking into account the potential burden on the industry and the potential benefits to investors.

In the case of trailer fees, the maximum percentage of the management fees receivable as per the distribution agreement with the product issuer should be disclosed. Intermediaries may comply with this requirement by disclosing the range of trailer fees receivable on an annualised basis as long as the maximum percentage receivable is disclosed in each case.

## ***Further consultation on disclosure requirements applicable to discretionary accounts***

Some respondents enquired whether the proposed amendments to the disclosure requirement under paragraph 8.3(b)(ii) of the Code of Conduct would apply to discretionary accounts. They commented that it would be impossible to provide specified details as to the nature and amount of the monetary benefits they would receive and retain for products purchased for their clients under discretionary portfolios prior to each transaction.

The SFC has therefore proposed the following approaches:

- Monetary benefits (under explicit remuneration arrangement)
  - Option 1 - specific disclosure by type of investment product
  - Option 2 - specific disclosure of the aggregate amount in percentage terms
- Monetary benefits (under non-explicit remuneration arrangement) and non-monetary benefits
  - An intermediary may purchase an in-house product for its clients. However, there may not be an explicit remuneration arrangement between the intermediary and the related product issuer. In such cases, the intermediary will be required to make a generic disclosure that it will benefit from purchasing in-house products for a client under a discretionary portfolio.

- Where an intermediary will receive non-monetary benefits from a product issuer when purchasing an investment product for a client, it will also be required to make a similar generic disclosure.

All the proposed disclosures are to be made to investors at the account opening stage or prior to entering into a discretionary client agreement. The disclosure must be made in writing, electronically or otherwise. In line with the existing position under the Code of Conduct, intermediaries will not be exempt from this proposed disclosure requirement with respect to clients who are Individual Professional Investors, but may be exempt with respect to Institutional and Corporate Professional Investors.

The proposed transition period is 6 months.

## **CONCLUDING REMARKS**

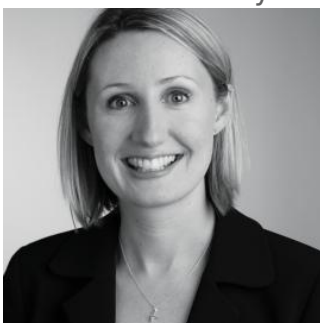
**THE NEW REQUIREMENTS ARE ALIGNED WITH GLOBAL AND INTERNATIONAL STANDARDS, AND ALSO DEMONSTRATE THE SHIFT TOWARDS GREATER TRANSPARENCY IN FINANCIAL MARKETS, PARTICULARLY IN RELATION TO FEES AND CONFLICTS OF INTEREST.**

**ASSET MANAGERS WILL NEED TO CAREFULLY CONSIDER THE IMPACT OF THE NEW FMCC ON THEIR BUSINESS MODELS, PARTICULARLY AS CERTAIN REQUIREMENTS ONLY APPLY TO THOSE FUND MANAGERS THAT ARE "RESPONSIBLE FOR THE OVERALL OPERATION OF A FUND". ONCE THIS ANALYSIS HAS BEEN COMPLETED, FIRMS SHOULD THEN START PREPARING TO MAKE THE NECESSARY CHANGES TO THEIR DOCUMENTATION (INTERNAL AND CLIENT-FACING), AS WELL AS SYSTEMS AND CONTROLS. AS A NUMBER OF THE AMENDMENTS ARE IN LINE WITH REGULATIONS IN THE UNITED KINGDOM AND THE EUROPEAN UNION, FIRMS SHOULD ALSO ENSURE THAT A HARMONISED APPROACH IS ADOPTED.**

**ABOVE ALL, EARLY PLANNING AND SCHEDULING OF IMPLEMENTATION STEPS WILL BE KEY.**

## **KEY CONTACTS**

If you have any questions, or would like to know how this might affect your business, phone, or email these key contacts.



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