SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Risk-focused Industry Meeting Series:

Asset Management: Looking Forward

January 2015

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SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

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The global financial crisis showed that it is important for regulators and market participants to have an active and open dialogue on the evolution of risk and risk mitigation to serve the common goal of promoting safer, fairer and more efficient markets.

From March to November 2014, the Risk and Strategy unit of the Chief Executive Officer's Office of the Securities and Futures Commission conducted a series of risk-focused industry meetings with a representative sample of asset managers. The meetings were held with senior officers of the business, risk management and compliance.

The objective of these meetings is for the Securities and Futures Commission to stay informed of and to better understand the evolution of the asset management industry including opportunities, challenges and risk governance, as well as to identify new risks and emerging risk trends.

This report provides a summary of key trends identified from these meetings. The Risk and Strategy unit will continue its engagement with market participants in the year ahead.

Ashley Alder
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About This Report

Background

In 2013, the Risk and Strategy unit (R&S) of the Securities and Futures Commission (SFC) conducted its inaugural series of risk-focused industry meetings with a representative sample of Global Systemically Important Financial Institutions (G-SIFIs).[1] At the end of the meeting series, the SFC issued a report entitled "G-SIFI Trends in Risk and Risk Mitigation" in December 2013.[2]

During the course of 2014, R&S continued to engage with a range of financial market participants. In particular, R&S conducted a series of risk-focused industry meetings with the asset management industry.

In order to obtain a broad perspective, the sample chosen comprised of global, local and Mainland China asset managers. The business mix of the asset managers we met with included active, passive and alternatives. We also engaged with global regulatory counterparts, industry associations, consultants, stock exchanges, prime brokers, pension funds, sovereign wealth funds, family offices and individual investors.

This report provides a summary of the outcomes of these meetings, as further supplemented by independent research and trend analysis based on public sources.

Structure of the Report

Similar to 2013, we sought the perspectives of the business, risk and compliance departments. We organised the outcomes as follows:

- ***Executive Summary:*** contains highlights of key thematic observations and trends.
- ***Part I: Business Perspective:*** contains an overview of the principal business and strategic observations derived from the meetings, including viewpoints on global business trends, the topic of fees and the need for scale.
- ***Part II: Risk Perspective:*** contains insights from Chief Risk Officers (CROs) and Heads of Risk as to the structure and scope of the risk function, as well as topical areas of risk focus.
- ***Part III: Compliance Perspective:*** contains insights from Chief Compliance Officers (CCOs) and Heads of Compliance as to the scope of the compliance function, as well as topical areas of compliance and regulatory focus.
- ***Part IV: Other Emerging Topics:*** discusses varying viewpoints on systemic risk as well as environmental, social and corporate governance (ESG) integration and risk assessment.

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1 See Financial Stability Board (FSB) "Update of group of global systemically important banks (G-SIBs)" (November 2012). http://www.financialstabilityboard.org/publications/r_12ten31ac.pdf.

2 The SFC report, "G-SIFI Trends in Risk and Risk Mitigation" (December 2013) can be accessed on the following link: http://www.sfc.hk/web/EN/files/ER/Reports/20140109_RIM(EN).pdf.

Definitions and Abbreviations

While we do not define all terms used in this report as many are broadly understood, we hereby highlight two material concepts:

- **Asset managers and fund managers:** manage investments on behalf of asset owners. Asset managers are hired by asset owners or by the operators of collective investment vehicles. In each case, they must comply with the provisions of an investment management agreement that establishes the relationship between the asset manager and the asset owner(s). While the terms asset manager and fund manager are often used interchangeably, in this report we used the term asset manager to refer to the firm and fund manager to refer to the individual.

- **Asset owners:** consist of the following broad categories:

  (i) ***Institutional investors:*** include sovereign wealth funds (SWFs), official institutions (including central banks), insurance companies, pension funds, foundations, endowment funds, family offices, etc.

  (ii) ***Individual investors:*** include private banking clients and retail investors.

A list of abbreviations can be found in the back of this report.

Acknowledgement and Comments

We wish to express our thanks to the CEOs, CIOs, COOs, CFOs, CROs, CCOs, Country Heads and other senior officers from the business, risk and compliance departments of the participating asset managers for their valuable time and input. We welcome comments on this report. Since the asset management industry continues to evolve, we look forward to a continuous dialogue with the industry.

Any comments to this report should be sent to riskandstrategy@sfc.hk or to any of the SFC Risk and Strategy staff listed below:

Bénédicte Nolens, Senior Director

Ron Chiong, Associate Director

Rogers Chan, Senior Manager

Sara Cheng, Senior Manager

Executive Summary

Key Trends

- ***Solid Growth:*** Notwithstanding the global financial crisis (GFC), global assets under management (AUM) have seen solid growth. While Asia ex-Australia and Japan AUM is small compared to the US and Europe, it has seen the fastest growth globally in the past 5 years.

- ***The Search for Yield Continues:*** As a result of the low interest rate environment, investor demand for high-yield products continues. This includes demand for funds with high-yield, multi-asset, unconstrained and alternative strategies, as well as for exchange-traded products (ETPs) with illiquid underlying assets.

- ***Indexing and Low Cost Product:*** Because it is hard to achieve yield, the low interest rate environment has spurred investor focus on returns net of fees. This in turn has contributed to substantial growth in indexing and low cost products, such as passive funds and exchange-traded funds (ETFs), especially in markets with large scale and liquidity such as the US and UK.

- ***Distribution Continues to Move Online:*** Online platforms enable investors to be more self-directed by making available tools to select a fund from a broad list of choices, in line with the evolution in recent years towards investors being able to do more investment via internet and mobile-based solutions.

- ***Increased Focus on Risk Governance:*** The GFC has contributed to increased focus on the risk governance of financial market participants. This trend is not limited to banks, brokers and corporates, but also extends to asset managers and asset owners.

PART I: Business Perspective

- ***Fee Structures:*** A recurring theme from our meetings is the balance among the cost of asset management, fees charged along the distribution chain, investor outcomes and investor choice. The following observations were raised during our meetings:

  (i) ***Competition in Fund Distribution:*** Diversified distribution chains tend to lead to greater competition on fees and more investor choice. Compared to other global markets, the fund distribution chain in Hong Kong is concentrated. In other markets, privately owned online platforms and Exchange platforms have introduced more competition.

  (ii) ***Product Diversity:*** Diversified product also leads to greater competition on price and more investor choice. Because passive index tracking is cheaper than active fund management, passive and ETF products have seen substantial global growth. Compared to other markets, individual investor awareness of low cost products remains low in Hong Kong.

  (iii) ***Investor Awareness:*** Developments in global markets in terms of fund distribution and low cost product have in part been driven by greater investor focus on fees. Greater investor awareness can be achieved through investor education, as well as through other methods such as broadening the choice of low cost products in the pension system.

- ***Need for Scale:*** Asset management is a scale business. If cost is high, investment returns and investor choice suffer. Asset managers discussed the following opportunities for Hong Kong to continue to grow as an asset management centre:

(i) ***Further Connection to China:*** Asset managers support the efforts of Mainland China and Hong Kong authorities to collaborate and thereby grow the scale of the asset management industry. All asset managers indicated that the greatest opportunity in terms of scale continues to lie in growing connectivity with China.

(ii) ***Grow the Pension System:*** Asset managers believe that pensions systems play a crucial role in familiarising retail investors with the importance of portfolio diversification and long-term investment. Asset managers therefore view further growing the pension system as strategically important and suggested incentives to encourage more voluntary contributions.

PART II: Risk Perspective

- ***Scope of the CRO Function:*** CROs observed that the scope of the CRO function continues to broaden from investment risks to non-investment risks. Overall we observed variance in terms of scope, authority and tools of the investment and non-investment risk management functions of the asset managers we met with. In light of this, more dialogue and sharing of knowledge and expertise across the asset management industry as to risk management best practices would be beneficial.
- ***Areas of Topical Risk Focus:*** CROs noted that asset owner due diligence is becoming more intense and includes increased focus on risk governance and culture. Separately, CROs observed that strategies focused on achieving higher yield require tailored risk management approaches, models and tools to ensure the risk is properly measured. Market risk remains a continued area of focus.

PART III: Compliance Perspective

- ***Scope of the CCO Function:*** We observed that the scope of the Hong Kong compliance program is relatively consistent across the asset managers we met with. Looking forward, especially among large asset managers, more automation of market misconduct and communications surveillance is an area of focus.
- ***Areas of Topical Compliance Focus:*** CCOs emphasised increased global regulatory complexity and noted it is difficult and costly to track and implement rules enacted in other jurisdictions that have a global reach. Because increased costs ultimately are passed on to investors, CCOs emphasised their wish for continued cooperation among global and regional securities regulators with a view to greater regulatory harmonisation.

PART IV: Other Emerging Topics

- ***Varying Viewpoints on Systemic Risk:*** The GFC led regulators to assess whether certain financial institutions should be labelled "systemic". While asset managers have expressed strong reservations about such label for various reasons, most acknowledge that products and activities that are more exposed to liquidity risk may warrant further focus.
- ***ESG Integration and Risk Assessment:*** Globally there is an emerging focus on the integration of environmental, social and corporate governance (ESG) factors as part of long-term investment and reputational risk assessment. Moreover, environmental sustainability is widely acknowledged to be important to China's long-term future.

PART I: Business Perspective

Chapter 1: Business Trends

1. Trends in Assets Under Management (AUM)

The global asset management industry experienced stable growth since the GFC. AUM reached USD 68.7 trillion globally in 2013.[3] AUM in the Asia Pacific region reached USD 10.6 trillion, 42% of which originated from Asia ex-Australia and Japan.

Despite the comparatively smaller AUM size of USD 4.4 trillion, Asia ex-Australia and Japan had a higher average annual growth rate than the rest of the world, at an average of 16% per year since 2008. Exhibit 1 shows AUM growth trends globally and regionally since the GFC.

Exhibit 1: AUM sizes and growth rates from 2008 to 2013

	Global		**North America**		**Latin America**		**Europe**		**Middle East and Africa**		**Australia and Japan**		**Asia ex AU and JP**	
	AUM ($T)	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*
2013	68.7	*12.8%*	34.0	*15.6%*	1.7	*13.3%*	19.3	*7.2%*	1.4	*16.7%*	6.2	*19.2%*	4.4	*15.8%*
2012	60.9	*6.8%*	29.4	*6.1%*	1.5	*15.4%*	18.0	*11.1%*	1.2	*9.1%*	5.2	*-11.9%*	3.8	*18.8%*
2011	57.0	*1.1%*	27.7	*0.4%*	1.3	*0.0%*	16.2	*-3.0%*	1.1	*10.0%*	5.9	*11.3%*	3.2	*10.3%*
2010	56.4	*7.6%*	27.6	*8.2%*	1.3	*18.2%*	16.7	*7.1%*	1.0	*0.0%*	5.3	*1.9%*	2.9	*11.5%*
2009	52.4	*12.7%*	25.5	*13.3%*	1.1	*22.2%*	15.6	*10.6%*	1.0	*25.0%*	5.2	*8.3%*	2.6	*23.8%*
2008	46.5		22.5		0.9		14.1		0.8		4.8		2.1	
	Avg Growth	*8.1%*	*Avg Growth*	*8.6%*	*Avg Growth*	*13.6%*	*Avg Growth*	*6.5%*	*Avg Growth*	*11.8%*	*Avg Growth*	*5.3%*	*Avg Growth*	*15.9%*

Source: Boston Consulting Group, Global Asset Management Report 2011 -2014 and SFC R&S Research

2. Net Revenue[4], Cost and Operating Margin Trends

Asset managers typically operate a stable business model. Net revenues and costs as a percentage of AUM tend to be stable. Profitability directly correlates with AUM. Therefore asset managers benefit from economies of scale, explaining a trend towards larger asset managers. Operating margins as a percentage of net revenue improved in recent years due to an additional focus on tightening operating costs.

Exhibit 2 shows the trend in net revenues, costs and operating margins of the global asset management industry. While this exhibit provides a general overview, margins differ between different types of asset managers and across regions/ countries.

Exhibit 2: Net revenue, costs and operating margins in basis points of AUM

	Net revenue *(basis points of AUM)*	**Costs** *(basis points of AUM)*	**Operating Margins** *(basis points of AUM)*	**Operating Margins** *(% of Net Revenue)*
2013	29.4	17.9	11.5	39.0
2012	29.2	18.5	10.7	37.0
2011	29.5	19.0	10.5	36.0
2010	29.6	18.8	10.8	36.0
2009	27.3	18.5	8.8	32.0
2008	28.4	17.9	10.5	37.0

Source: Boston Consulting Group, Global Asset Management Report 2014 and SFC R&S Research

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3 See Boston Consulting Group "Global Asset Management 2014 – Steering the Course to Growth" (July 2014). https://www.bcgperspectives.com/content/articles/financial_institutions_global_asset_management_2014_steering_course_growth/. See also Boston Consulting Group "Global Asset Management Report 2011-2014". http://www.bcg.com/expertise_impact/publications/ViewPublicationSearchResults.aspx?page=1&q=global+asset+management+report+2011&site=BCGCom_Pubs.

4 Management fees net of distribution costs.

3. Product Trends

3.1. Active, Passive and Alternatives

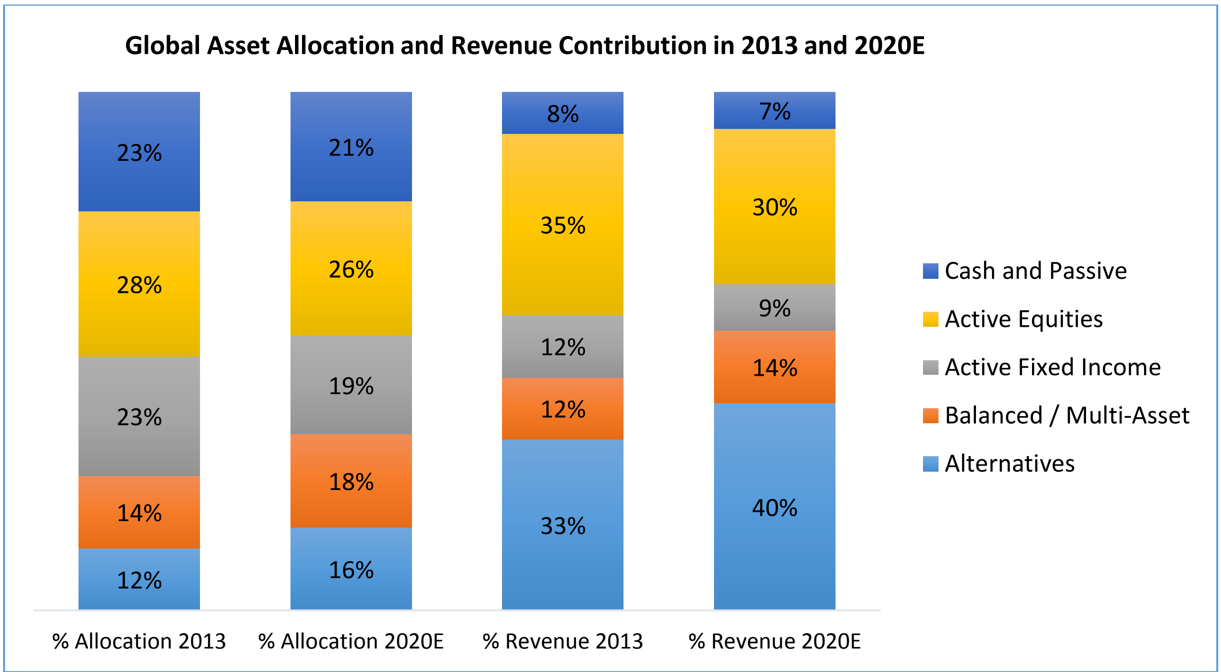
The global asset management industry has experienced a gradual change in product offerings since the GFC and more changes are expected in the future. Exhibit 3 shows the global asset allocation and the corresponding revenue contribution in 2013 and 2020E[5] with the following trends:

(i) Increase in balanced and multi-asset portfolios for further yield enhancement and asset class diversification.

(ii) Increase in alternative portfolios with a view towards outperformance through exposure to specific asset classes or unconstrained investment strategies.

In line with these trends, several global asset managers we met with have been allocating more resources, including in Asia, to establish their multi-asset and alternative investment capabilities.

Exhibit 3: Global Asset Allocation and Revenue Contribution in 2013 and 2020E



Source: McKinsey & Company, The Trillion Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments

3.2. Exchange–Traded Funds (ETFs)

ETFs have continued a trend of very solid growth. Global ETF assets reached USD 2.3 trillion in 2013, with both cash inflow and increases in asset prices contributing equally to the 28.2% year-on-year growth. Exhibits 4 and 5 show the global ETF asset growth rate across various regions and asset classes.[6]

5 See McKinsey & Company "The Trillion-Dollar Convergence: Capturing the Next Wave of Growth in Alternative Investments" (August 2014). http://dailyalts.com/wp-content/uploads/2014/08/McKinsey-Company_2014_Capturing-the-Next-Wave-of-Growth-in-Alternative....pdf.

6 See Deutsche Bank "ETF Annual Review & Outlook – Eyeing $3 trillion Assets Milestone in 2014" (January 2014). http://www.etf.db.com/DEU/DEU/Download/Research-Global/8148686e-b3f4-423e-bde6-b61c811242b0/ETF%20Annual%20Review%20and%20Outlook.pdf.

Exhibit 4: Global ETF asset growth rate per region from 2008 to 2013

	Global		US		Europe		Asia Pacific		Rest of the World	
	AUM ($B)	*Growth*	*AUM ($B)*	*Growth*	*AUM ($B)*	*Growth*	*AUM ($B)*	*Growth*	*AUM ($B)*	*Growth*
2013	2253.8	*28.2%*	1614.4	*33.0%*	396.6	*18.6%*	167.4	*23.8%*	75.4	*2.3%*
2012	1757.4	*29.8%*	1214.2	*29.3%*	334.3	*23.8%*	135.2	*49.1%*	73.7	*36.0%*
2011	1354.3	*3.1%*	939.3	*5.1%*	270.1	*-4.8%*	90.7	*6.8%*	54.2	*5.0%*
2010	1313.4	*26.2%*	893.3	*26.5%*	283.6	*25.0%*	84.9	*30.4%*	51.6	*21.1%*
2009	1040.9	*42.9%*	706.3	*36.8%*	226.9	*64.8%*	65.1	*22.6%*	42.6	*100.0%*
2008	728.4		516.3		137.7		53.1		21.3	
	Avg Growth	*25.3%*	*Avg Growth*	*25.6%*	*Avg Growth*	*23.6%*	*Avg Growth*	*25.8%*	*Avg Growth*	*28.8%*

Source: Deutsche Bank, ETF Annual Review & Outlook - Eyeing $3 trillion Assets Milestone in 2014

Exhibit 5: Global ETF asset growth rate attribution across regions and asset classes in 2013

	Global			US			Europe			Asia Pacific			Rest of the World		
	Growth	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*	*Growth*	*$ Flow*	*Px*
Equity	**36.7%**	*17.7%*	*19.0%*	**41.8%**	*21.2%*	*20.6%*	**28.6%**	*8.9%*	*19.7%*	**24.7%**	*11.6%*	*13.1%*	**6.1%**	*7.2%*	*-1.1%*
Fixed Income	**3.7%**	*6.8%*	*-3.1%*	**-0.3%**	*3.8%*	*-4.1%*	**16.9%**	*15.1%*	*1.8%*	**26.9%**	*23.7%*	*3.2%*	**-0.8%**	*9.8%*	*-10.6%*
Commodity	**-40.7%**	*-19.3%*	*-21.4%*	**N/A**	*N/A*	*N/A*	**-42.0%**	*-19.3%*	*-22.7%*	**-20.5%**	*0.7%*	*-21.2%*	**-44.7%**	*-36.5%*	*-8.2%*
Currency	**41.9%**	*48.1%*	*-6.2%*	**56.3%**	*64.9%*	*-8.6%*	**-69.8%**	*-72.1%*	*2.3%*	**49.0%**	*49.4%*	*-0.4%*	**232.9%**	*244.0%*	*-11.1%*
Multi Asset	**56.7%**	*50.2%*	*6.5%*	**62.9%**	*55.5%*	*7.4%*	**34.6%**	*23.4%*	*11.2%*	**42.1%**	*47.2%*	*-5.1%*	**30.9%**	*30.3%*	*0.6%*
Alternative	**27.7%**	*22.5%*	*5.2%*	**85.8%**	*71.6%*	*14.2%*	**0.1%**	*-8.8%*	*8.9%*	**-23.5%**	*64.4%*	*-87.9%*	**82.9%**	*335.5%*	*-252.6%*
Total	**28.2%**	**14.7%**	**13.5%**	**32.9%**	***17.6%***	***15.3%***	**18.7%**	***7.2%***	***11.5%***	**23.8%**	***12.0%***	***11.8%***	**2.3%**	***6.2%***	***-3.9%***

Source: Deutsche Bank, ETF Annual Review & Outlook - Eyeing $3 trillion Assets Milestone in 2014

The majority of ETF listings and trading takes place in key developed markets that are open to international capital flow. Cross-border capital flow plays an important role in the development and success of the ETF market. Exhibit 6 shows the top 8 Exchanges for ETF turnover in USD billion in 2013.[7]

Exhibit 6: Top 8 Exchanges for ETF turnover in USD billion in 2013

Ranking	Exchange	ETF T/O (USD billion)		No. of ETF Listings	
		2013	**As of Sept 2014**	**As of Sept 2014**	**Ytd Chg**
1	NASDAQ OMX	6,696	5,050	142	+20
2	NYSE Euronext (US)	3,589	2,098	1,481	+74
3	London Stock Exchange	258	209	736	+8
4	Japan Exchange Group	237	200	181	+12
5	Korea Exchange	179	123	166	+20
6	Deutsche Börse	163	130	1,029	0
7	Hong Kong Stock Exchange	116	84	121	+5
8	Shanghai Stock Exchange	109	74	59	+12

Source: World Federation of Exchanges, London Stock Exchange and SFC R&S Research

According to the statistics from Hong Kong Exchanges and Clearing Limited (HKEx), as of September 2014 there were a total of 121 ETFs listed in Hong Kong, with a total market capitalisation of HKD 341 billion.[8] There were 25 ETF issuers offering products tracking 100 different benchmarks, with 33 designated market makers to provide liquidity.[9] Exhibit 7 shows the landscape of the Hong Kong ETF market as of September 2014.

7 See data from World Federation of Exchanges and London Stock Exchange.
8 See HKEx ETF Market Perspective (September 2014). http://www.hkex.com.hk/eng/prod/secprod/etf/Documents/ETFMarketPerspective_201409.pdf.
9 See HKEx ETF Website. http://www.hkex.com.hk/eng/prod/secprod/etf/etfmain.htm.

Exhibit 7: Hong Kong ETF Market Landscape as of September 2014

Benchmark	# ETFs	Market Cap HKD Million	Market Cap %	YTD T/O HKD Million	YTD T/O %
Mainland A Share	39	160,801	47.17%	462,854	71.07%
Hong Kong	19	120,634	35.39%	181,524	27.87%
Asia Pacific	43	13,603	3.99%	2,916	0.45%
Other Equities	7	12,616	3.70%	359	0.06%
Fixed Income and Currency	7	32,230	9.45%	2,089	0.32%
Commodities	6	1,023	0.30%	1,534	0.24%
Total	121	340,907	100.00%	651,276	100.00%

Source: HKEx ETF Market Perspective (January to September 2014) and SFC R&S Research

3.3. Collective Investment Schemes (CIS)

As of 2013, the total AUM of CIS was about USD 30 trillion globally, with the Americas and Europe representing 88.0% and Asia 11.5% of the total.[10] The key drivers of the growth of CIS are the increasing value of invested assets and the popularity of CIS as an investment choice for retail investors.[11] Exhibit 8 shows the trend and growth of AUM in CIS globally and regionally.

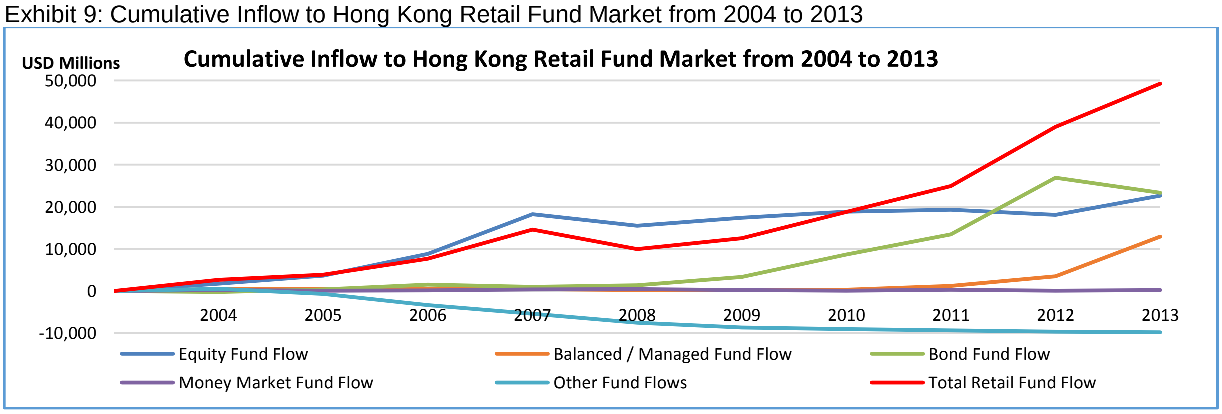
Exhibit 8: CIS AUM sizes and growth rates from 2008 to 2013

	Global		Americas		Europe		Asia Pacific		Africa	
	AUM ($T)	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*	*AUM ($T)*	*Growth*
2013	30.0	*12.0%*	17.2	*13.3%*	9.4	*13.9%*	3.4	*1.6%*	0.1	*-2.1%*
2012	26.8	*12.8%*	15.1	*11.9%*	8.2	*14.0%*	3.3	*13.7%*	0.1	*16.1%*
2011	23.8	*-3.7%*	13.5	*-0.5%*	7.2	*-8.6%*	2.9	*-4.8%*	0.1	*-11.8%*
2010	24.7	*7.7%*	13.6	*8.1%*	7.9	*4.7%*	3.1	*13.0%*	0.1	*33.3%*
2009	22.9	*21.3%*	12.6	*18.9%*	7.5	*21.1%*	2.7	*33.3%*	0.1	*53.9%*
2008	18.9		10.6		6.2		2.0		0.1	
	Avg Growth	*9.7%*	*Avg Growth*	*10.1%*	*Avg Growth*	*8.5%*	*Avg Growth*	*10.6%*	*Avg Growth*	*15.5%*

Source: IOSCO Securities Markets Risk Outlook 2014-15

According to data from Hong Kong Investment Funds Association (HKIFA), the Hong Kong retail fund market grew to approximately USD 50 billion from 2004 to 2013 as shown in Exhibit 9.[12]

Exhibit 9: Cumulative Inflow to Hong Kong Retail Fund Market from 2004 to 2013



Source: HKIFA, 2014

10 The terminology and format of CIS vary by country and jurisdiction, for example, Mutual Funds and Unit Trusts in Hong Kong, Mutual Funds in US, UCITS in Europe, etc.

11 See IOSCO "Securities Markets Risk Outlook 2014-15" (October 2014). http://www.iosco.org/library/pubdocs/pdf/IOSCOPD453.pdf.

12 See Hong Kong Investment Funds Association Retail Funds Sales and Redemptions Data 2004-2013. http://www.hkifa.org.hk/eng/sales-redemptions-data.aspx.

3.4. Pension Funds

The growth of private pension funds has been driven by the reform of pension systems around the world. The aim is to address the adequacy of retirement savings in light of lengthened average life expectancies. Exhibits 10 and 11 show the growth and asset allocations of the seven biggest pension systems in the Organisation for Economic Co-operation and Development (OECD) plus Hong Kong, which together accounted for 92% of global pension assets in 2012.[13]

Exhibit 10: Trend of AUM of selected pension systems in the OECD

Country	**AUM in USD billion**						**5 yr avg growth**	**AUM as % of GDP in 2012**
	2007	**2008**	**2009**	**2010**	**2011**	**2012**		
Australia	978	1,057	844	991	1,401	1,378	7.1%	91.7%
Canada	966	673	879	1,048	1,072	1,199	4.4%	67.3%
Japan	1,153	1,275	1,365	1,498	1,525	1,448	4.7%	26.3%
Netherlands	1,137	933	979	1,016	1,056	1,267	2.2%	160.2%
Switzerland	538	506	581	661	665	734	6.4%	113.6%
UK	2,189	1,352	1,821	2,018	2,233	2,327	1.2%	95.7%
USA	10,725	8,345	9,612	10,647	10,840	11,613	1.6%	74.5%
Hong Kong	*64*	*60*	*67*	*78*	*79*	*90*	*7.1%*	*34.3%*

Source: OECD Pension Markets in Focus 2013 and SFC R&S Research

Exhibit 11: Asset allocations of selected pension systems in the OECD in 2012

<table>
<tr><th>Country</th><th>Cash & Deposits</th><th>Public bills and bonds</th><th>Private bills and bonds</th><th>Loans</th><th>Shares</th><th>Land and buildings</th><th>Mutual funds</th><th>Others</th></tr>
<tr><td>Australia</td><td>18.4%</td><td>1.3%</td><td>8.3%</td><td>1.0%</td><td>46.0%</td><td>7.4%</td><td>0.0%</td><td>17.6%</td></tr>
<tr><td>Canada</td><td>2.7%</td><td>19.5%</td><td>8.1%</td><td>0.3%</td><td>24.6%</td><td>5.5%</td><td>34.6%</td><td>4.7%</td></tr>
<tr><td>Japan</td><td>5.1%</td><td colspan="2">36.3%</td><td>2.8%</td><td>9.7%</td><td>0.0%</td><td>0.0%</td><td>46.1%</td></tr>
<tr><td>Netherlands</td><td>1.3%</td><td>17.0%</td><td>7.0%</td><td>3.8%</td><td>11.6%</td><td>0.9%</td><td>51.9%</td><td>6.5%</td></tr>
<tr><td>Switzerland</td><td>7.3%</td><td colspan="2">19.9%</td><td>3.3%</td><td>13.0%</td><td>9.7%</td><td>42.8%</td><td>4.0%</td></tr>
<tr><td>UK</td><td>2.9%</td><td>12.6%</td><td>9.3%</td><td>1.2%</td><td>29.6%</td><td>2.8%</td><td>23.3%</td><td>18.3%</td></tr>
<tr><td>USA</td><td>0.9%</td><td>9.4%</td><td>6.9%</td><td>0.3%</td><td>38.2%</td><td>1.7%</td><td>22.0%</td><td>20.6%</td></tr>
<tr><td>Hong Kong</td><td>13.3%</td><td colspan="2">24.8%</td><td>0.0%</td><td>57.4%</td><td>0.0%</td><td>0.0%</td><td>4.5%</td></tr>
<tr><td colspan="9">“Others” include unallocated insurance contracts, hedge funds, private equity funds, structured products, assets issued by entities located abroad, and assets issued in foreign currencies
“Others” in Japan also include accounts payable and receivable, plus outward investments in securities
There are no data for the UK for 2012. The data shown above are from 2007</td></tr>
</table>

Source: OECD Pension Markets in Focus 2013 and SFC R&S Research

[13] See OECD “Pension Market in Focus 2013” (2013). http://www.oecd.org/pensions/PensionMarketsInFocus2013.pdf.

Chapter 2: Fee Structures

1. Global Comparison

A recurring theme in our meetings concerned the balance among the cost of asset management, fees charged along the distribution chain, investor outcomes and investor choice. In Hong Kong the cost to investors of buying funds includes a subscription fee and a management fee, as well as other fees.

The subscription fee, sometimes referred as the front-end load fee, is a fee the investor pays to the distributor upon first investment and, unless waived, also when switching. The fee is set by the distributor. Per standard fund documentation, front-end load fees in Hong Kong range from 0%-5% of the subscription amount, although in practice they are towards the middle of this range and are sometimes waived upon switching.

The management fee is paid to the asset manager on an ongoing basis and is deducted from the net asset value (NAV) of the mutual fund or unit trust. Embedded in the management fee in Hong Kong is a trailer fee.[14] The trailer fee is a percentage of the annual management fee that is paid by the asset manager to the distributor as compensation for distribution costs and as a reward for having sold the product. In Hong Kong the trailer fee typically ranges between 30%-60% of the management fee, though for small and new asset managers with less negotiating power it can be around 70% of the management fee.[15]

While in certain markets such as the UK, Australia and the Netherlands, regulators have intervened to abolish subscription and trailer fees and have by regulation replaced them with a "pay-for-advice regime" (see Part III, Chapter 2, Section 2 for more detail), in other markets such as the US, distribution fees and load fees remain permissible as long as they are properly disclosed.[16]

Exhibit 12 is a fee comparison based on public information. It shows fees applied to comparable funds in different markets and by different types of distributors. Because advisory fees vary widely and are not always publicly available, this exhibit assumes that investors are self-directed and require no advisory services. If investors require advisory services, fees apply and must be added to the figures set out in Exhibit 12 to achieve full comparability.

While funds are not fully comparable and while in practice certain fees may be lowered or waived, Exhibit 12 shows that there is significant variance among the types of fees charged in different markets, the types of fees charged by different distributors and the total fees charged to investors.

We sought the views of asset managers about the drivers for fund related fees in Hong Kong. Most noted that the fee structure is the result of a series of factors, notably:

(i) A concentrated distribution chain;

(ii) Low penetration of low cost product; and

(iii) Low investor focus on fees.

We elaborate on each of these factors in further detail below.

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[14] Referred to in other markets as commissions, inducements or retrocessions. See more in Part III, Chapter 2, Section 2.

[15] Asset managers noted a marked increase in the trailer fees from 30-50% several years ago to the current 40-70% range.

[16] For the definition of distribution fees in the US, see Rule 12b-1 http://www.sec.gov/investor/pubs/inwsmf.htm. "No-load funds", "front-end load" and "back-end load" funds have been available in the US for many years.

Exhibit 12: Fee comparison excluding advisory fees

Jurisdiction	Hong Kong	Hong Kong	US	UK (c)	Australia
Distribution intermediaries **Investment type (a)**	Bank Global equity	Broker Global equity	Broker Global equity	Broker Global equity	Broker Global equity
Subscription (Front-end load) or brokerage fees (b)					
Actual charged/ Stated in fund prospectus	2.00%/ 5.00%	1.00%/ 5.00%	3.00%/ 5.25%	0.00%/ 5.00%	0.22%/ 0.00%
Total	***2.00%***	***1.00%***	***3.00%***	***0.00%***	***0.22%***
Account management fee					
Account maintenance fee	0.00%	0.00%	0.00%	0.04%	0.00%
Account administration fee	0.00%	0.00%	0.00%	0.35%	0.00%
Total	***0.00%***	***0.00%***	***0.00%***	***0.39%***	***0.00%***
Fund management fees (d)					
Management fees	1.50%(e)	1.50%(e)	0.90%	0.75%	0.98%
Trustee/ Custodian/ Other Expenses	0.40%	0.40%	0.18%	0.18%	Undisclosed
Distribution fees	0.00%	0.00%	0.25%	0.00%	0.00%
Total	***1.90%***	***1.90%***	***1.33%***	***0.93%***	***0.98%***

(a) This exhibit includes funds that track global equity benchmarks.
(b) The subscription or brokerage fees are one-off costs charged by intermediaries when investors subscribe to, or buy, funds. These fees vary with the size of the investment, the customer relationship, the promotion scheme, etc. The typical subscription fee in Hong Kong ranges from 1% to 3% through the bank distribution channel. Brokers in the US typically charge according to a breakpoint schedule. In Australia, brokers collect brokerage fees based on the size of the investment.
(c) In view of the regulatory changes brought by the Retail Distribution Review (RDR), brokers in the UK do not charge a one-off subscription fee upon fund purchase. Instead, they charge advisory and account management fees. These fees may take different forms, including a percentage of the client's investment, a fixed fee or an initial review fee. See more detail in Part III, Chapter 2, Section 2.
(d) Fund management fees are recurring costs deducted from the NAV of the fund, which include the management fee collected by asset managers, the trustee/ custodian/ other expenses, and the distribution fees. The trustee/ custodian/ other expenses vary significantly in Hong Kong, with a typical disclosed range from 0.2% to 0.7% per annum.
(e) In Hong Kong the management fee includes the trailer fee, which typically ranges between 30%-70% of the annual management fee.

Source: SFC R&S Research

2. Distribution Chain

2.1. Concentrated Distribution Chain

Exhibit 13 below shows that in Hong Kong 78% of retail funds are distributed by banks.[17] Per the exhibit, this is different from other Asian markets where other distribution channels take up a more significant market share. It is also different from certain other developed markets, such as the US and UK, where privately owned fund distribution platforms, independent financial advisers (IFAs),[18] WRAP accounts,[19] and Exchange-owned fund distribution platforms play a larger role.

While the Hong Kong bank distribution model has benefits, including the fact that the banks have made substantial investment in developing user-friendly and regulatory compliant distribution platforms,[20] it also presents draw-backs. In particular, since retail fund distribution is concentrated in one channel, the banks are in a strong negotiating position on fees.

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17 According to the asset managers we met with, four leading banks capture the majority of the fund distribution market share in Hong Kong, of which one bank captures about 45%. Some banks prioritise cross-selling of affiliated fund products over those of external asset managers.
18 Popular in the UK before the Retail Distribution Review (RDR). See Part III, Chapter 2, Section 2 below.
19 Popular in the US. A "WRAP Account" is an internet based investment account which enables investors to view all their financial assets on one platform. Within a WRAP-account the whole portfolio can be analysed and quantified according to money value, tax treatment, product type and asset allocation. Large US securities brokers offer WRAP accounts.
20 For example, compliance with anti-money laundering, know-your-client and suitability regulations.

Exhibit 13: Retail Fund Distribution in Asia as of December 2013

Retail Fund Distribution in Asia in 2013					
Channels (% Market Share)	**Hong Kong**	**China**	**Korea**	**Japan**	**Taiwan**
Banks	78%	42%	27%	33%	30%
Brokers/ IFAs/ Distribution Companies/ Agents	3%	13%	63%	66%	9%
Fund Company Direct Distribution	-	35%	5%	1%	43%
Insurance Companies/ e-platform/ FoFs/ Master Trust	19%	10%	4%	-	17%

Source: PricewaterhouseCoopers, PwC Roundtable – The Future of Funds Distribution in Asia 2014

Views of asset managers about fees differed depending on the products they manage. However, the following observations were common:

(i) Active asset managers highlighted that unless distributors are paid to compensate for the cost of fund distribution, they will no longer distribute the product.[21] Active asset managers noted that because banks are a very important fund distribution channel in Hong Kong, a reasonable level of trailer fees that compensates for distribution expenses is justifiable.

(ii) Passive asset managers and ETF providers noted that their key focus is to keep costs down. In their view, not having trailer or inducement fees leads to a better alignment of interest between advisers and clients as advisers are incentivised to look for the best product rather than the product that pays the highest trailer or inducement fee.

(iii) New, small and niche active asset managers noted that leading bank distributors have significantly reduced the number of retail funds sold by them in recent years. This has made it harder for new, small and niche active asset managers to find distributors for their product, unless they pay higher trailer fees.[22] It has also led to the leading bank distributors offering similar products to retail investors, resulting in more limited investor choice.

2.2. Looking Forward – More Competition in Fund Distribution

2.2.1. Independently Operated Online Platforms

Globally asset management distribution continues to move online. Online platforms enable investors to be more self-directed by making available tools to select a fund from a broad choice, in line with the evolution in recent years towards investors being able to do more investment via internet and mobile-based solutions.

Asset managers observed that the adoption of online distribution has been faster in markets that are open to the use of the internet and social media, as well as those that have adopted "pay-for-advice" regimes.[23] For example in Mainland China, Alibaba's and Tencent's online platforms have used their standing distribution chain for commercial goods to introduce money market fund services.[24] By pooling the excess balances of a very large amount of customers,

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21 For example, as noted in Part III, Chapter 2, Section 2 below, in the case of India when a prohibition on certain types of fees was introduced, banks adapted by selling structured deposits and insurance products instead. Also, in the absence of payment for distribution, private banks may prefer to sell discretionary account management services for which annual fees are charged rather than funds.

22 For example, Mainland China asset managers which are relatively new to the market noted that they were unable to secure the top-tier banks to distribute their products.

23 See Caceis and PwC "Social Media Studies – Asset Management in the Social Era" (June 2013). http://www.caceis.com/fileadmin/pdf/reference_papers_en/SocialMedia_Studies.pdf.

24 Alibaba's online platform Yuebao sells money market funds (MMFs) which offer yield that to date is materially higher than

Alibaba and Tencent have built up AUM at a very fast pace. In the US, FINRA provides an exemption from the suitability requirements for various types of communications that are educational in nature as long as they do not include a recommendation on a particular security or securities. Asset allocation models and certain investment analysis tools fall under the FINRA exemption from suitability.[25] In the UK, the RDR pay-for-advice regime has led to more investors becoming self-directed and going online (see Part III, Chapter 2, Section 2 below).

In the view of asset managers, while the growth of platforms not operated by banks has been slower in Hong Kong than in some other global markets, some independently operated online platforms are starting to appear and there are early indications of this development leading to more fee competition. For example, the Hong Kong broker in Exhibit 12 above operates an online platform and advertises a front-end load fee of 1% and free switching. Certain bank distributors have responded by offering the same fee structure.

2.2.2. Exchange Platform for Fund Distribution

Fund products can be distributed through platforms operated by Exchanges. The NYSE-Euronext[26] and Deutsche Börse[27] are popular platforms covering the western markets. In Asia, the ASX[28] and the Shenzhen Stock Exchange[29] offer similar models.

There are different operating models for Exchange distribution platforms: some facilitate the subscription and redemption of funds, some involve market makers for secondary trading, and some operate a combination of both. Much like privately owned platforms, certain Exchange distribution platforms provide information that assists the retail investor to make his or her own assessment of the fund prior to investing.[30] Exchange distribution platforms thereby assist the retail client to become more "self-directed" in his or her long-term investment management.

Though Hong Kong at present does not have an Exchange distribution platform for funds, most asset managers we met with observed they would find an additional distribution channel to be useful, especially in the context of greater connection between the Hong Kong and Mainland China Exchanges. Asset managers pointed out the following challenges that would need to be overcome:

(i) An Exchange distribution platform would only be attractive to investors and asset managers if the fees are lower than the fees paid through the current bank distribution channel. If Exchange trading requires brokers to act as intermediaries, fees may reappear in the system in the form of broker distribution fees.

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the bank deposit rate. Tencent started a similar platform known as Licaitong in the beginning of 2014. As of June 2014, AUM of the largest MMF in Yuebao and Licaitong reached RMB 570 billion and RMB 60 billion respectively. These online platforms cover the whole China, a reach that is very hard to achieve for physical distributors. That said, the yields offered by these MMFs have dropped from a 6%-7% range in Q1 2014 to a 4%-5% range in Q3 2014.

25 See FINRA Rule 2111. http://finra.complinet.com/en/display/display_main.html?rbid=2403&element_id=9859.

26 See NYSE-Euronext NAV Trading Facility at https://etp.euronext.com/en/content/nav-trading-overview.

27 See Deutsche Börse XETRA at https://xetra.com/xetra/dispatch/en/kir/navigation/xetra#.

28 See ASX mFund at http://www.asx.com.au/mfund/. The ASX mFund is still in its infancy. It was approved by ASIC in February 2014 and launched on May 8, 2014. http://www.asx.com.au/documents/asx-news/ASX_mFund_Launch_8_May_2014.pdf.

29 See Shenzhen Stock Exchange at http://www.szse.cn/main/marketdata/jypz/fundlist1/. The Shenzhen Stock Exchange platform became operational in December 2010. It covers closed-end funds, open-end funds, ETFs, and structured products on the same platform. Currently there are 347 funds listed on the Shenzhen Stock Exchange.

30 The mFund platform of the ASX provides fund information, transaction procedure, fees and charges, selection of brokers for execution, and educational videos.

(ii) An Exchange distribution platform would require greater investor awareness and behavioural change. Hong Kong retail investors are used to relying on banks for advice. An Exchange distribution platform would require investors to act in a more self-directed fashion.

3. Low Cost Product

As noted in Part I, Chapter 1, Section 3 above, ETFs have seen material growth in part because they are a lower cost option for investors. In the US, ETF fees range between 0.10% and 1.00%. In Hong Kong ETF fees range between 0.15% and 1.50%.[31] According to the asset managers we met with, individual investor awareness of the fee structure of ETFs remains low in Hong Kong. This contrasts to institutional investor awareness which is high. For example, asset managers use ETFs in institutional mandates for market access, asset allocation, and sometimes for liquidity purposes. Private banks include ETFs in managed and discretionary portfolios.

4. Investor Education

Investors should know that fees may differ between different distribution channels and different types of products. Also, the concept of trailer fees, while well-understood among asset managers and banks, is not well-understood by retail investors because the trailer fee is embedded in the management fee. Education of retail investors as regards to this and the various options that are available to them in terms of distribution channels and products is important. Investors should also be aware of the impact of fees and charges on their return on investment (ROI) net of fees.

[31] ETF issuers noted that there are various reasons why the fees are higher in Hong Kong, including less scale, the cost of local set up, demand and supply factors, higher legal fees and higher trustee/ custodial costs.

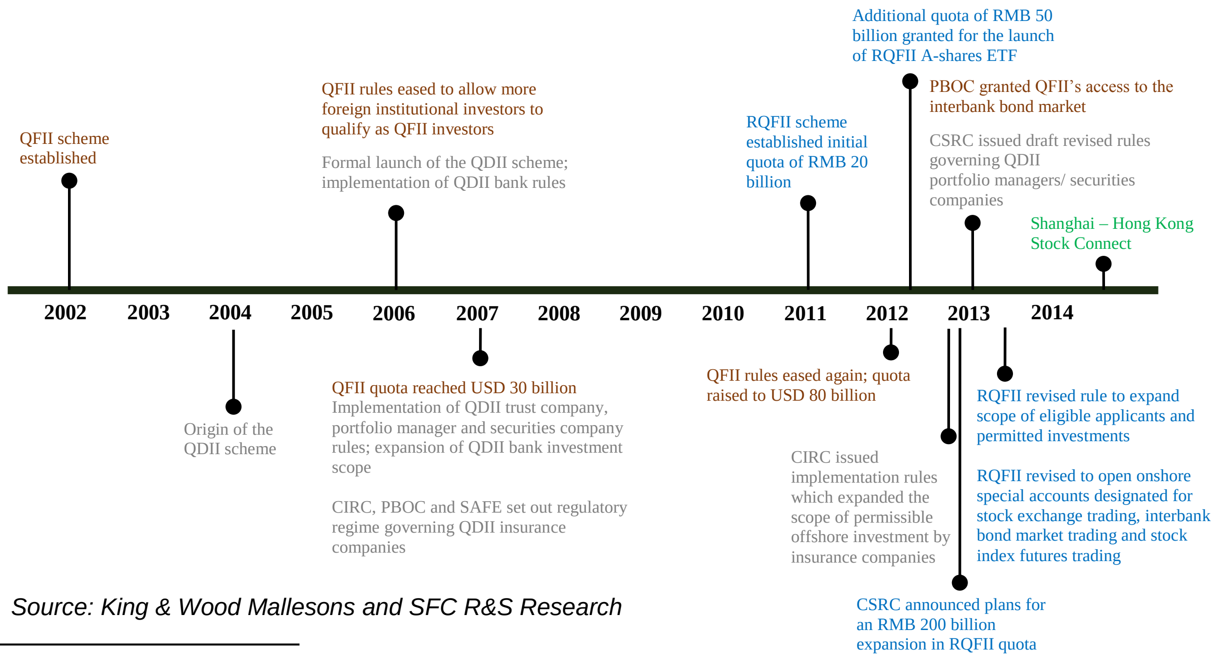
Chapter 3: Need for Scale

1. The Mainland China Advantage

Asset management is a scale business. Without scale, cost is high and high cost lowers net returns for investors. It also causes asset managers to exit certain business lines. Asset managers noted that the key advantages of Hong Kong as a regional asset management centre lie in its solid rule of law and increasing connectivity to a large investor base in Mainland China. Asset managers expect the Mainland China investor base to continue to grow in wealth, maturity and international orientation. In their view, serving this investor base will create further opportunities for Hong Kong as an International Financial Centre (IFC).

As noted in the 2013 SFC Fund Management Activities Survey,[32] the asset management industry continues to grow. The combined fund management business in Hong Kong reached HKD 16 trillion as of the end of 2013, representing year-on-year growth of 27.2% and a 10-year compounded average growth rate of 18.4% since 2003. The survey indicated that Hong Kong continued to be a preferred platform in Asia for international investors who contributed 71.9% of the total fund management business in 2013, excluding real estate investment trusts (REITs). Since 1997, close collaboration between the Mainland China and Hong Kong authorities led to a series of milestones that supported the continued growth of Hong Kong as an asset management centre, including among others, the QFII,[33] QDII[34] and RQFII.[35] Exhibit 14 shows a timeline of the key completed milestones.

Exhibit 14: Timeline of Implementation of QFII, QDII, RQFII, and Shanghai-Hong Kong Stock Connect



Source: King & Wood Mallesons and SFC R&S Research

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[32] See SFC "Fund Management Activities Survey 2013" (July 2014). http://www.sfc.hk/web/EN/files/ER/Reports/2013%20FMAS%20Report.pdf.

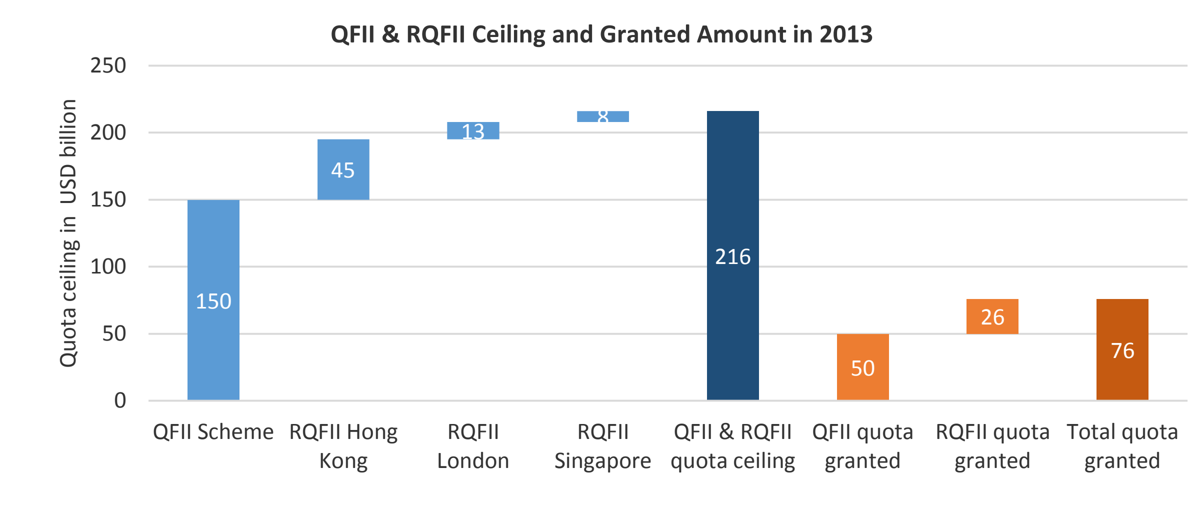
[33] Qualified Foreign Institutional Investor (QFII) quota allows foreign investors to use their offshore foreign currency to invest in the onshore capital markets in China, subject to a specified amount approved. With a QFII quota, foreign investors have the option to invest in a broad set of securities which include both equities and fixed income instruments.

[34] Qualified Domestic Institutional Investor (QDII) quota allows domestic institutional investors in China to invest in offshore securities markets via fund management institutions, insurance companies, securities companies and other asset management institutions which have been approved by Chinese regulators. Each QDII is granted a specific quota by the State Administration of Foreign Exchange (SAFE). There is no cap on the aggregate QDII quota.

[35] Renminbi Qualified Foreign Institutional Investor (RQFII) is a modified version of QFII quota which allows foreign investors to use their RMB raised offshore to invest in the onshore capital market in China.

Exhibit 15 shows the QFII and RQFII quotas granted as of December 2013.[36] Exhibit 16 shows Hong Kong retail fund participation in the QFII scheme from 2006 to June 2013.

Exhibit 15: QFII and RQFII ceiling and granted amount as of December 2013



Source: BNP Paribas Investment Partners, "Expert Eye on China Q1 2014"

Exhibit 16: Evolution of Hong Kong retail funds directly investing in the mainland market through QFII scheme

End of Period	Hong Kong retail funds directly investing in mainland markets through the QFII scheme	
	Number	AUM (USD million)
2006	1	308
2007	1	808
2008	3	285
2009	5	970
2010	9	1,837
2011	9	1,399
2012	16	2,091
June 2013	18	2,138

Source: Hong Kong Government, "Hong Kong: China's Global Financial Centre"[37]

2. Looking Forward – Continue to Broaden the Investor Base[38]

2.1. Further Connection with China

All asset managers we met with indicated they look forward to future initiatives, including in due course the Hong Kong-Mainland China Mutual Recognition of Funds (MRF). In this respect, asset managers added that they are carefully analysing the Mainland China onshore distribution model.[39] Asset managers are assessing factors such as the size of onshore

[36] See BNP Paribas Investment Partners "Expert Eye on China Q1 2014" (Q1 2014). http://publicationsystem.secure-zone.net/v2/index.jsp?id=2565/3100/9138.

[37] See Hong Kong Government publication "Hong Kong: China's Global Financial Centre" (November 2013). http://www.fstb.gov.hk/fsb/topical/doc/pitchbook_brochure(Nov%202013)_e.pdf.

[38] Other suggestions that were discussed during the course of our meetings include: (i) Developing the fixed income market; (ii) Encouraging asset managers to trade Asian securities out of Hong Kong; (iii) Conducting investor and university education on the importance of portfolio diversification; (iv) Facilitating international school placement for children of incoming overseas fund managers; (v) Offering incentives or official mandates to attract and grow new asset managers; and (vi) Focusing on improving air quality and environmental protection in Hong Kong.

[39] In the Mainland China, banks and fund company direct distribution accounted for 80% of the fund distribution in 2013. See "PwC Roundtable – The Future of Funds Distribution in Asia 2014" (May 2014).

demand,[40] distribution costs, marketing costs and training programs that can enable onshore staff to understand the products and provide fair and balanced investment advice to clients. Asset managers added that Hong Kong has clear advantages in launching MRF over other financial centres in that it has a longer history as an offshore RMB centre and has deeper RMB liquidity, thereby providing a platform for smooth launch of RMB product classes.

As per Exhibit 7, the Hong Kong ETF market is highly concentrated on local benchmark products. Since Asian markets are fragmented, ETF issuers believe there is an opportunity for Hong Kong to position itself as a regional ETF platform. ETF issuers observed that consideration can be given to extending Shanghai-Hong Kong Stock Connect to ETFs. In their view, expansion of the ETF investor base to Mainland China investors can lead to increased ETF demand for not only local products, but also regional and global products as the sophistication and international orientation of Mainland China investors grows. ETF issuers added that Hong Kong is well positioned for future ETF growth in view of its financial infrastructure and international expertise.

Asset managers emphasised that benefits of these possible developments must be viewed over the long-term. For example, Mainland China investors still have a home bias, but this is expected to change. Also, investment by asset managers is a gradual process that is correlated to future expectations of demand and growth.

2.2. Grow the Pension System

Pension systems are a significant source of asset management growth globally. Asset managers noted that Hong Kong investors have a tendency to invest short-term. Pensions systems in their view play a crucial role in familiarising retail investors with the importance of portfolio diversification and long-term investment. Asset managers therefore view further growth of pensions systems as strategically important and suggested the following:

(i) ***Create incentives for voluntary contributions:*** Asset managers noted that the pension system in Hong Kong is small because both the mandatory and voluntary contributions are low. Asset managers noted policymakers can consider introducing incentives, such as tax relief and broader early withdrawal conditions, to encourage more voluntary contributions.[41]

(ii) ***Broaden low cost products such as passive portfolios, ETFs and target date funds as constituent funds to pension schemes:*** Passive portfolios and ETFs are discussed in more detail in Part I, Chapter 1, Section 3 above. Target date funds are structured to address a "target date" such as retirement. The fund portfolio automatically resets the asset mix of stocks, bonds and cash equivalents according to the selected time frame and the corresponding change in risk profile of the investor. The return of the fund is not guaranteed.[42]

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40 Many Mainland China visitors already come to Hong Kong to buy fund products. See "2013 Mainland Traveller Finance Monitor Press Conference" by HKIFA/ Nielsen. http://www.hkifa.org.hk/upload/Documents/2014News/April23PC_Nielsen.pdf.

41 See the Towers Watson "Mandatory Provident Fund Survey" (September 2012). http://www.towerswatson.com/en-HK/Insights/IC-Types/Survey-Research-Results/2012/09/mpf-how-bothered-are-we-and-should-we.

42 In the US, target date funds have grown at a double digit rate over the past decade. See Morningstar "2014 Target-Date Series Research Paper" (July 2014). http://corporate.morningstar.com/us/documents/MethodologyDocuments/MethodologyPapers/2014-Target-Date-Series-Research-Paper.pdf.

PART II: Risk Perspective

Chapter 1: Role of the CRO/ Head of Risk

1. Regulatory Focus

The establishment of a risk management function and reviews of its internal framework have been a growing area of regulatory focus. For example:

(i) In Hong Kong, asset managers should maintain satisfactory risk management procedures commensurate with their business as stipulated in the SFC's Fund Manager Code of Conduct and in the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission.[43] Asset managers must also comply with the SFC's Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, which sets out risk management requirements for operating collective investment schemes that involve retail hedge funds and investments in financial derivative instruments.[44]

(ii) In the EU, rules such as MiFID II, CRD IV, UCITS IV, AIFMD and EMIR include focus on the establishment of an independent risk management function and robust risk management processes. To maintain independence, certain of these regulations require that the remuneration of the senior officers in the risk management function is directly overseen by the remuneration committee. Also under CRD IV, the head of the risk management function cannot be removed without prior approval of the management body (the board).

(iii) In Australia, the Australian Securities and Investments Commission (ASIC) issued a consultation paper in March 2013 and proposed regulatory guidance on risk management practices for responsible entities in the asset management industry. ASIC's objective is to standardise fundamental risk management practices and to set out good practices in risk management.[45]

(iv) For alternative asset managers, which previously were not subject to the same level of regulatory scrutiny, many will need to overhaul their risk management systems to meet the new regulatory requirements. For example, in the US, the SEC's Form PF requires hedge funds and other private funds to identify a chief risk management officer.

2. Growing Role of the CRO

According to the asset managers we met with, an effective CRO can help fund managers optimise risk-adjusted investment returns while reducing non-investment risks. The CRO also focuses on corporate liquidity risk, risk culture, risk governance and, importantly, fiduciary risk. This includes understanding how business decisions are made, putting in place robust checks

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43 See SFC "Fund Manager Code of Conduct" (January 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_838_VER20.pdf.
See SFC "Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission" (April 2003). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_162_VER10.pdf.

44 See "SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products" (April 2013). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_3038_VER20.pdf.

45 See ASIC Consultation Paper: "Risk management systems of responsible entities" (March 2013). https://dv8nx270cl59a.cloudfront.net/media/1335518/cp204-published-21-March-2013.pdf.

and balances, and ensuring that fund managers act with honesty, integrity and reasonable care to the asset owners.

While all asset managers we met with have a global CRO, there is only a nascent trend of creating regional and Hong Kong CRO roles. One of the reasons may be that in many cases, Hong Kong serves as a sales office and not an investment management office. This, however, is expected to change with the onset of broader Mainland China opportunities (see Part I, Chapter 3, Section 2 above).

Also, we observed variance in the seniority of the CRO function. In particular, in asset managers that emphasise the importance of the risk management function, the CROs tend to be more senior, are a more integral part of the executive management team (including senior management decision-making committees) and have more tools (including tools that require IT investment). Inversely, in asset managers that assign less importance to the risk management function, there was no local CRO and the risk functions have fewer resources and tools to independently contribute to the risk management process.

CROs noted that aside from investment risk management, there is a growing list of risks which risk managers must be aware of and control, including but not limited to: [46]

(i) ***Fiduciary risk:*** The most senior CROs we met with emphasised that asset managers invest money on behalf of asset owners and as such act as fiduciaries. This, in their view, is the most fundamental principle that must govern and guide the behaviour of fund managers and asset managers. It leads to the need for an independent and empowered risk management function, as well as a clearly agreed and monitored risk appetite and compliance with limits set out in the investment management agreement.

(ii) ***Liquidity risk:*** Because the GFC showed that liquidity can dry up quickly in times of stress, CROs consider liquidity risk management a critical area of focus. Lack of liquidity impacts asset managers in two ways: firstly, illiquidity makes unwinding impossible, which reduces the ability for asset managers to control risk; secondly, illiquidity accentuates mark-to-market losses as it is difficult to obtain fair valuations of assets without reliable trading prices.

(iii) ***Counterparty risk:*** Counterparty risk moved to central stage upon the collapse of Lehman Brothers which left many intermediaries, asset managers and asset owners exposed. Even though the movement of over-the-counter derivatives (OTC) to Central Counterparties (CCPs) is targeted at reducing counterparty risk, CROs emphasised that they need to conduct a CCP risk assessment. This includes due diligence of the operational processes, default waterfalls and margin requirements.[47]

(iv) ***Operational risk:*** Since the GFC, operational risk has gained more attention throughout the financial industry. Asset management CROs took note of the fact that the fines levied against banks and brokers have materially increased. While they do not think the business model of asset managers is comparable to that of banks or brokers, these fines in their view underscore the need for operational risk management.

CROs also observed an increased focus on emerging risk and reputational risk. While the approach varies between asset managers, some have set up specific committees focused on surfacing and discussing these risks:

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[46] In further support to the information contained in this section, see also “Risk Management Lessons Worth Remembering from the Credit Crisis of 2007-2009” by Bennett Golub and Conan Crum (October 2009). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=1508674.

[47] See IOSCO “Securities Markets Risk Outlook 2014-15” (October 2014). http://www.iosco.org/library/pubdocs/pdf/IOSCOPD453.pdf. See also Exhibit 19 below for the Bank/ Non Bank nexus.

(i) ***Emerging risk*****:** CROs observed that emerging risk, while still a new concept, in many ways is intuitive to asset managers because as part of the investment risk management process, asset managers routinely monitor and assess a broad range of risks, trends and shifts that lie "at or beyond the horizon" (see Chapter 2, Section 3 below).

(ii) ***Reputational risk:*** CROs note that because the scope of reputational risk evolves over time, in part due to regulatory, policy and social expectations, it is hard to predict. Consequently, CROs noted it should be part of the culture of the firm for every employee to understand that they own the reputation of the firm and that they have an obligation to escalate such risks.

CROs also noted that there are certain other risks that are managed on a day-to-day basis by dedicated departments but that may interlink with the CRO function:

(i) ***Human Resources risk:*** Asset management is a people business. In particular, holding on to good fund managers is critical because institutional investors only entrust their assets to highly experienced fund managers who have a track record of sustained outperformance. Because of this, fund manager years of experience and attrition are key metrics tracked by all the asset managers we met with.

(ii) ***Vendor and service provider risk:*** In the asset management industry there is a high variety of service providers, including custodians, trustees, administrators and brokers, as well as providers of compliance, legal and corporate secretarial services. Asset managers apply operational risk oversight over these processes.

(iii) ***IT risk:*** In view of the increasing reliance on technology, controlling IT risk is a major focus of operational risk managers. This includes business continuity planning, crisis management and cyber risk control.

(iv) ***Compliance and regulatory risk:*** We elaborate on the compliance and regulatory landscape in more detail in Part III, Chapter 1 below.

3. Structure of the CRO Function

3.1 Investment Risk Management

There is a strong incentive for an alignment of interest between asset managers and asset owners. If fund performance is bad, asset owners can switch. Because of this, investment risk management is the blood that runs through the veins of every asset manager. It is an integral part of doing business.

CROs emphasised that investment risk management does not equate to risk avoidance. Instead investment risk management is about calculating, judging and achieving the proper balance between risk and reward. This requires both bottom-up risk management, including the use of quantitative tools, and top-down risk management, including a strong qualitative understanding of global and local dynamics that may impact investments in the short- and long-term.

All the asset managers we met with have an investment risk management function. However, there is still variance in the scope and reporting line of this function. While for most asset managers it is independent from the CIO, in some asset managers it is not. Most CROs who oversee independent investment risk functions felt that while the investment risk function must work closely with the CIO, it should not report to the CIO and instead should provide independent oversight over investment risks that affect all the funds managed by the asset manager. This includes:

- Market and trading risk
- Currency and interest rate risk
- Market liquidity and pricing risk
- Credit and counterparty risk
- Position concentration risk
- Portfolio compliance risk
- Settlement and basis risk
- Product risk
- Model risk (development and application).

Box 1 shows examples of investment risk management indicators and tools referred to in our meetings.

Box 1: Investment Risk Management Indicators and Tools

1) Portfolio and execution risk controls

- Portfolio risk exposure
  - VaR utilisation by portfolio
  - VaR utilisation by fund manager
- Relative and stressed VaR of portfolio
- Counterparty risk limits
- Stop-loss limits
- Execution limits
- Limits set out in the investment management agreements
- Analysis of abnormal trade executions

2) Analysis of portfolios and asset classes

- Analysis of AUM size and fund flows
  - Tracking of new funds launched
  - Summary of fund flows
- Analysis of performance of asset classes and investment strategies
  - Short-term impact from active positions
  - Portfolio return versus investment style
  - Return contribution from best and worst performing positions and asset classes
- Analysis of fundamental ratios per asset class
  - Equity - dividend yield, P/E ratio, P/B ratio, sales growth, operating margin, etc.
  - Fixed income - duration, yield to maturity, credit of issuer, interest rate forecasts, etc.
- Benchmark comparisons
  - Tracking errors
  - Information ratio (excess return divided by tracking error)
  - Investment style comparison between portfolio and benchmark

3) Portfolio liquidity risk management

- Monitoring of liquidity position per asset class
  - Equity positions versus market capitalisation and trading volume
  - Fixed Income positions versus issued amount
- Monitoring of liquidity positions of listed derivatives contracts
  - Contract positions versus open interest and trading volume
- Liquidity limit controls
  - Liquidity limits per position and asset class
  - Liquidity limits per fund manager
- Estimation and control of liquidation periods
- Monitoring of concentration limits and illiquid positions

4) Portfolio performance review and simulation

- Portfolio performance and contribution analysis
  - Measurement of active beta and risk contribution

- Comparison between target and actual excess returns
- Trend of upturn and downturn of excess returns

- Sensitivity analysis of portfolio returns, including Monte Carlo simulations

5) *Research of the market environment*

- Yield curves
- Market risk appetite
- Investor sentiment

6) *Competitive analysis*

- Top 20 AUM by investment strategy
- Top 20 AUM by sales volume
- Investment fund flow analysis (heat map)
- Market share analysis
- Top/ bottom asset manager analysis

7) *Cash management and house funding*

- Redemption management and projections
- Unencumbered cash management report

8) *Stress testing and scenario analysis*

- Stress testing based on historical scenarios such as
  - Nikkei shock (1990)
  - Russia default (1997/98)
  - Lehman crisis (2008)
  - Euro debt crisis (2011)
- Stress testing, including reverse stress testing, based on hypothetical scenarios such as
  - Surprise movements of yield curves
  - Extreme portfolio movements

9) *Other risk analytics*

- Identification and attribution of risk factors such as value, growth, momentum, etc.
- Measurement of marginal contribution of risk factors to total risk
- Trend analysis of tracking error, beta, risk factors, investment style, etc.

3.2. Non-Investment Risk Management

Non-investment risk management functions are typically part of the risk governance framework of the asset managers, rather than of the fund only. We observed that these functions are structured differently among the asset managers we met with. While the landscape is still evolving, we noted the following clusters:

- ***Corporate/ Business Risk Management:*** Works closely with the CEO to ensure that there is oversight over:

  - Corporate financial risk
  - Corporate liquidity risk
  - Volatility in business performance and earnings
  - Investment performance risk
  - Capital adequacy and solvency risk
  - Model risk (strategy and vendor management)

- ***Operational Risk Management:*** Monitors and tests operational frameworks to reduce the risk of losses resulting from inadequate or failed internal processes and systems, human errors or misconduct, and external events, including:

  - Organisational set-up/ process risk
  - Outsourcing/ third party risk
  - Legal/ tax/ regulatory risk
  - IT/ business continuity risk
  - Fraud/ corruption risk
  - Human resources/ people risk
  - Model risk (validation and testing)

  The operational risk management function showed variance in terms of reporting lines including to the CRO, COO, the head of corporate risk or the head of compliance. We also observed variance in the interpretation and scope of the operational risk function. Box 2 summarises operational risk management indicators and tools referred to in our meetings.

Box 2: Operational Risk Management Indicators and Tools

1) Account and fiduciary risk management
- Client on-boarding and account opening exceptions
- Fee exceptions
- Breaches of investment management agreements
- Investment style appropriateness
- Trade errors/ failed trades
- Delays in account closings
- Delays of asset allocation to client accounts
- Client contact frequency
- Missing or outdated account data (incomplete account reviews)
- Client complaints, frequency and handling time
- Volume of business from same client and business group
- Number of accounts with shared fiduciary responsibility
- Overdraft/ idle cash
- New business activity/ product approval processes

2) Periodic counterparty due diligence
- Regular assessment of trading counterparties
- Monitoring of changes in counterparty risk ratings
- Monitoring of breaches in counterparty risk limits

3) Vendor and service provider risk assessment
- Regular risk assessment of vendors and service providers, including custodians, trustees, administrators and brokers, as well as providers of compliance, legal and corporate secretarial services

4) Transaction risk management and fraud controls
- Pre-trade controls escalated for business, risk or compliance approval
- Post-trade controls over trade reconciliation, allocation to portfolios and NAV valuation
- Incident reports that include investment management agreement breaches, failed trades, execution errors, NAV errors and backdated amendments that were not pre-approved
- Percentage of clients in business activities/ locations that are rated high risk for AML
- Number and amount of high risk country wire transactions
- Anti-fraud controls, including analysis of fraud instances and independent call-backs
- Average dollar loss per case
- Unpriced assets
- Pricing/ valuation outside of standard pricing systems
- Outlier receipt/ disbursement volumes
- Near-misses

- Reconciliation of open/ aged items for accounting compliance
- Oversight over fair and consistent treatment in allocation of positions among different portfolios

5) Technology risk management and controls

- Technology incident reports
- Cyber-attack logs and measurement
- Crisis management, business continuity and disaster recovery planning

6) Model risk controls

- Periodic model validation and evaluation of model algorithms and functions
- Periodic assessments of risk data governance, including data quality, mapping and reconciliation
- Review of parameters and usage of the models
- Stress testing of the models using stressed market data

3.3. Enterprise Risk Management

Several asset managers we met with adopt the Enterprise Risk Management (ERM) approach which creates an integrated picture of risk for the CRO, CEO and the Board. This picture typically aggregates risks from across the organisation, even those that are not within the day-to-day management scope of the CRO (see Section 2 directly above). International and large-sized asset managers indicated that they use an ERM approach for identifying, measuring, controlling and reporting significant risks. The ERM team normally works with the CRO, CEO and the Board to define the firm-wide risk management policy and risk tolerance levels.

4. Looking Forward – Need for Further Convergence

History points to the importance of independent risk management. To succeed, risk management functions must be vested with sufficient scope, authority and tools, including the reporting hierarchy, participation in executive management meetings, human resources and IT investment. During our meetings, we observed variance in the scope, authority and tools of the investment and non-investment risk management functions of the asset managers we met with. In light of this, more dialogue and sharing of knowledge and expertise across the asset management industry as to risk management best practices would be beneficial.

Chapter 2: Topical Areas of Risk Focus

1. Risk Governance and Risk Culture

Asset managers, prime brokers and consultants observed that the expectations of institutional investors concerning risk governance and risk culture have increased since the GFC. Multiple rounds of due diligence have become the norm, especially when selecting smaller or lesser known asset managers. Areas of focus of due diligence are:

(i) **Organisational structure of the asset manager:**

- ***Key person risk:*** Institutional investors look at this from various angles. On the one hand they recognise that asset management is a people business and that therefore it is critical to retain good fund managers or CIOs; on the other hand, excessive dominance by one fund manager or CIO may not be optimal as it can create succession planning related risks as well as insufficiently empowered risk functions.

- ***Remuneration:*** Institutional investors increasingly want to understand long-term alignment of interests with the asset manager by looking at deferred compensation and claw-backs.

(ii) **Organisational structure of the fund:**

- ***Fund terms:*** Institutional investors are focused on consistency among the fund prospectus, the investment management agreement and the articles of association.

- ***Fund expense attribution:*** Institutional investors focus on understanding the split of fees between the asset manager and the fund, with a view to ensure that costs that must be borne by the asset manager are not charged to the fund. In this context, soft dollar arrangements are also reviewed (see more in Part III, Chapter 2, Section 3 below).

(iii) **Governance of the asset manager and fund:**

- ***Corporate governance:*** Some institutional investors conduct due diligence on the background, qualification and independence of the non-executive directors (NEDs) of the asset manager. They also look for the number of directorships the NEDs hold and their time allocation to the asset manager concerned. They expect NEDs to be on top of industry evolution, emerging risks, risk management frameworks and critical transactions. To assess how actively the NEDs play their role, institutional investors may decide to interview them. Institutional investors may also focus on the quality of risk reporting to the Board, which in turn is relevant to the ERM processes of the asset manager (see more in Part II, Chapter 1, Section 3 above).

- ***Risk governance:*** Institutional investors are focused on the independence of risk functions, their authority and seniority in the governance of the organisation and their scope of coverage:

  - ***Risk management***, institutional investors focus on key risk management functions, including investment risk management, liquidity risk management, counterparty risk management and non-investment risk management (see more in Part II, Chapter 1, Section 3 above).

- ***Compliance***, in view of expanded regulations across the globe, including those requiring regulatory reporting, transparency and disclosure, institutional investors focus on who is responsible for compliance with these requirements. For active asset managers and hedge funds, especially those investing in emerging markets (EMs), institutional investors focus on control processes over usage of expert networks (see more in Part III, Chapter 1, Section 1 below).

(iv) **Front-to-back processes**

- ***Cash controls and treasury management:*** Institutional investors scrutinise control processes on cash transfers for non-delivery versus payment (non-DVP) transactions, cash overdrafts and treasury transactions.

- ***Operational risks:*** To understand process weaknesses, institutional investors focus on dealing errors, failed trades, complaints, investment management agreement breaches and NAV errors, as well as on operational risk control processes to track, investigate and control such risks.

- ***Outsourcing and service providers:*** Institutional investors focus on third party services, which are frequent in the asset management industry. This includes focus on who is responsible for due diligence, oversight and periodic reviews of service providers (see more in Part III, Chapter 2, Section 4 below).

- ***Valuation processes:*** In the case of alternatives and less liquid assets, institutional investors scrutinise the valuation approach set out in the investment management agreement, the valuation policy, independent risk control processes and valuation committees. They may also review monthly reports from fund administrators and prime brokers. In case of high complexity or illiquidity of the assets, they may require external valuation and oversight.

(v) **Other topical and emerging areas of focus**

- ***Information technology and cyber security:*** In view of increasing cyber security incidents and technology risks, crisis management, IT risk, data protection and cyber risk defences are captured in the institutional investor's due diligence processes.

- ***ESG Integration:*** To limit investment and reputational risk, institutional investors increasingly ask questions about ESG integration (see more in Part IV, Chapter 2, Section 2 below).

As can be noted from the above, institutional investors due diligence is increasingly demanding and comprehensive. For smaller asset managers and hedge funds, increased institutional investor expectations typically mean they have a higher break-even point than in the past and need more initial investment to be viable.

2. Emerging Strategies and Alternatives

The low interest rate environment has led investors across the globe to search for yield.[48] In the case of asset management this has translated into rising interest and investment in funds focused on the following strategies. Each of these strategies has risk management complexities associated with it:

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[48] See IOSCO "Securities Markets Risk Outlook 2014-15" (October 2014). http://www.iosco.org/library/pubdocs/pdf/IOSCOPD453.pdf.

(i) ***High-yield strategies:*** This includes funds investing in high-yield bonds,[49] leveraged loans and EM assets. Each of these assets is less liquid and harder to value than developed market equity or investment grade debt.[50]

(ii) ***Multi-asset strategies:*** Multi-asset strategies are more complex to risk manage because they require a lot of experience, judgement and the ability to consider and measure risks across a variety of asset classes. Also, to manage correlation risk for multi-asset strategies, models need to be adjusted, or tailored models need to be developed and applied.

(iii) ***Unconstrained strategies:*** Unconstrained strategies offer leeway for asset managers to capture investment opportunities or to mitigate risks by not being bound by a benchmark. Using fixed income asset managers as an example, unconstrained strategies offer more flexibility to invest in a broader fixed income universe with different investment grades, durations, and derivatives, which in turn creates increased risk management complexity.

(iv) ***Alternatives:*** The assets underlying alternative funds may be less liquid and harder to value. They therefore require extensive due diligence and risk assessment on an ongoing basis.

3. Market Risks

In the market risk category, asset managers emphasised the following:

(i) ***Market liquidity risk:*** As a result of significant changes in global rules and regulations, in case of severe market stress, banks may not be as ready to act as market makers and intermediaries as they did in the past. This is relevant for the fixed income markets, as well as other markets that are heavily reliant on liquidity created by market making.

(ii) ***Interest rate risk:*** Since the GFC, global market correlation to US central bank action has increased. The financial markets, including bonds, equities, commodities and currencies, etc., have reacted repeatedly to indications of timing of the first US interest rate increase since the GFC.

(iii) ***Macro risk:*** Asset managers continue to watch macro-economic developments in the US, Europe, Japan and China, as well as the relationship among the oil price fall, deflation risk and currency moves.

(iv) ***Geopolitical risk:*** All asset managers noted increased geopolitical risk. This includes tensions associated with Russia, the Ukraine and the Islamic State, as well as geo-political risk associated with the oil price fall.

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[49] In the case of Asia, high-yield bond funds were highly sought after in 2012-2013. As pointed out in the IOSCO "Securities Markets Risk Outlook 2013-14" (October 2013), there is a risk of correction in bond prices as interest rates rise. Corrections have happened in June 2013, August 2014, September 2014 and November 2014. http://www.iosco.org/library/pubdocs/pdf/ioscopd426.pdf.

[50] For more detailed description of the liquidity risks for high-yield corporate bonds, leveraged loans and EM debt, see BlackRock "Who Owns the Assets?" (September 2014). https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf.

PART III: Compliance Perspective

Chapter 1: Role of the CCO / Head of Compliance

1. Scope of the Compliance Program

We observed that the scope of Hong Kong compliance programs is fairly consistent across the asset managers we met with and includes, among others, the following aspects and processes.

1.1. Compliance Risk Assessment

Many asset managers conduct compliance risk assessments on an annual basis, or sometimes more frequently. Risk themes derived from compliance risk assessments allow senior management to develop response measures and strategies (e.g. training and surveillance) and to allocate resources appropriately to the risks identified. The following are some of the top risk themes noted by several asset managers during our meetings: regulatory reform (e.g. AML, FATCA), cross-border travel, sales and marketing, know your client (KYC) processes, conflicts of interest and safeguarding of material non-public information.

1.2. Investment Guideline Monitoring

As noted under Part II, Chapter 1, Section 2 above, CROs emphasised that asset managers invest money on behalf of asset owners and as such act as fiduciaries. This, in their view, is the most fundamental principle that must govern and guide the behaviour of fund managers and asset managers. It leads to the need for monitoring of compliance with limits set in the investment management agreement. At most asset managers, the coding and monitoring of these limits are conducted by either the compliance or operations division.

1.3. Marketing Materials

Reviewing marketing materials is an important function to ensure that disclosures are in place and marketing materials are in compliance with regulatory requirements and internal policies and procedures.[51] At some asset managers, the review of marketing materials may be outsourced or offshored.

1.4. Handling Errors

All asset managers have established error handling policies and procedures. When an asset manager makes an error or breaches an investment management agreement which results in a monetary loss, many asset managers compensate the client for the loss, even if it is a de minimis amount. Also, most asset managers report all errors or breaches of an investment management agreement to clients, regardless of the amount.

1.5. Gifts and Entertainment

All asset managers we met with have gifts and entertainment policies and procedures in place.[52] However, there is a high level of discrepancy in the pre-approved monetary value threshold for gifts and entertainment among the asset managers. Most asset managers require staff to report

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[51] See SFC "Fund Manager Code of Conduct" (January 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_838_VER20.pdf.

[52] See SFC "Fund Manager Code of Conduct" (January 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_838_VER20.pdf.

and log gifts and entertainment or require approval from compliance, finance or management. Also, some asset managers have processes in place to monitor the frequency of giving gifts and entertainment to track for excessiveness or lavishness.

1.6. Personal Account Trading

All asset managers that we met with have employee personal account trading policies and procedures in place.[53] Most employees generally have to pre-clear personal account trades, along with a self-certification that the employee does not have any confidential information. The minimum holding period varies from 30, 60 and 90 days.[54] Fund managers are generally subject to a pre and post trading blackout period for stocks in their portfolio, which varies from 3, 5 and 7 days.[55] One asset manager stated that if the fund manager purchases securities in the firm's fund, then the fund manager cannot trade out of the securities until the fund closes, unless it is a liquid security that exceeds a certain level of market capitalisation.

1.7. Training

Conducting training is an essential part of compliance. Many asset managers noted that due to many new and enhanced regulations, training is crucial to keep employees up-to-date on rules that impact them. The training plan is typically closely correlated to the results derived from the risk assessment.

1.8. Consequence Management

- ***Performance Review, Promotions and Compensation:*** At some asset managers, compliance has direct input into the performance review, promotion and compensation of professional staff. Some asset managers noted that assessment of an employee's compliance is built into the performance review or appraisal system.
- ***Disciplinary Process:*** At most asset managers, compliance is involved in the disciplinary process. Disciplinary matters are generally handled by a combination of business management, legal, compliance and human resources. Several asset managers noted that disciplinary matters include personal account trading violations, code of conduct breaches, misuse of emails such as sending proprietary information to third parties or to oneself, and violations of gift and entertainment policies.

1.9. Market Misconduct and Communications Surveillance

While most asset managers noted the importance of conducting trade surveillance to monitor market misconduct related risks, only few of the asset managers we met with had automated surveillance systems. While automated systems are particularly important for large asset managers with high volumes of trades, smaller asset managers sought to address the risks of market misconduct through targeted manual surveillance. This included "following the money" and conducting enhanced surveillance in case of persistent fund manager outperformance or underperformance.

With respect to communications surveillance, several asset managers noted that aside from email, staff use the messaging systems of financial data service providers. In markets such as the US, staff also increasingly use social media to communicate information that is educational

53 See SFC "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission" (March 2014) http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_1868_VER50.pdf and SFC "Fund Manager Code of Conduct" (January 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_838_VER20.pdf.

54 In Hong Kong, the minimum required holding period is 30 days. See SFC "Fund Manager Code of Conduct" (January 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_838_VER20.pdf.

55 In Hong Kong, it is 1 day for pre and post trading blackout period. See SFC "Fund Manager Code of Conduct" (January 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_838_VER20.pdf.

in nature to investors. Most noted that the compliance or security departments conduct surveillance of such communications.

1.10. Complaints Handling

All asset managers we met with have complaints handling policies and procedures.[56] Compliance is actively involved in complaints that are related to regulatory or compliance breaches, including complaints that need to be reported to the regulator.

1.11. Whistle-blowing

All asset managers we met with noted they have whistle-blowing policies and procedures. Most asset managers have a hotline that may go to an external counsel or to a member of the legal or compliance departments or to corporate security. One asset manager stated that whistle-blowing cases would be assigned to a non-executive Director on the Board in order to ensure independent review and investigation.

1.12. Expert Networks

Asset managers may utilise expert networks to gain insight from industry specialists on market trends, investment opportunities and other business intelligence across industry sectors. With the use of expert networks, a key compliance risk is the potential disclosure of insider information by experts to fund managers. Another risk associated with expert networks may be bribery and corruption.

In view of these risks several asset managers we met with noted that they do not use expert networks in Asia. Any exceptions to the rule would need business, legal and compliance approval. Asset managers that utilise expert networks noted they have put in place policies and procedures to mitigate the risks above, including but not limited to the following:

(i) Experts and consultants can only be used from a list of approved expert network groups.

(ii) Due diligence is conducted on the expert network before using them.

(iii) A compliance officer chaperones the discussions between the fund manager and the expert.

(iv) The fund manager reads a disclaimer to the expert before a discussion takes place.

(v) Staff compliance training.

[56] See SFC “Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission” (March 2014) http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_1868_VER50.pdf and SFC “Fund Manager Code of Conduct” (January 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_838_VER20.pdf.

Chapter 2: Topical Areas of Compliance Focus

1. International Regulatory Landscape

Asset managers observed that since the global financial crisis, there has been a growing volume of new and enhanced regulations that have significantly impacted the industry. Compliance officers highlighted the following:

(i) In the US, the Dodd-Frank Act and FATCA.

(ii) In the EU, the regimes under MiFID, UCITS, AIFMD, CRD and EMIR.

(iii) In the UK, the FCA rules on retail distribution and soft dollars (further discussed below).

Compliance officers raised the implications on Hong Kong operations of rules with extraterritorial reach enacted in other jurisdictions, as well as the compliance cost and operational risk implications of rules and regulations that are inconsistent on global and regional levels. Because increased costs ultimately are passed on to investors and may thus lead to lower returns, they emphasised their wish for continued cooperation among global and regional securities regulators with a view towards greater harmonisation.

2. Ban on Inducements

One of the major regulatory reforms highlighted by compliance officers relates to fees and inducements. Compliance officers provided their perspectives on the implications of these reforms. It should be noted that while the various reforms use different terms to describe fees and inducements, the broad objectives are similar.

2.1. UK – RDR

The Retail Distribution Review (RDR) in the UK was first announced in 2006 and was implemented on 31 December 2012.[57] The FCA, among other things, raised the minimum level of adviser qualification, banned commissions from being paid to both independent and restricted financial advisers[58] for recommending investment products to retail investors and banned commissions to platform service providers that offer and distribute funds through online platforms to retail investors.[59]

The FCA aimed to ensure that advisers are not inappropriately influenced by the payment of commissions when providing advice to their retail clients on choosing which funds to buy.[60] Consequently, advisers now have to establish a charging structure that is disclosed upfront and in writing to retail investors, with clear information on the adviser's charges, which among others,

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57 See FSA Policy Statement "Distribution of Retail Investments: Delivering the RDR" (March 2010). http://www.fca.org.uk/static/documents/policy-statements/fsa-ps10-06.pdf.

58 Independent advisers provide advice on all types of retail investment products and will consider different product providers across the market. Restricted advisers can only recommend a limited selection of retail investment products and can only consider a limited number of product providers. See FCA Financial Advice "Different types of investment advisers" (March 2014). http://www.fca.org.uk/consumers/financial-services-products/investments/financial-advice/independent-and-restricted-advisers.

59 In December 2014, the FCA issued findings from its first stage of post-implementation review of the RDR (December 2014). http://www.fca.org.uk/news/early-indications-that-reforms-of-financial-advice-are-working.

60 See FCA Finalised Guidance "Supervising retail investment advice: inducements and conflicts of interest" (January 2014). http://www.fca.org.uk/static/documents/finalised-guidance/fg14-01.pdf.

may include hourly rates, a percentage of the client's investment, a fixed fee or an initial review fee.[61]

For online platforms (that include both advised and non-advised/ execution-only platforms), the FCA banned commissions paid by the asset manager to the platform service provider in order to have the asset manager's products included and sold through the online platform. These commissions often came from annual management fees charged to the investor. With the FCA's ban on commissions, platform service providers can only charge for platform services if the charges are disclosed to and agreed by the retail investor.[62]

Following the RDR, many asset managers have introduced new RDR-compliant share classes in funds, called clean share classes. These generally bear a lower annual management charge since commissions are stripped out.[63] The lower annual management charge is generally between 0.75% to 1.0%, as compared to an average of 1.5% on traditional funds that pay commissions.[64] Exhibit 17 sets forth some of the types of share classes that asset managers may offer post-RDR in the UK.

Exhibit 17: Post-RDR share classes

Legacy share class:	• Annual management charge of typically 1.5% available to retail clients under legacy businesses through online platforms until April 2016[65]
Commission share class:	• Annual management charge of typically 1.5% available to institutional investors or intermediaries whose business remains eligible for commission (persons or entities not impacted by the RDR)
Clean share class:	• Post-RDR retail share class that carries a typical annual management charge of generally between 0.75% to 1.0% that strips out commission to retail investors

Source: SFC R&S Research

Moreover, the FCA implemented a ban on asset managers giving cash rebates to retail clients, who purchase the asset managers' products on advised and non-advised platforms. However, unit rebates in the form of shares are permitted.[66]

2.2. Netherlands – Ban on Inducements

The Netherlands Authority for the Financial Markets (AFM) implemented a ban on inducements paid by asset managers to advisers, distributors and platforms in the retail market on 1 January

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61 See FCA "Retail Distribution Review – Adviser Charging" (September 2014). http://www.fca.org.uk/firms/being-regulated/meeting-your-obligations/firm-guides/guide-financial-advisers/rdr-adviser-charging#.

62 The FCA allows a few payments from fund managers to platforms which include work incurred in (i) correction of price errors, (ii) corporate actions, (iii) management of information on investors of the product and (iv) product advertisement on the online platform. See FCA Policy Statement "Payments to platform service providers and cash rebates from providers to consumers" (April 2013). http://www.fca.org.uk/static/documents/policy-statements/ps13-1.pdf.

63 In May 2014, the FCA issued guidance on the transfer of investors from pre-RDR unit classes to post-RDR unit classes setting forth guidance on the conversion procedures to post-RDR unit classes. See FCA Finalised Guidance "Changing customers to post-RDR unit classes" (May 2014). http://www.fca.org.uk/static/documents/finalised-guidance/fg14-04.pdf.

64 See FTadviser "Clean share classes: Seeing 'clean' clearly" (November 2013). http://www.ftadviser.com/2013/11/25/investments/clean-share-classes-seeing-clean-clearly-ap6YBoYRJSA8mh9N0FjiWO/article.html.

65 The FCA continues to allow commissions to be paid to platforms for all legacy business until 6 April 2016, so that platforms will have some time to move existing clients to the new explicit charging model. See FCA Policy Statement "Payments to platform service providers and cash rebates from providers to consumers" (April 2013). http://www.fca.org.uk/static/documents/policy-statements/ps13-1.pdf.

66 Rebate occurs where an investor is given a refund of part of the charge the investor pays for products as an incentive for choosing to invest in those products. Platforms usually pass cash rebates to the investor. The FCA allows cash rebates where they have a value of less than GBP 1 per fund per month as this would be unlikely to offset any adviser or platform charges. See FCA Policy Statement "Payments to platform service providers and cash rebates from providers to consumers" (April 2013). http://www.fca.org.uk/static/documents/policy-statements/ps13-1.pdf.

2014. The Dutch ban extends beyond that in the UK as the AFM also imposed a ban in 2013 on mortgages and life insurance policies sold to retail investors.[67] The distribution landscape in the Netherlands is heavily bank-dominated, accounting for over 95% of fund distribution, whereas in the UK distribution is dominated by financial advisers. Like the UK, Dutch asset managers have created clean share classes that have commissions stripped out.[68]

2.3. EU – MiFID II

In the broader EU context, MiFID II introduces RDR-like rules to an EU market in which distribution models vary widely. However, the MiFID II rules vary from the UK and Netherlands rules. For example, the ban on inducements under MiFID II applies to independent advisers and not restricted advisers. Accordingly in Europe, restricted advisers will still be able to accept inducements, unless otherwise prohibited by member state's national law.[69] Also, MiFID II does not apply to insurance investment products which is separately covered under the Insurance Mediation Directive (IMD) regime.

2.4. Australia – FOFA

In Australia, the Future of Financial Advice (FOFA) reforms were mandatory from July 2013 and introduced, among other things, a statutory best interest duty for financial advisers, enhanced client disclosures and a ban on commissions for providing financial advice.[70] Following the election in 2014, the new government amended some of the FOFA rules aiming to reduce compliance costs and regulatory burdens for the financial services industry.[71] However, in November 2014, a senate majority disallowed the amended provisions.[72]

2.5. India – Ban on Entry Load Fees on Mutual Fund Sales

In India, the Securities and Exchange Board of India (SEBI) banned front-end load or entry load fees on mutual fund sales in 2009.[73] Several asset managers stated that this ban created a lack of incentives for advisers and bank distributors to sell mutual fund products. Consequently, advisers and bank distributors shifted from selling mutual fund products to non-mutual fund products and that the ban therefore had a significant impact on the mutual fund industry.

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67 See Financial Times "Netherlands enacts ban on inducements" (26 December 2013). http://www.ft.com/intl/cms/s/0/4f8bc83a-6e33-11e3-8dff-00144feabdc0.html#axzz3J7qYUz37.

68 See Financial Times "Netherlands edging closer to RDR-style reform" (10 April 2013). http://www.ft.com/intl/cms/s/0/1ba97e5a-a1dc-11e2-ad0c-00144feabdc0.html#axzz35vf9UbIP.

69 See FTadviser "EU directive revisions reach agreement" (17 March 2014). http://www.ftadviser.com/2014/03/17/investments/europe/eu-directive-revisions-reach-agreement-gLHt62MJDYYEun8hgceogJ/article.html.

70 See Australian Government, The Treasury: Future of Financial Advice. http://futureofadvice.treasury.gov.au/Content/Content.aspx?doc=home.htm.

71 The Corporations Amendment (Streamlining Future of Financial Advice) Regulation 2014 includes, among others, removal of the "catch-all" provision (requirement for the adviser to take any other step reasonably regarded as being in the best interest of the client) from the best interests duty; removal of certain ongoing fee disclosure requirements; facilitate the provision of "scaled advice" by allowing an adviser and a client to explicitly agree on the scope of advice to be provided; and expanding exemptions from the ban of on conflicted remuneration provisions. See Ashurst Australia "Streamlining FOFA – July Update" (9 July 2014). https://www.ashurst.com/page.aspx?id_Content=10714.

72 See The Sydney Morning Herald "FoFA changes in tatters in body blow to Abbott Government" (19 November 2014). http://www.smh.com.au/business/comment-and-analysis/fofa-changes-in-tatters-in-body-blow-to-abbott-government-20141119-11piah.html.

73 According to the Association of Mutual Funds in India, in the year before the new rules were implemented, net inflows for those products affected stood at GBP 1.09bn, but in the following year net outflows stood at GBP 1.61bn. See FTadviser "RDR: 'We must learn from India's mistakes'" (4 October 2010). http://www.ftadviser.com/2011/10/26/rdr-we-must-learn-from-india-s-mistakes-okumEqI3tL32jc3UmsB7cL/article.html.

2.6. Looking Forward – Implications

Since inducement bans have been transformative in the markets in which they have been implemented, they have given rise to implications which have differed from market to market depending on the overall structure of the asset management industry. We list below some of the views of the asset managers we met with: [74]

(i) ***Fee repackaging:*** Because fees are hard to compare without in depth research, knowledge and experience, fees can be bundled and reappear under other charges such as platform charges, distribution fees, marketing fees, administration fees, advisory fees, account management fees, etc. Furthermore, bank distributors may also cross-sell their own fund products in order to internally re-bundle fees.

(ii) ***Advice gap:*** Material changes in the distribution chain as a result of regulatory reform may lead to certain distributors not finding distribution profitable. [75] This may lead them to focus on distributing funds only to more profitable client segments such as high net worth clients who can afford to pay for advice, rather than to less wealthy retail clients who may not want to pay since the fee may appear large compared to their personal income.[76] This may lead to an outcome dubbed as "banking for the wealthy" [77] and create an "advice gap" for retail clients.

(iii) ***Growth of online platforms:*** Material changes in the distribution chain as a result of regulatory reform may lead to the growth of online platforms for retail clients. In particular, with a growing advice gap, retail investors who are reluctant to pay for advice may opt for online platforms. This may in part explain the move towards online distribution of funds (see Part I, Chapter 2, Section 2 above).

(iv) ***Growth of low cost product:*** In a "pay-for-advice" regime, intermediaries may have a greater incentive to recommend low cost products. This may in part explain the growth in passive products and ETFs (see Part I, Chapter 1 above). However, this has also led to questions about pro-cyclical effects and herding (see Part IV, Chapter 1, Section 1 below).

3. Soft Dollars Arrangements

Another major regulatory reform highlighted by compliance officers is the rules on soft dollars. Compliance officers observed these reforms may have global implications.

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74 See Cass Consulting, Cass Business School "The impact of the RDR on the UK's market for financial advice - Challenge and Opportunity" (June 2013). http://www.cass.city.ac.uk/__data/assets/pdf_file/0016/202336/The-impact-of-RDR-Cass-version.pdf; Pershing (BNY Mellon) "An executive perspective of UK wealth management in a Retail Distribution Review (RDR) world" (April 2013). http://www.financiallibrary.co.uk/abstract/looking-glass-executive-perspective-uk-wealth-management-retail-distribution-review-rdr-world-17011; and Scorpio Partners Report "Wealth management services in RDR - A HNW investors perspective (November 2013). http://www.scorpiopartnership.com/knowledge/report/hnw-rdr-wealth-management-services-2014/.

75 See Moneymarketing.co.uk "First official RDR stats: adviser numbers down 20%, bank advisers fall 44%" (March 2013). http://www.moneymarketing.co.uk/news-and-analysis/advisers/first-official-rdr-stats-adviser-numbers-down-20-bank-advisers-fall-44/1068505.article.

76 In the view of most asset managers we met with, most Asian investors do not pay for advice but rather, seek free advice from their friends and family as well as from the banks.

77 See FTadviser "Half a million people leave their IFAs in 2012" (18 March 2013). http://www.ftadviser.com/2013/03/18/ifa-industry/advisory-companies/half-a-million-people-leave-their-ifas-in-MUXG91QZXhkhbxtTu4kgeO/article.html. It should be noted that in Hong Kong IFAs only represent a small share of the market.

3.1. UK Regime – FCA Dealing Commission Rules

Soft dollar arrangements generally arise when an asset manager receives a "bundled package" of execution and research products and services from a broker in exchange for commissions paid for securities transactions to the broker.

While soft dollar practices have been in place for a number of years (see Box 3), the FCA became concerned that with bundled rates, price transparency for the value of research is difficult to obtain since the amount paid for research is linked to the volume of trades the asset manager places with the broker. In other words, lack of price transparency of the costs of actual execution and research services obtained with soft dollars leads to concerns about asset managers paying an appropriate amount for execution and research, which can ultimately lead to higher fees charged to clients.

Box 3: Soft Dollar Bundling Approaches

With soft dollars, asset managers generally utilise two models to pay for external research: a bundled rate model and a commission sharing arrangement model. Both models are further discussed below, along with a process called the "broker vote" which asset managers use to rank and pay for research services provided by brokers.

1) ***Bundled Rates***
In the bundled rates model, brokers generally charge by setting a rate for research and a rate for execution. The rates are allocated from the commission received for each executed trade transaction. Brokers may require a minimum amount of commissions to be paid before they give access to proprietary research.

2) ***Commission Sharing Arrangements***
In the commission sharing arrangement (CSA) model, the broker and asset manager enter into an agreement to allow for the commissions related to the research component to be set aside into a separate account or "pot" held by the broker. The pot can be used to pay for (i) research provided by the broker itself or (ii) research from other brokers, (iii) independent research houses or (iv) market research providers. The broker will administer payments from the pot at the instruction of the asset manager. Asset managers may enter into CSA agreements with multiple brokers.

Some asset managers prefer to use the CSA model since it gives them more flexibility to exercise control over research payments, as well as to obtain research from brokers that they do not trade with. Once an asset manager's research budget is used up, the asset manager can switch to paying for the execution only rate component to the broker. However, with CSAs, asset managers also noted that additional administration work is required such as providing instructions to the broker to allocate expenses from the pot and reconciliation of research commissions with the broker.

3) ***Broker Vote***
Many asset managers informed us that they rely on a process called the "broker vote" to rank the quality of research provided by different brokers. The results from the broker vote allow asset managers to reward brokers that have higher rankings to receive a higher percentage share of the research commission pot in the CSA or to reward the brokers with more execution business through the bundled rates model.

In the view of the FCA, risks of conflicts of interest exist in the case of soft dollar arrangements between brokers and asset managers. For example, since broker commissions charged to funds pay for the entire bundle of execution and research services, conflicts of interest arise if asset managers fail to apply the same rigour and scrutiny in controlling these costs as they might if they were paying for these services themselves. Also, asset managers may have an incentive to select brokers based on the soft dollar services they receive rather than the actual quality of the products and services received.

Consequently the FCA made sweeping changes to the soft dollar rules. In particular, the amendments to the Dealing Commission Rules[78] in June 2014 defined much more narrowly than other global rules the type of goods and services that can be paid for from soft dollars. Under the FCA rules, commissions are allowed to pay for only a limited range of costs, in particular:

(i) ***Execution-related services:*** Execution-related services that are eligible to be paid from soft dollars must be (i) linked to the arranging and conclusion of a specific investment transaction (or series of related transactions) and (ii) provided between the point at which the asset manager makes an investment or trading decision and the point at which the investment transaction is completed.[79] The FCA explicitly excludes post-trade analytics as an execution-related service.[80]

(ii) ***Substantive research:*** The FCA's view is that "substantive research" should add value to investment decisions; represent original thought and not merely repeat or repackage what has been presented before; have intellectual rigour and not merely state what is commonplace or self-evident; and present the asset manager with meaningful conclusions based on analysis or manipulation of data.[81] The objective of the FCA, among others, is to improve controls over the use of broker commissions and to address the lack of price transparency in the supply of brokerage and research products and services.[82]

(iii) ***Corporate access:*** Corporate access is a service provided by brokers to clients, such as asset managers, to facilitate access to senior management of companies that asset managers are invested in or may intend to invest in. Under the revised FCA rules, corporate access is no longer deemed as substantive research. Accordingly, corporate access is not allowed to be paid out of soft dollars, but rather should be paid from the asset managers own resources or separately disclosed and charged to clients.[83]

(iv) ***Market data:*** General market data research provided by data service providers does not qualify as substantive research. Under the FCA rules, market data services such as price-feeds or historical price data are also not deemed as substantive research.[84] Accordingly, asset managers noted that in the UK, they now pay for these services in hard dollars which has a direct impact on the asset manager's earnings.

(v) ***Hardware:*** Computer hardware and connectivity services such as electronic networks and telephone lines are not deemed as goods or services related to execution of trades or substantive research and ineligible to be paid from soft dollars.[85]

3.2. EU Intervention – MiFID II

Although the FCA revised rules were made effective in June 2014, broader EU regulation continues to evolve around the subject of soft dollars. It remains to be seen whether MiFID II will go beyond the revised FCA rules to effectively unbundle research and execution services across Europe since the rules are currently undergoing a European Securities and Markets

78 See FCA COBS 11.6. http://fshandbook.info/FS/html/FCA/COBS/11/6.
79 See FCA COBS 11.6.4. http://fshandbook.info/FS/html/FCA/COBS/11/6.
80 See FCA COBS 11.6.6. http://fshandbook.info/FS/html/FCA/COBS/11/6.
81 See FCA COBS 11.6.5. http://fshandbook.info/FS/html/FCA/COBS/11/6.
82 See FCA Policy Statement: "Changes to the use of dealing commission rules" (May 2014). http://www.fca.org.uk/static/documents/policy-statements/ps14-07.pdf.
83 See FCA Policy Statement "Changes to the use of dealing commission rules" (May 2014). http://www.fca.org.uk/static/documents/policy-statements/ps14-07.pdf.
84 See FCA COBS 11.6.7. http://fshandbook.info/FS/html/FCA/COBS/11/6.
85 See FCA COBS 11.6.8. http://fshandbook.info/FS/html/FCA/COBS/11/6.

Authority (ESMA) consultation. However, the FCA stated that they will be supportive of any higher standards imposed under MiFID II.[86]

In ESMA's consultation paper on MiFID II, ESMA proposed a strict ban on most research to be paid out of commissions, such as access to research analysts, bespoke reports or analytical models, corporate access and market data services. According to ESMA, only "minor non-monetary benefits" such as research that is widely-distributed or generic would be acceptable under inducement arrangements. Therefore, asset managers would have to purchase bespoke and other valuable external research through separate contractual agreements with brokers or independent research providers and would have to make a commercial decision on how to pay for these services. That said, in November 2014 ESMA indicated that it had received a great deal of market feed-back related to inducements, notably from the asset management industry. ESMA indicated that it will take into account the feed-back received and is currently developing revised technical advice aimed at addressing industry concerns while still complying with the limitations imposed by MiFID II.[87]

3.3. US Regime – Securities Exchange Act of 1934

In the US, soft dollars have been long established. In particular, soft dollars are allowed under Section 28(e) of the Securities Exchange Act of 1934, which is a safe harbor provision that permits certain types of goods and services to be purchased by asset managers with soft dollars without breaching their fiduciary duties to clients.[88] US asset managers are required to disclose their soft dollar arrangements and conflicts of interests under their annual SEC filing in Form ADV.

The scope of permissible goods and services allowed under Section 28(e) to be paid from soft dollars is wider than the UK regime and includes the following:

(i) ***Brokerage services:*** Brokerage services within Section 28(e) that can be paid from soft dollars are products and services that relate to the execution of a trade which include, among other things, execution clearing and settlement services; post-trade matching of trade information; exchange of messages among brokers, custodians and institutions related to the trade; electronic communication of allocation instructions; routing settlement instructions to custodian banks and clearing agents; and electronic confirmation of institutional trades.[89]

(ii) ***Eligible research services:*** Under Section 28(e), eligible research includes, among other things, traditional research reports analysing a company or stock; discussions with research analysts, meetings with corporate executives to obtain oral reports on an issuer; financial newsletters and economic publications or journals that are not mass-marketed; corporate governance research and corporate governance rating services, market data, company financial data or economic data reports; and seminars or conferences if they relate to research.[90]

(iii) ***Corporate access:*** Meetings with corporate executives to obtain oral reports on the performance of a company is deemed to be eligible research (as noted above) to be

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[86] See FCA Discussion Paper "Discussion on the use of dealing commission regime: Feedback on our thematic supervisory review and policy debate on the market for research" (July 2014). http://www.fca.org.uk/static/documents/discussion-papers/dp14-03.pdf.

[87] See Speech by Steven Maijoor, Chair of ESMA "Asset management–The regulatory challenges ahead" (November 2014). http://www.esma.europa.eu/system/files/2014-1333_steven_maijoor_keynote_speech_at_efama_5_nov_2014.pdf.

[88] See SEC Interpretive Release (July 2006) http://www.sec.gov/rules/interp/2006/34-54165.pdf.

[89] See SEC Interpretive Release (July 2006) http://www.sec.gov/rules/interp/2006/34-54165.pdf.

[90] See SEC Interpretive Release (July 2006) http://www.sec.gov/rules/interp/2006/34-54165.pdf.

paid out of soft dollars because reasoning or knowledge will be imparted at the meeting. Corporate access is explicitly permitted in the SEC's 2006 interpretive release. [91]

(iv) ***Market data***: Market data, company financial data and economic data provided by market data providers are deemed to be eligible research and can be paid from soft dollars (as noted above) so long as they assist in the investment decision-making process.[92]

(v) ***Hardware:*** While the portion of the cost of computers that relates to receiving research (such as market data, company financial data and economic data) can be paid from soft dollars, computer hardware such as computer terminals, and computer accessories are ineligible because they do not reflect substantive content related to the investment decision-making process. Similarly, peripherals such as telecommunications lines, transatlantic cables, and computer cables, are ineligible services and cannot be paid from soft dollars.[93]

3.4. Looking Forward – Implications

Feed-back we received about the implications of unbundling of soft dollars on asset managers was varied:

(i) ***Impact on asset managers:*** While some asset managers stated that stricter soft dollar rules will benefit investors since costs will be more transparent and directly linked to the service used, costs to asset managers will be higher. These costs may be repackaged in the form of higher annual management fees and may still be passed on to investors. Also, several asset managers raised concerns about whether these rule changes favour larger asset managers. For example, unbundling will lead to brokers needing to put a price on research and corporate access, which may not work in favour of smaller asset managers who are more heavily reliant on these services. In particular, smaller asset managers may not be able to absorb research and corporate access costs if directly paid out of their own expenses. Also, while larger asset managers may respond by expanding in-house research, smaller asset managers may not have the resources to do so.

(ii) ***Impact on research***: Many asset managers believe that the impact on the research industry will be very significant. Asset managers noted that some global brokers have already started to develop new methods for charging customers for equity research through subscription and full pricing models.[94] "Putting a price on research" may prompt brokers to be more selective and choose coverage of blue chip companies or large cap stocks that generate more investor interest and trading income to pay for the research. This in turn may result in less research coverage on small and medium size enterprises, unless this space is filled by independent research providers.

(iii) ***Extraterritorial effect:*** Asset managers noted that the FCA rules may impact Hong Kong, especially if the EU adopts similar rules under MiFID II, because global brokers may decide that it is more efficient to apply a uniform global approach rather than a per jurisdiction approach. This is because from a broker standpoint a "per jurisdiction approach" increases both the costs of compliance as well as the risk of non-compliance. Some asset managers noted that they are worried about the extended application of the UK rules as it is very hard to decide in practice what qualifies as "substantive research" and tracking compliance with this definition may increase administrative costs.

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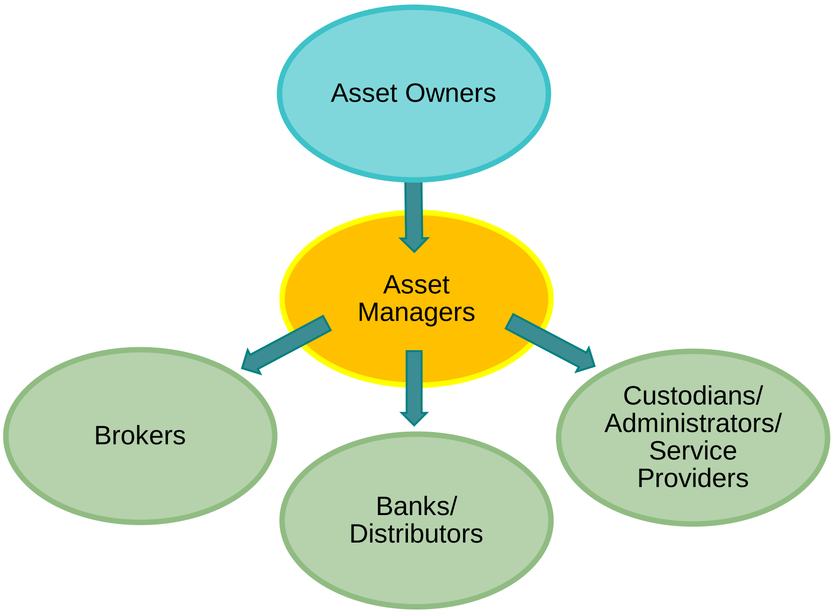
[91] See SEC Interpretive Release (July 2006) http://www.sec.gov/rules/interp/2006/34-54165.pdf.
[92] See SEC Interpretive Release (July 2006) http://www.sec.gov/rules/interp/2006/34-54165.pdf.
[93] See SEC Interpretive Release (July 2006) http://www.sec.gov/rules/interp/2006/34-54165.pdf.
[94] See Financial Times "London banks and brokers face research business shake-up" (24 July 2014). http://www.ft.com/intl/cms/s/0/b5d608ba-0e94-11e4-a1ae-00144feabdc0.html#axzz3E7qrlFov.

4. More Due Diligence

As noted in Part II, Chapter 2, Section 1 above, there is increased due diligence by asset owners of the asset managers, including the robustness of risk governance frameworks. In addition to this, compliance officers highlighted trends toward greater due diligence by asset managers of distributors, brokers, custodians and service providers. Exhibit 18 shows the relationship between the various types of due diligence which asset managers emphasised during our meetings (see also Part II, Chapter 1, Section 3 above on vendor risk).

Exhibit 18: Due Diligence



Source: SFC R&S Research

4.1. Distributor Due Diligence

Prior to selecting a distributor for investment product distribution, many asset managers have processes in place to screen the distributor.

Many asset managers that utilise bank distribution channels conduct due diligence on the distributor with the use of standard due diligence questionnaires that, among other things, inquire about the distributor's organisation structure, business activities, client on-boarding procedures (e.g. KYC processes), hiring processes and compensation policy for the sales team, compliance and risk management, litigation and regulatory violations, and penalties.

Periodic monitoring and annual reviews are also performed to effectively assess the soundness and reputation of a distributor bank. Some asset managers monitor news events for regulatory penalties and misconduct and routinely review the distributor's registration and licensing status.

However, considering the current distribution landscape in Hong Kong in which the market is concentrated on a limited number of bank distributors with high levels of competition for limited shelf space, there may not be much room for asset managers to discriminate between distributors.

4.2. Custodian Due Diligence

Many asset managers outsource account opening and other middle-office and back-office operations to custodians. Some asset managers noted that custodian service charges can be high due to limited competition and choices available in Hong Kong.

Asset managers that utilise custodian services conduct due diligence on the custodian with the use of due diligence questionnaires that, among other things, inquire about the custodian's organisation structure, AML processes, delegation to sub-custodians, business continuity planning, safekeeping of assets, trade and cash reconciliations, and settlement processes.

Periodic monitoring and annual reviews are also performed to effectively assess the soundness and reputation of a custodian.

4.3. Broker Due Diligence

As noted under Section 5.1 below, asset managers indicated they conduct due diligence on brokers to meet the requirements of the electronic trading rules in Hong Kong.

5. Focus on Hong Kong Regulatory Changes

As for Hong Kong regulations, compliance officers noted they are focused on the following developments.

5.1. SFC Electronic Trading Rules

Paragraph 18 of the SFC Code of Conduct on Electronic Trading [95] became effective on 1 January 2014. Many asset managers stated that they had spent significant time and resources to comply with the new rules.

5.2. SFC Guidance on Internal Product Approval Process

The SFC circular, Guidance on Internal Product Approval Process[96] was issued on 30 April 2014. Many asset managers noted that the principles allowed them to formalise procedures and processes, such as the creation of checklists for record-keeping, the establishment of committees and a requirement for formal sign-off by senior management.

5.3. FSTB Consultation on Open–Ended Fund Companies

In March 2014, the FSTB issued the Open-Ended Fund Companies Consultation Paper on the introduction of an open-ended fund company structure in Hong Kong. The new open-ended fund company structure aims to complement the existing unit trust structure to provide more flexibility in establishing and operating funds in Hong Kong.[97] Asset managers took note and are assessing this additional option proposed in the FSTB consultation paper.

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[95] See SFC "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission" (March 2014). http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_1868_VER50.pdf.

[96] See SFC Circular "Guidance on Internal Product Approval Process" (30 April 2014). http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=14EC25.

[97] See FSTB "Open-Ended Fund Companies Consultation Paper" (March 2014). http://www.fstb.gov.hk/fsb/ppr/consult/doc/ofc_e.pdf.

PART IV: Other Emerging Topics

Chapter 1: Varying Viewpoints on Systemic Risk

1. The Systemic Risk Debate

Discussions continue on the subject of systemic risk in asset management, including whether (and if so how) the label of "non-bank non-insurance global systemically important financial institution" (NBNI G-SIFI) should be applied to asset managers and funds. Several authorities have issued papers on these topics, for example the Financial Stability Board (FSB) and International Organization of Securities Commissions (IOSCO) paper proposed factors and criteria to assess whether different types of institutions, including asset managers, investment funds and hedge funds, are systemic; the US Office of Financial Research (OFR) issued a paper that singled out certain key factors that, in the view of the OFR, make the industry vulnerable to shocks including herding; and along the same theme, the Bank of International Settlements (BIS) issued a paper on pro-cyclical effects of asset management in emerging markets. In the case of hedge funds, the effects of leverage and derivatives, the margin practices of prime brokers and the importance of asset segregation are areas of focus. There are a series of other papers, including industry views, on the topic of systemic risk in asset management.[98]

During our meetings certain asset managers expressed reservations about the NBNI G-SIFI denomination for various reasons, including the fact that asset managers and funds are already regulated by securities regulations in most jurisdictions in which they operate.[99] They also observe that asset managers are different from banks in that they do not take deposits and that certain forms of macro-prudential regulation may not be appropriate or effective. For example, while macro-prudential guidance on credit extension is a common feature of the banking industry whereby central banks instruct banks to tighten lending standards, asset managers indicated that they are not able to comply with macro-prudential guidance to invest or divest as this could put the asset manager in violation of its investment mandate and fiduciary duties. Other forms of macro-prudential regulation such as holding more capital at the firm level may not be effective as capital at the firm level cannot be transferred to the fund level.[100] Capital also adds to cost which may lower returns for investors.

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98 See FSB/ IOSCO Consultative Document "Assessment Methodologies for Identifying Non-Bank Non-Insurer Global Systemically Important Financial Institutions Proposed High-Level Framework and Specific Methodologies" (January 2014). http://www.financialstabilityboard.org/publications/r_140108.pdf;
Office of Financial Research (OFR) "Asset Management and Financial Stability" (September 2013). http://www.treasury.gov/initiatives/ofr/research/Documents/OFR_AMFS_FINAL.pdf;
BIS "Asset managers in emerging market economies" (September 2014) http://www.bis.org/publ/qtrpdf/r_qt1409e.pdf;
The Brookings Institution "Systemic Risk and the Asset Management Industry" (May 2014). http://www.brookings.edu/~/media/research/files/papers/2014/05/systemic%20risk%20asset%20management%20elliott/systemic_risk_asset_management_elliott.pdf;
The Rand Corporation "Hedge Funds and Systemic Risk" (2012). http://www.rand.org/content/dam/rand/pubs/monographs/2012/RAND_MG1236.pdf;
Andrew G Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee, speech on "The age of asset management?" (April 2014). http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf and other papers cited in the footnotes to this Chapter.

99 See Parts II and III of the report for examples of recent regulatory changes.

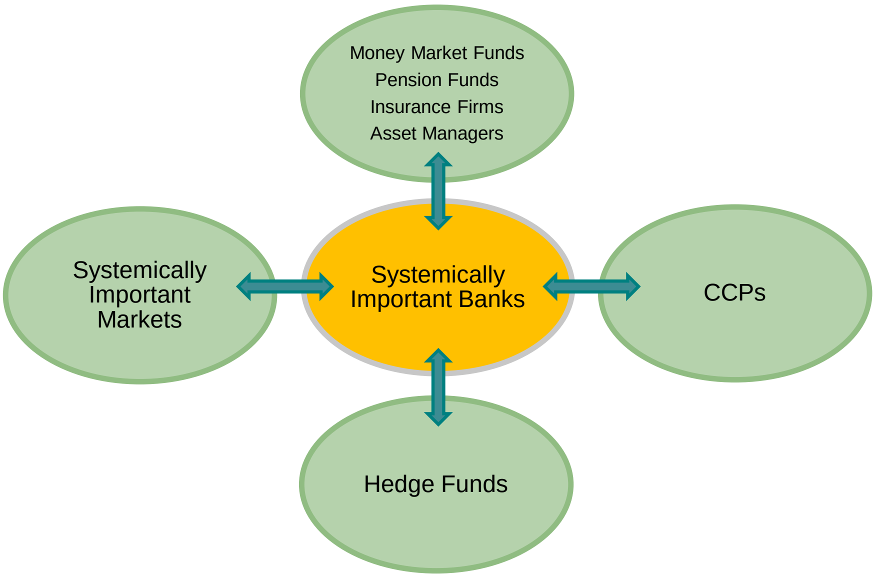
100 See the industry responses to the OFR paper. All comment letters are available on the following website: http://www.sec.gov/comments/am-1/am-1.shtml. The comment letters also include observations on resolution.

2. Risks in certain Activities and Products

Notwithstanding the above, asset managers agree that products and activities that are more exposed to liquidity risk warrant further focus:

(i) ***Activities:*** There are certain activities which, while vital to the financial system, may contribute to interconnectedness. The activities include leverage,[101] derivatives, sale and repurchase agreements and securities borrowing and lending.[102] While these activities are centred on the systemically important banks, asset managers participate and as such are part of the broader nexus and in certain cases are exposed to risks. For example, depending on the rules and regulations governing the fund, funds may hold derivatives for investment or hedging purposes or both. Also products such as synthetic ETPs use derivatives to track the underlying market or benchmark.[103] While central clearing of derivatives was introduced to reduce the risks of interconnectedness, in case of a jump or a tail-of-tail event, risks may materialise and impact the clearing members, asset managers and asset owners.[104] Exhibit 19 shows the bank/ non bank relationship in the financial system.[105]

Exhibit 19: Bank/ Non Bank Nexus



Source: Manmohan Singh, IMF Senior Economist, 2014

[101] The IOSCO "Securities Markets Risk Outlook 2014-15" (October 2014) elaborates in more detail on leverage in the financial system in Chapter 1: The Search for Yield and the Return of Leverage in the Financial System. http://www.iosco.org/library/pubdocs/pdf/IOSCOPD453.pdf.

[102] See Securities Lending Times report "The role of securities lenders in the supply of (re-usable) collateral" by M Singh (2014). http://www.securitieslendingtimes.com/sltimes/collateral_management_online2014.pdf.

[103] See BlackRock "Exchange Traded Products: Overview, Benefits and Myths" (June 2013) which notes that: "Whereas conventional index-tracking ETFs directly own the underlying securities of their benchmarks, "synthetic" ETPs rely on derivatives to track their benchmark exposures. Most commodities ETPs also rely on derivatives, as do "leveraged" or "inverse" ETPs which provide a multiple or short exposure to a benchmark. Synthetic ETPs introduce a set of complexities not present with ordinary ETFs. We sponsor a handful of synthetic ETPs in order to provide investors with exposure to markets that cannot practicably be tracked with physical securities. While synthetic ETPs that are collateralized and use multiple counterparties can be useful and appropriate investments, we have publicly questioned synthetic ETPs that are uncollateralized or use a single affiliated derivative counterparty." https://www.blackrock.com/corporate/en-pl/literature/whitepaper/viewpoint-etps-overview-benefits-myths-062013.pdf.

[104] See example of a jump event in the IMF paper "Limiting Taxpayer "Puts"—An Example from Central Counterparties" by M Singh (November 2014). http://www.imf.org/external/pubs/cat/longres.aspx?sk=42451. See also Chapter 3: Risks in Central Clearing in the IOSCO "Securities Markets Risk Outlook 2014-15" (October 2014). http://www.iosco.org/library/pubdocs/pdf/IOSCOPD453.pdf.

[105] See IMF Working Paper by M Singh "Financial Plumbing and Monetary Policy" (June 2014). http://www.imf.org/external/pubs/ft/wp/2014/wp14111.pdf.

To address the risks of interconnectedness, regulatory authorities in various key markets have introduced reporting requirements that seek to monitor and capture the build-up of systemic risk. For example, in the EU, AIFMD requires regulatory reporting by alternative investment fund managers to allow the regulatory authorities to identify, monitor and manage systemic risks to the EU financial system. In the US, the Dodd-Frank Act requires hedge fund managers and private fund managers to file Form PF with the SEC with information to identify and respond to threats and risks to US financial stability. In Hong Kong, information on the risk profiles of licensed hedge fund managers and portfolios managed by them is obtained through periodic surveys.

Nevertheless, to achieve a globally integrated picture of risk in those activities, further global regulatory collaboration is needed, including harmonisation of regulatory filing requirements. For example, the recent IOSCO hedge fund survey reiterated that too little information is available to properly be able to assess hedge fund leverage.[106] Also during our meetings asset managers reflected that variance in the systemic risk data that must be reported in different markets not only makes it hard for regulators to form a globally integrated picture of risk, but also adds to asset management costs. Ultimately higher costs are passed onto investors.

(ii) ***Products:*** As a result of the low interest rate environment, investor demand for high-yield products has continued. This includes demand for funds with high-yield, multi-asset, unconstrained and alternative strategies, as well as for ETPs with illiquid underlying assets. For example, on a global level there is increased investor interest in strategies known as "liquid alternatives". However, as noted above, the risk with alternatives is that they are less liquid in a shock scenario. Furthermore, in Hong Kong there is significant investor interest in "balanced funds". Even though these funds invest in various assets, they are oriented towards achieving yield and as such are more akin to multi-asset or high-yield strategies. Furthermore, asset managers have drawn attention to synthetic ETPs, including leveraged and inverse ETPs, because they make use of swaps and consequently become part of the broader financial system nexus set out in Exhibit 19 above. Also, some global asset managers have drawn attention to ETPs with underlying assets that are illiquid because if there are sudden market movements, the assets may no longer have a market price or may see sudden large drops in prices.[107]

3. Looking Forward: Liquidity Risk, Risk Governance and Transparency

The central theme that ran across our industry dialogue on systemic risk is the paramount importance of liquidity risk management. In case of severe market stress or shock, asset managers may need to adjust positions, putting downward pressure on prices. Drops in prices negatively impact fund net asset value (NAV) which may contribute to redemptions (referred to as "run risk"). Liquidity risks vary widely depending on a series of factors, including but not limited to liquidity of the underlying assets, exposure to interconnectedness in the financial system and the presence or absence of redemption restrictions.

Other central themes from our industry dialogue are the importance of robust risk governance in funds and asset managers, as well as the importance of disclosure, reporting and transparency (see Part II and Part III above).

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[106] See IOSCO "Report on the second IOSCO hedge fund survey" (October 2013). http://www.iosco.org/library/pubdocs/pdf/ioscopd427.pdf.

[107] For more detailed description of the liquidity risks for high-yield corporate bonds, leveraged loans and EM debt, see BlackRock "Who Owns the Assets?" (September 2014). https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-closer-look-selected-asset-classes-sept2014.pdf. See also Société Générale, "ETFs Uncovered: Where the systemic Risk Lies – Illiquidity" (November 2014).

Box 4 notes certain regulatory developments and industry views in relation to liquidity risk in mutual funds.[108]

Box 4: Liquidity Risk

1) ***Requiring asset managers to establish robust liquidity risk management practices*** and requiring disclosure thereof in the fund prospectus. For example, UCITS must be able to measure liquidity risk, including risks arising from potential changes in market conditions that might adversely impact the UCITS. AIFMD prescribes stress testing under normal and exceptional liquidity scenarios. AIFMD also requires extensive reporting to regulatory authorities of the liquidity profile of the fund, exposure to counterparties and the nature of leveraged positions.

2) ***Limiting levels of illiquid assets and establishing concentration limits:*** asset managers note that there is divergence in global regulatory approaches. For example, UCITS rules mostly focus on risk management practices and transparency, while the US Investment Company Act of 1940 (US 1940 Act) imposes a definition of what is illiquid and of the maximum allocation as a percent of fund NAV.

3) ***Establishing proportionate controls and transparency over the use of leverage for less liquid asset classes:*** leverage can come in the form of borrowing or embedded in derivatives. Consequently, the UCITS rules limit short-term borrowing, but allow derivatives for investment and hedging purposes, while imposing extensive rules such as defining eligible derivatives, appropriate counterparties, collateral requirements, maximum risk exposure and limits on borrowing for short-term purposes. The US 1940 Act imposes a total assets debt leverage limit, disclosure and asset segregation requirements in case of investment in derivatives.

4) ***Providing tools to stem downward spirals from redemptions in case of crisis:*** asset managers observed that during the GFC when a money market fund "broke the buck", the liquidity dried up mostly due to loss of trust. Investors judged that to move first was safest. This in turn started a spiral of redemptions that could only be stemmed by government intervention to restore trust. Looking forward and while learning from this experience, asset managers believe that downward spirals stemming from loss of trust in crisis scenarios can be better handled by using a combination of in-kind redemptions where operationally feasible and by allowing fund boards greater discretion to manage redemptions, including in exceptional cases by putting up a gate and suspending redemptions. UCITS allows for gates to be used when total outflows exceed 10% of the fund NAV on a given business day, while the US 1940 Act only allows redemption suspensions in case of trade suspensions and other limited scenarios. The recent money market fund (MMF) regulatory revisions in the US also provide for gates or the imposition of redemption fees when weekly liquid assets fall below 30% of the MMFs total assets. Furthermore, MMFs are required to impose a 1% redemption fee when the weekly liquid assets fall below 10% of the MMF's total assets unless the board decides such a fee is not in the interest of the MMF investors.

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[108] See BlackRock Viewpoint "Fund Structures as Systemic Risk Mitigants" (September 2014). https://www.blackrock.com/corporate/en-fi/literature/whitepaper/viewpoint-fund-structures-as-systemic-risk-mitigants-september-2014.pdf. For a detailed analysis of the risks presented by hedge funds, see "Hedge Funds and Systemic Risk" by the Rand Corporation (2012). http://www.rand.org/content/dam/rand/pubs/monographs/2012/RAND_MG1236.pdf.

Chapter 2: ESG Integration and Risk Assessment

1. History and Global Backdrop

Globally there is an emerging focus by investors on the integration of environmental, social and corporate governance (ESG) factors in the investment process. In the case of China, this is further catalysed by the emphasis of the Mainland China leadership on the importance of sustainability to China's long-term future.

The concept of ESG integration goes back to 2006. In particular, after mounting evidence of the financial materiality of ESG issues, as well as growing demands for more sustainable approaches to investment, a group of the world's largest asset owners and asset managers agreed to the United Nations-supported Principles for Responsible Investment (the UN PRI) as well as to possible actions that can be taken to implement the principles. See Box 5 for the UN PRI. The asset owners and asset managers who are signatories to the UN PRI together represent USD 45 trillion AUM.[109]

Box 5: The UN PRI – Six Principles

- **Principle 1:** We will incorporate ESG issues into investment analysis and decision-making processes.
- **Principle 2:** We will be active owners and incorporate ESG issues into our ownership policies and practices.
- **Principle 3:** We will seek appropriate disclosure on ESG issues by the entities in which we invest.
- **Principle 4:** We will promote acceptance and implementation of the Principles within the investment industry.
- **Principle 5:** We will work together to enhance our effectiveness in implementing the Principles.
- **Principle 6:** We will each report on our activities and progress towards implementing the Principles.

Since the UN PRI were agreed in 2006, ESG integration in the investment process has grown. For example, on a global level there is a broad range of ESG themed products, including funds, ETFs, hedge funds, green bonds, etc.[110] Moreover, non-governmental organisations (NGOs), data vendors and consultants provide an increasing range of tools to measure ESG risk factors. In addition, academic,[111] NGO[112] and private sector[113] research on the topic has grown.

[109] See PRI "Signatories to the Principles for Responsible Investment" http://www.unpri.org/signatories/signatories/.

[110] See Mercer "The Evolution Of Responsible Investment" (August 2014). http://www.mercer.com.hk/insights/view/2014/the-evolution-of-responsible-investment.html ; the Global Sustainable Investment Alliance (GSIA). http://www.gsi-alliance.org/; and the "Asia Sustainable Investment Review" of the Association for Sustainable & Responsible Investment in Asia (ASrIA) (December 2014) which notes that as of the end of 2013 there were USD 44.9 billion of assets in Asia (ex-Japan) being managed using one or more sustainable investment strategies, and that Hong Kong saw a growth of 24% growth per year since 2011. http://asria.org/asias-sustainable-investment-market-is-robust-and-growing/.

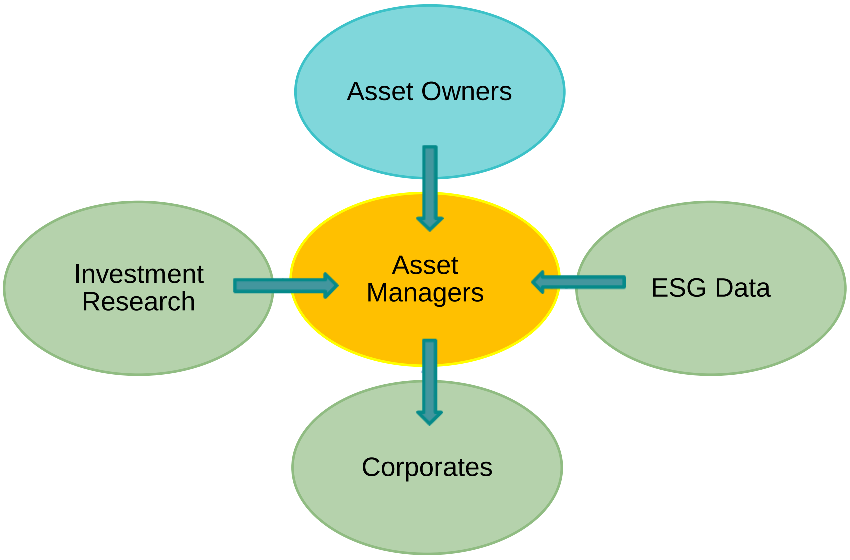
[111] See Harvard Business Review "Creating Shared Values" (January 2011). https://hbr.org/2011/01/the-big-idea-creating-shared-value; "Socially Responsible Funds and Market Crises" (September 2012). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2142343 and "Active Ownership" (August 2014). http://papers.ssrn.com/sol3/papers.cfm?abstract_id=2154724.

[112] See the Carbon Disclosure Project (CDP) "Linking Climate Engagement to Financial Performance: An Investor Perspective" (September 2013) which notes that its analysis demonstrated that industry leaders are not only taking critical steps to establish the requisite governance, management systems and environmental efficiencies to engage on climate, but that they are also generating superior profitability, cash flow stability and dividend growth for investors. https://www.cdp.net/CDPResults/linking-climate-engagement-to-financial-performance.pdf.

[113] See Empirical Research Partners "Perspectives on Socially Responsible Investing". http://www.empirical-research.com/.

Exhibit 20 provides an overview of ESG integration.

Exhibit 20: ESG integration



Source: SFC R&S Research

2. Looking Forward: ESG Factors as part of Long-term Risk Assessment

During our meetings we noticed the following developments:

(i) ***Investment Risk Assessment***: The Mainland China asset managers were more attuned than international asset managers to the latest emphasis of the Mainland China leadership on sustainability (see examples in Box 6 below) and the investment risk implications that may flow from this. One asset manager noted that China is showing considerable leadership on sustainability. Another active asset manager noted that, in his view, long-term social and environmental risks are under-priced in China and therefore, he actively considers long-term environmental and social risks as part of investment risk assessment. NGOs took note of the same, including the evolving focus on carbon emissions. NGOs noted that if a price is placed on carbon, this would have significant implications for companies and can be considered as part of long-term investment risk assessment.

Box 6: Mainland China Emphasis

- In March 2013, Premier Li Keqiang announced that China would focus on environmental protection and sustainable economic development.[114]
- In March 2014, Premier Li Keqiang reiterated that efforts to protect the environment matter to people's lives and the future of the Chinese nation.[115]
- In April 2014, Mainland China passed the biggest changes to its environmental protection laws in 25 years, outlining plans to punish polluters more severely. It allows for consecutive daily fines on polluters if they do not improve and offers channels for whistle-blowers to make environment-related appeals. Non-government groups can also file lawsuits for

[114] See Xinhuanet, media conference by Premier Li Keqiang (March 2013). http://news.xinhuanet.com/english/video/2013-03/17/c_132239467.htm.

[115] See CCTV News coverage of the media conference by Premier Li Keqiang (March 2014). https://www.youtube.com/watch?v=UEoOKFrprO4.

environmental damage under certain conditions.[116]

- In November 2014, President Xi Jinping and US President Obama agreed in principle to further collaborate to combat climate change. China will for the first time set a target for capping carbon emissions and the US pledged deeper cuts in greenhouse gas emissions.[117]
- In November 2014, the State Council took another step forward in strengthening its air pollution control law, adding new amendments aimed at increasing penalties for heavy polluters. The proposed changes include making local governments more responsible for air pollution in their regions and complements moves to incorporate protection of the environment into the criteria used to assess local leaders' performance.[118]

(ii) ***Asset Owner Perspective*****:** Because asset managers compete to win and retain institutional mandates, institutional investors are able to influence ESG integration by asset managers. On an international level, European, Canadian and Australian institutional investors routinely ask ESG related questions as part of hiring or retaining asset managers (see Part II, Chapter 2, Section 1 above).[119] Some asset managers and consultants we met with observed that this trend is also emerging in Asia among SWFs, family offices, foundations and endowments.[120] One large global institutional investor phrased it as follows: "While risk management is part of the plumbing, asset managers should also evaluate forward looking trends such as civil society's demands for environmental and social accountability. Social media constitutes a tool for civil society to express its views rapidly and broadly and is likely to transform this into a long-term, secular tend".[121] One Asian SWF noted that "considering ESG factors signals the long-term orientation of the asset manager"[122] and that it deploys ESG integration in the investment process to control long-term investment risk and reputational risk.

(iii) ***Asset Manager Perspective*****:** While most of the global asset managers we met with are signatories to the UN PRI, the practices on ESG integration diverge. Practices referred to in our meetings included screening, research, engagement and proxy voting.[123] Asset managers distinguish between positive and negative screening. Positive screening consists of actively considering ESG factors as part of the investment decision-making process and stock selection. Negative screening is a more passive approach that consists of excluding sectors or companies from an investment portfolio based on certain ESG screens. One global asset manager observed that at present only few global broker research departments conduct systematic analysis on ESG factors as part of investment research and that such analysis would assist them in more actively

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[116] See King and Wood Compliance Report "Environmental Protection Law: Big Changes in 2014" (May 2014). http://www.chinalawinsight.com/2014/05/articles/compliance/environmental-protection-law-big-changes-in-2014-2/.

[117] See U.S.-China Joint Announcement on Climate Change (November 2014). http://www.whitehouse.gov/the-press-office/2014/11/11/us-china-joint-announcement-climate-change.

[118] See Xinhuanet "Chinese legislature revising law to tackle smog" (December 2014). http://news.xinhuanet.com/english/china/2014-12/22/c_133870872.htm.

[119] One asset manager noted that in Europe, 70% of institutional investors' requests for proposal include ESG questions.

[120] For a Hong Kong example, see "How an Asian family office incorporated climate change mitigation into its portfolio" by Katy Yung and Ivo Knoepfel (February 2014). http://www.alliancemagazine.org/opinion/stewarding-wealth-for-the-common-good-how-an-asian-family-office-incorporated-climate-change-mitigation-into-its-portfolio/.

[121] For a Mainland China example, see the Institute of Public & Environmental Affairs (IPE). http://www.ipe.org.cn/en/about/about.aspx.

[122] For expressions and measurement by the Bank of England of short-termism, see the speech on "The age of asset management?" given by Andrew G Haldane, Executive Director, Financial Stability and member of the Financial Policy Committee (April 2014). http://www.bankofengland.co.uk/publications/Documents/speeches/2014/speech723.pdf. See also before that the "Kay review of the UK Equity Markets and Long-Term Decision Making" (July 2012). https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/253454/bis-12-917-kay-review-of-equity-markets-final-report.pdf.

[123] Several asset managers noted that while they are an active owner, they are not an activist owner. They distinguish these two as the former involving mostly bi-lateral dialogue between the investor and the corporate and the latter involving a broader constituency of shareholders.

considering these factors as part of the investment process. Another global asset manager noted it has an in-house research team dedicated to analysing ESG risk factors. Analysts work closely with the fund managers and supplement their research with external broker research as well as with data obtained from ESG focused rating systems and databases. They participate in investment due diligence meetings with corporates if the ESG risk is considered high as a result of their independent research. Based on the outcome of those meetings it is then decided whether the investment proceeds or not. If the investment proceeds, the analysts and fund managers continue engagement with the company, including the Board and the NEDs, to improve the ESG risk profile. While uncommon, if improvement is not achieved, the investment may be sold as it may not meet the desired long-term risk profile.

Conclusion

We thank the participants in the asset management industry who have provided risk and strategic insights that contributed to this report.

The SFC will consider the topics discussed in this meeting series as part of its policy and strategic priority-setting, including to foster the further development of Hong Kong as an asset management centre. Furthermore, the risk and compliance related observations may assist asset managers in the continued development of their risk and compliance governance frameworks.

We look forward to a continued engagement with the asset management industry on these and other topics, including new and emerging risk topics as and when they arise.

Table of Abbreviations

AFM	Authority for the Financial Markets - Netherlands
AIFMD	Alternative Investment Fund Managers Directive
AML	Anti-money laundering
ASIC	Australian Securities and Investments Commission
AUM	Assets under management
BIS	Bank for International Settlements
CCO	Chief Compliance Officer
CCP	Central Counterparty
CDP	Carbon Disclosure Project
CIO	Chief Investment Officer
CIRC	China Insurance Regulatory Commission
CIS	Collective Investment Schemes
CRD	Capital Requirements Directive
CRO	Chief Risk Officer
CSA	Commission sharing arrangement
CSRC	China Securities Regulatory Commission
Dodd-Frank Act	Dodd-Frank Wall Street Reform and Consumer Protection Act
EM	Emerging market
EMIR	European Market Infrastructure Regulation
ERM	Enterprise Risk Management
ESG	Environmental, social and corporate governance
ESMA	European Securities and Markets Authority
ETF	Exchange-traded fund
ETP	Exchange-traded product
FATCA	Foreign Account Tax Compliance Act
FCA	Financial Conduct Authority – United Kingdom
FCA COBS	FCA Conduct of Business Sourcebook
FINRA	Financial Industry Regulatory Authority – United States
FOFA	Future of Financial Advice
FSB	Financial Stability Board
FSTB	Financial Services and the Treasury Bureau
GFC	Global financial crisis
G-SIFI	Global Systemically Important Financial Institution
HKEx	Hong Kong Exchanges and Clearing Limited
HKIFA	Hong Kong Investment Funds Association
IFA	Independent Financial Advisor

IFC	International Financial Centre
IMD	Insurance Mediation Directive
IOSCO	International Organization of Securities Commissions
KYC	Know your client
MiFID	Markets in Financial Instruments Directive
MMF	Money market fund
MRF	Mutual Recognition of Funds
NAV	Net Asset Value
NBNI G-SIFI	Non-Bank Non-Insurer Global Systemically Important Financial Institution
NED	Non-executive director
NGO	Non-governmental organisation
Non-DVP	Non-delivery versus payment
OECD	Organisation for Economic Co-operation and Development
OFR	Office of Financial Research – United States
OTC	Over-the-counter
PBOC	People’s Bank of China
QDII	Qualified Domestic Institutional Investor
QFII	Qualified Foreign Institutional Investor
R&S	Risk and Strategy Unit
RDR	Retail Distribution Review
REIT	Real Estate Investment Trust
RMB	Renminbi
ROI	Return on Investment
RQFII	RMB Qualified Foreign Institutional Investor
SAFE	State Administration of Foreign Exchange
SEBI	Securities and Exchange Board of India
SEC	Securities and Exchange Commission – United States
SWF	Sovereign wealth fund
UCITS	Undertakings For The Collective Investment of Transferable Securities
UN PRI	United Nations-supported Principles for Responsible Investment
US 1940 Act	US Investment Company Act of 1940
VaR	Value at Risk

This report has a Chinese version. An online version is also available on the SFC website.