



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

Consultation Conclusions on Proposed Disclosure Requirements Applicable to Discretionary Accounts

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Executive summary

1. On 23 November 2016, the Securities and Futures Commission (**SFC**) issued a Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency (**Consultation Paper**) which proposed, amongst other things, to enhance the disclosure of monetary benefits received or receivable that are not quantifiable prior to or at the point of entering into a transaction.
2. In response to the Consultation Paper, we received enquiries from the industry about the application of the disclosure requirements under paragraph 8.3 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) to discretionary accounts.
3. In light of these enquiries, the SFC further consulted the public on proposed disclosure requirements applicable to discretionary accounts. Details of the further consultation were included in the Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts (**Further Consultation Paper**) issued on 16 November 2017. Comments were invited from the public by 15 January 2018.
4. During the consultation period, the SFC received 10 written submissions, including submissions from asset management firms and various industry associations. A list of respondents (other than those who requested anonymity) is set out in **Appendix B**.
5. The majority of the respondents supported the proposed disclosure requirements as a means to enhance transparency. However, a few respondents were of the view that the proposed disclosure may not be sufficiently meaningful to investors to achieve the stated objective of facilitating investors' selection of a discretionary account manager.
6. Most respondents who supported the proposed requirements preferred the specific disclosure of monetary benefits under an explicit remuneration arrangement to be made in the form of option 1 (ie, disclosure of the monetary benefits by type of investment product) and some other respondents wished to retain both disclosure options so that intermediaries could adopt the option most appropriate to their circumstances.
7. Other comments mainly sought clarification of various technical issues, such as the scope of the specific disclosure requirements and the frequency of making the disclosure.
8. Having regard to the majority support for the proposed requirements and to facilitate comparison of remuneration arrangements by investors, the SFC has decided to adopt the specific disclosure requirements under option 1 for monetary benefits under an explicit remuneration arrangement. The SFC will proceed with the proposed amendments to the Code of Conduct with certain clarifications to the application of the disclosure requirements. The amendments set out the disclosure requirements applicable to intermediaries (a) receiving benefits from product issuers in the course of providing discretionary management services; and (b) making trading profits from products purchased from or sold to third parties for the discretionary accounts. We will also provide guidance to the industry in form of Frequently Asked Questions (**FAQs**), which will be updated from time to time.
9. Major comments received and the SFC's responses are set out in greater detail below.



Implementation

10. The marked-up texts of the amendments to the Code of Conduct are set out in **Appendix A**, which will become effective six months from the gazettal of the amendments to the Code of Conduct.
11. We would like to thank all respondents for their time and effort in reviewing our proposals and for their detailed and thoughtful comments.
12. The Further Consultation Paper, the responses (other than those from respondents who requested they be withheld from publication) and this paper are available on the SFC website at www.sfc.hk.



Comments received and the SFC's responses

I. Proposed disclosure requirements applicable to discretionary accounts

Question 1: Do you have any comments on the proposed disclosure requirements in relation to monetary and non-monetary benefits for discretionary accounts set out above?

Question 2: Do you have any comments on the suggested manner of disclosure set out above? Do you have any other suggestions to ensure the disclosure will be clear, fair, meaningful and easy to understand for investors?

Rationale for the proposed disclosure

Public comments

13. The majority of the respondents supported the proposed disclosure to enhance transparency. However, one respondent considered that the proposed disclosure could not fundamentally address the inherent risk of conflicts of interest, and suggested that the SFC consider setting a timeline for introducing a fee-based model (ie, banning commissions) for discretionary management services provided by intermediaries.
14. There were a few respondents who opposed the proposed requirements and commented that they were complicated and not justifiable from a cost-benefit perspective.
15. One respondent commented that the proposed disclosure may direct investors to choose a discretionary account manager with lower disclosed benefits without due consideration of other factors (eg, investment expertise and track records).

The SFC's response

16. The objective of the proposed disclosure is to enable investors to make better informed decisions. Increased transparency makes it easier to detect potential conflicts of interest. It also facilitates comparison of the benefits receivable by different intermediaries. Hence, the SFC will proceed to amend the Code of Conduct to give effect to the proposed disclosure.
17. We will work with the Investor Education Centre (**IEC**) on educational materials to enhance investors' understanding of the new disclosure requirements and related matters such as the fee models for discretionary accounts and fee structures for different products, as well as what investors should note when selecting a discretionary account manager.
18. As mentioned in the Further Consultation Paper, the SFC has been monitoring the measures taken in some overseas jurisdictions, over and above disclosure of commissions, to address conflicts of interest and incentives. We will keep the merits of fee-based models under active consideration, taking into account local and international market and regulatory developments.



Scope of disclosure

Public comments

19. A few respondents sought clarification as to whether the specific disclosure requirements under the proposed new paragraph 7.2(a) of the Code of Conduct cover only quantifiable monetary benefits, or both quantifiable and non-quantifiable monetary benefits.
20. One respondent also enquired whether an intermediary is required to disclose the trading profits it makes when it sources an investment product from a third party and re-sells the product to its client's investment portfolio without taking any market risk.
21. A respondent pointed out that sometimes the incentive to invest a discretionary client's money in an in-house product is the individual discretionary manager's performance bonus rather than the benefits receivable by the intermediary and therefore suggested requiring the disclosure of benefits receivable by the individual discretionary manager for effecting a transaction in an in-house product for a client.

The SFC's response

22. The SFC would like to clarify that the specific disclosure requirements should apply to both quantifiable and non-quantifiable monetary benefits receivable by an intermediary, as such benefits, irrespective of whether they are quantifiable, would give rise to potential conflicts of interest.
23. The SFC is of the view that the specific disclosure requirements should apply to trading profits made by an intermediary when it takes no market risk and either (a) sources an investment product from a third party and re-sells the product to its client's investment portfolio; or (b) purchases a managed investment product from its client's portfolio and re-sells the product to a third party. This is because such trading profits are similar to monetary benefits receivable by the intermediary from a product issuer for effecting a transaction in an investment product for a client.
24. Having regard to the comments received, the SFC has revised the Code of Conduct to provide greater clarity for the specific disclosure requirements under the new paragraph 7.2(a) of the Code of Conduct.
25. The disclosure requirements are imposed at the institutional level and it is not a mandatory requirement for intermediaries to disclose benefits receivable by individual discretionary managers. Having said that, intermediaries are required to put in place adequate systems and controls to promptly identify issues which may be detrimental to a client's interest¹ (eg, cases in which transactions may have been effected merely to meet sales targets or driven by financial or other incentives).

Manner of disclosure

Public comments

26. Most respondents who supported the proposed requirements preferred the specific disclosure of monetary benefits under an explicit remuneration arrangement to be made

¹ Please refer to the SFC's Circular to Intermediaries – Frequently Asked Questions on Compliance with Suitability Obligations, 23 December 2016.



in the form of option 1 (ie, disclosure of the monetary benefits by type of investment product) as it is easy for investors to understand and for the industry to implement. One respondent considered that option 2 (ie, disclosure of the aggregate amount of monetary benefits in percentage terms) could provide a better picture of the total benefits receivable by an intermediary for managing an investment portfolio. Some respondents suggested that intermediaries be allowed to choose either option 1 or 2 when disclosing monetary benefits to their clients.

27. A few respondents commented that providing an exhaustive list of investment product types at the outset under option 1 would be difficult, if not impossible. One of them also considered that setting out the investment product types at the outset may limit investment choice and hinder a discretionary manager from managing the client's portfolio.
28. One respondent suggested that the disclosure could be made at the same time as entering into a discretionary client agreement, or during the interval between entering into a discretionary client agreement and the commencement of discretionary management activities.
29. A number of respondents were of the view that the disclosure should be made on a one-off basis. One further suggested that the disclosure should not be made at regular intervals. Another respondent commented that an intermediary should advise investors where there is any material increase in the maximum percentage of monetary benefits receivable.

The SFC's response

30. Taking into account views from the majority of respondents, the SFC has decided to adopt the specific disclosure requirements under option 1 for monetary benefits under an explicit remuneration arrangement. We are not in favour of allowing intermediaries to adopt both options because adoption of a single format would facilitate comparison of remuneration arrangements by investors.
31. The aim of the proposed requirements is to facilitate investors' choice of a discretionary account manager. Therefore, we believe that the disclosure should be made to investors at the account opening stage or prior to entering into a discretionary client agreement, instead of after an agreement has been entered into.
32. We have revised the Code of Conduct to clarify that the proposed disclosure is a one-off disclosure, and where there are changes (eg, additional investment product types or an increase in the maximum percentage of the monetary benefits receivable) to the one-off disclosure, an updated disclosure should be provided to the client as soon as reasonably practicable. Intermediaries should put in place adequate systems and controls to ensure that the additional investment product types match with the discretionary investment mandate agreed with the client².

² Please refer to the SFC's Circular to Intermediaries – Frequently Asked Questions on Triggering of Suitability Obligations, 23 December 2016.



Application of the disclosure requirements

Public comments

33. One respondent enquired whether, when it effects a transaction for a client in an investment product issued by it or any of its associates, the generic disclosure requirements under the proposed new paragraph 7.2(b)(i) of the Code of Conduct apply to a non-explicit remuneration arrangement, non-quantifiable monetary benefits or both.
34. Another respondent sought clarification of the expected disclosure requirements for benefits receivable on a discretionary basis (eg, the volume of transactions may be one of the factors determining the discretionary incentive amount).
35. A respondent suggested that the SFC provide examples of a generic disclosure statement for non-monetary benefits.
36. A respondent asked whether the proposed disclosure would apply to an intermediary who manages discretionary accounts investing in funds issued by it or any of its associates.
37. A respondent cited a few examples (eg, sales or training event sponsorships and shelf fees) and enquired whether they would be considered disclosable monetary benefits.

The SFC's response

38. The new paragraph 7.2(b)(i) of the Code of Conduct would apply in situations where an intermediary effects a transaction in an investment product issued by it or any of its associates under a non-explicit remuneration arrangement, while monetary benefits under an explicit arrangement (whether quantifiable or not) would be required to be disclosed under the new paragraph 7.2(a)(i) of the Code of Conduct.
39. Monetary benefits not quantifiable at the point of sale may include benefits receivable by intermediaries based on the volume of transactions. In such cases, the maximum percentage and the basis of such benefits should be disclosed. We have revised paragraph 7.2(a)(i) of the Code of Conduct to clarify that the existence and nature of such monetary benefits should also be disclosed.
40. The SFC does not mandate the length or style of disclosure and, provided the requirements are observed, intermediaries may adopt any appropriate manner of disclosure. The extent of disclosure of non-monetary benefits would vary and depend on the facts and circumstances of each case.
41. The proposed disclosure requirements would apply to an intermediary who manages discretionary accounts investing in funds issued by it or any of its associates, but an intermediary may be exempt from the proposed disclosure requirements with respect to Institutional and Corporate Professional Investors. In respect of the form of the disclosure, intermediaries should exercise professional judgement as to whether the benefits receivable by them or any of their associates in relation to the management of discretionary accounts fall under the scope of explicit or non-explicit remuneration arrangements and determine whether specific or generic disclosure is required on a case-by-case basis. To help their clients understand the disclosure, intermediaries should try to explain the nature of the benefits disclosed and ensure that the disclosure



is presented in a clear and concise manner and is easy for average clients to understand.

42. Set out below is a sample disclosure to illustrate the application of specific disclosure under paragraph 7.2(a) of the Code of Conduct:

Type of investment product (non-exhaustive)	Monetary benefits receivable or trading profits made by the intermediary and/or its associate
Bonds	Up to 3% of the investment amount of the transaction
Funds	Initial commission rebate ^[Note 1] : Up to 2% of the subscription amount Trailer fee ^[Note 2] : Up to 60% of a fund's annual management fee

Note 1: This represents the amount of subscription fee paid by an investor to a product issuer that is rebated to an intermediary for distribution of the product.

Note 2: This represents commission fee paid by a product issuer to an intermediary for so long as an investor holds the product.

II. Transition period

Question 3: Do you think a six-month transition period following the gazettal of the final form of the amendments to the Code of Conduct is appropriate? If not, what do you think would be an appropriate transition period and please set out your reasons.

Public comments

43. While a few respondents agreed with our proposed six-month transition period, others suggested a longer transition period of 12 months for enhancing systems, arranging operational support, etc.

The SFC's response

44. The proposed disclosure requirements are largely similar to the disclosure requirements under paragraph 8.3 of the Code of Conduct (including the enhanced disclosure requirements under paragraph 8.3(b)(ii) of the Code of Conduct effective on 17 August 2018). Hence, the SFC has decided that the proposed disclosure requirements will come into effect six months following the gazettal of the final form of the amendments to the Code of Conduct.
45. The SFC expects all intermediaries to immediately commence reviewing their systems and controls, and arranging necessary operational support, to ensure compliance with the new disclosure requirements.



III. Conclusion and way forward

46. The SFC will adopt the specific disclosure requirements under option 1 for monetary benefits under an explicit remuneration arrangement and proceed with the proposed amendments to the Code of Conduct with the clarifications set out in this paper. A marked-up version of the Code of Conduct with amendments for greater clarity is set out in **Appendix A** to this paper.
47. The amendments to the Code of Conduct will be adopted and become effective six months from the gazettal of the amendments.
48. The SFC would like to take this opportunity to thank all respondents for their submissions.

Final form of the amendments to the Code of Conduct

The highlighted parts indicate revisions to the Code of Conduct which differ from the proposed amendments set out in the Further Consultation Paper

Paragraph 7

Discretionary accounts

7.2 Disclosure of benefits

- (a) Specific disclosure - monetary benefits under explicit remuneration arrangement and trading profit made from a transaction

~~Option 1 as proposed under the further consultation on disclosure requirements~~

- (i) Where a licensed or registered person and/or any of its associates explicitly receives monetary benefits (whether quantifiable or not prior to or at the point of sale) from a product issuer (directly or indirectly) for effecting a transaction in an investment product for a client, the licensed or registered person should disclose the maximum percentage of the monetary benefits receivable by it and/or any of its associates by the type of investment product.

For monetary benefits that are not quantifiable, the licensed or registered person should also disclose the existence and nature of such benefits.

- (ii) Where a licensed or registered person takes no market risk and makes a trading profit for effecting (A) a purchase of an investment product from a third party for a client; or (B) a sale of an investment product to a third party for a client, the licensed or registered person should disclose the maximum percentage of the trading profit to be made by the type of investment product.

~~Option 2 as proposed under the further consultation on disclosure requirements~~

~~Where a licensed or registered person and/or any of its associates explicitly receives monetary benefits from a product issuer (directly or indirectly) for effecting a transaction in an investment product for a client, the licensed or registered person should disclose an estimated maximum percentage of monetary benefits receivable by it and/or any of its associates. This should be calculated by aggregating the maximum monetary benefits receivable from each product type according to the proportion such product type represents in the client's investment portfolio.~~

- (b) Generic disclosure - monetary benefits under non-explicit remuneration arrangement and non-monetary benefits
- (i) Where a licensed or registered person effects a transaction in an investment product which is issued by it or any of its associates and it will not explicitly receive monetary benefits when effecting such transaction for a client, the licensed or registered person should disclose that it or any of its associates will benefit from effecting such transaction.

- (ii) Where a licensed or registered person and/or any of its associates receives from a product issuer non-monetary benefits for effecting a transaction for a client, the licensed or registered person should disclose the existence and nature of such non-monetary benefits.

The licensed or registered person should make the above disclosure to clients at the account opening stage or prior to entering into a discretionary client agreement with a client for discretionary management services. The disclosure must be in writing, communicated to clients through electronically or otherwise other means. The information disclosed in written form should be in Chinese or English according to the language preference of the client.

The licensed or registered person should ensure that the disclosure in writing is prominent, is presented in a clear and concise manner and is easy for average clients to understand.

In respect of the disclosure to be made under this paragraph, a one-off disclosure is acceptable. Where there are changes, an update must be provided to the client as soon as reasonably practicable.

Notes

Examples of changes to the one-off disclosure include additional investment product types and an increase in the maximum percentage of the monetary benefits receivable.

Paragraph 15

Professional investors

15.4 Exempt provisions for Corporate Professional Investors where licensed or registered persons have complied with paragraphs 15.3A and 15.3B and Institutional Professional Investors

- (d) Discretionary accounts
 - (i) ...
 - (ii) ...
 - (iii) the need for a licensed or registered person to disclose benefits receivable for effecting transactions for a client under a discretionary account (paragraph 7.2 of the Code).



Appendix B

List of respondents

(in alphabetical order)

1. CompliancePlus Consulting Limited
2. Hong Kong Investment Funds Association
3. Private Wealth Management Association
4. The Alternative Investment Management Association
5. The Hong Kong Association of Banks
6. The Institute of Financial Planners of Hong Kong
7. The Law Society of Hong Kong
8. Vanguard Investments Hong Kong Limited
9. The submission of one respondent is published on a “no-name” basis upon request
10. The submission of one respondent is withheld from publication upon request