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2 August 2017

The Securities and Futures Commission  
35/F Cheung Kong Center  
2 Queen's Road Central  
Hong Kong

**Re: Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms**

Dear Sirs and Madams,

Yunfeng Securities Limited, as part of the Yunfeng Financial Group ("**Yunfeng**") would like to thank the Securities and Futures Commission ("**SFC**") for engaging the public and providing the opportunity for Yunfeng to respond to the Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms ("**the Consultation Paper**") issued in May 2017.

**YUNFENG RESPONSES**

***Yunfeng's General Comments***

As the SFC highlights in the Consultation Paper, the online platform business model brings new opportunities as well as risk; all participants (existing offline providers, future adopters, investors, regulators) will naturally, in one form or another, compare the online platform experience, in particular the advisory services, against the existing offline experience. At Yunfeng, we believe that there are two core aspects which all participants should bear in mind when this comparison occurs:

- (i) Coverage ratio, and
- (ii) Consistency.

***Coverage ratio***

When we compare online and offline advisory experiences, we generally gravitate towards services which in reality only exist in the High Net Worth and Ultra High Net Worth segments<sup>1</sup>, for example, receiving tailored investment strategic advice to meet personal goals, ongoing portfolio monitoring, regular portfolio reviews and provision of timely information. In practice, most retail clients do not receive this level of service on an offline basis while online robo advisory platforms aim to provide these services to the masses.

***Consistency***

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<sup>1</sup> There were 142,000 High Net Worth Individuals (HNWI) where HNWIs are defined as those having investable assets of US\$1m or more, excluding primary residence, collectibles, consumables, and consumer durables, in Hong Kong in 2015 (Source: Capgemini Financial Services Analysis, 2016), roughly 2% of the (7.3 million as per the data provided by the Census and Statistics Department) population.



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The ongoing debate on consistency of robots compared to humans also exists in the Robo advisory debate. In some sense, the arguments for robots in financial advice are even stronger than perhaps for industrial robotic use. There is a large variation in the quality of human advisors, and typically the best advisors will tend to congregate towards the Ultra High Net Worth segment due to the compensation structure. These advisors tend to be long tenure, cover only a small number of clients, can understand the client deeply and will be adaptive in providing tailored recommendation as the client's circumstance evolves.

However, for the broader human advisor population (particularly those who serve the mass retail market), they tend to have high turnover rates, a large number of clients to cover and as a result, provide inconsistent advice as well as providing investment recommendation based on limited amount of understanding of the client.

#### *Summary*

Online distribution and robo-advice will tend to target the mass retail market; we therefore believe participants should bear the points raised above in mind which are reflected in our responses on the Consultation Paper and the regulatory framework.

In general, we believe robo-advice is more likely to perform a better job in ensuring a large number of investors enjoy consistent, unbiased, objective and continuous service.

#### ***Responses to the Consultation Paper***

We set out our detailed responses to the Consultation Paper below.

##### ***1. Do you agree with the factors relevant to online platforms identified above? Please explain your view.***

We agree with the observations - online platforms give clients broader access to different products, lower fees and less biased advisory opinion.

We would also like to add the following points:

Paragraph 31: In addition to the access and cost benefits to investors, investors are likely to also receive unbiased advice, additional services not received from offline experience and potentially more investment educational material as Platform Operators compete with new innovations.

As highlighted in the introduction of this letter, face-to-face communication has advantages and disadvantages. The primary advantage is that a client can obtain immediate explanation/advice from the sales representative or advisor. However, conversely, sales representatives/advisors may have tendencies to focus on products that their financial institution is focusing on at the time, or products which the sales representatives/advisors have little knowledge but receive a higher commission. Online models have a greater "coverage ratio" compared to offline.



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Paragraph 41 to 44: We agree that in an on-line context, clients are offered more products. We tend to think that clients will benefit from more options because they can compare these products' characteristics (performance statistics, investment strategy, and fees etc.) when making their investment decision. More importantly, in an online context, clients will normally not just depend on one single source of information (i.e. just from the Platform Provider), but also to use external third party content. In other words, it should be easier for clients to cross and fact check information before they ultimately make their investment decision. In an offline context, information is largely provided by a single source and subject to quality of the intermediary's representative.

We are also aware that many clients may not have sufficient knowledge and experience to choose a suitable investment product. We tend to think this could be overcome by improving investor education.

Paragraph 42: As mentioned in Appendix 2, Platform Provider could adopt Instant Message tool (similar to 阿里旺旺 in Taobao's e-commerce platform) or Hotlines to provide a more interactive environment for clients to interact. This also provides a natural online/offline model where the customer service (behind the Instant Message tool) are licensed representative, and can alleviate the concern that "online" distribution is less interactive.

**2. Are there any factors that the SFC has not identified? Are these covered by existing conduct requirements? If not, do you have any suggestions about how they can be addressed through specific requirements? Please explain your view.**

Compared to an offline context, the on-line context will have one more advantage in tracking user behaviour ("big data" analysis) which is helpful to offer more customized services. It will be helpful to have some standard and guidelines on the use of big data in terms of what kind of information online platforms can be tracked, and collected for aggregated use as well as how this data can be used to provide investment advice.

Additionally, the speed of technological advancement is unquestionable, so how do Platform Operators assess the adoption of new technology without contravening SFC's principles and guidelines? What should Platform Operators consider before the adoption of new technology and how will the SFC respond to these advancements?

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

The six principles are well thought and cover the key aspects of an online platform. In particular, we agree on the principle that online and offline should be treated equally as they are increasingly competing for the similar groups of clients.



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An area which is not directly addressed in the core principles is the management of third party vendors and the roles and responsibilities of each party in such an arrangement. More and more technological solutions are using third party integration and therefore there may be a need to address directly this type of arrangement which impacts all of the other six principles in one way or another.

In addition, with respect to Core Principle 2 b) regarding the disclosure of remuneration information to be paid by the client or “other persons”, we agree with this disclosure requirement where this is limited to commissions/fee/charges/monetary benefits in connection with the sale of products but would highlight that it is possible to have ‘ad space’ on an online platform and the advertisement could be non-financial in nature and not pose any conflict of interest. We would therefore suggest clarification that the fees received by a platform operator should only be disclosed if it is directly linked to a potential trade or transaction.

Finally, with respect to paragraph 61 (c), which requires that audit trails for all suitability assessments to be retained for at least seven years for investment products and at least two years for exchange traded products, we believe the retention period should be based on whether the product is “complex”, rather than whether it is exchange traded.

**4. Are there any other areas relating to robo-advice which you think the Proposed Guidelines should cover? Please explain your view.**

We agree with the main points the SFC have mentioned on robo-advice. We believe that there are several areas that the SFC should consider further.

We believe that the SFC should stress that robo advice is focused currently on ETFs and that the area is expanding. As this develops, the focus should be on making sure adequate checks and balances are in place to ensure investor protection. For example, we mentioned the use of “big data” analysis earlier, this type of analysis will eventually become part of the robo advisory algorithm such as predicting what clients will do and their preferences and therefore will require guidelines from the SFC on how this type of analysis can be adopted and the potential suitability questions which arises. We tend to think the use of “big data” will enhance the Risk and Client profiling, and hence should be encouraged.

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

One aspect where people in general view as a shortcoming of robo-advice is the inability to incorporate investor’s ongoing preference into the investment process. A human advisor is typically viewed as more capable of learning and adapting to each investor’s circumstance as he/she continues to develop their relationship with the client. However, most people believe with the current technology, communication via robo-advice is more one-way and less likely to adapt.

We refer back to the “coverage ratio” and “consistency” themes we highlighted in the introduction. There is a huge variation in the quality of human advisor, and typically the best advisor will tend to congregate towards the Ultra High Net Worth segment. We agree if you benchmark robo-advice to the “cream of the crop” advisors, robo-advice might have the short-coming of not being adaptive enough.

However, for the broader human advisor population (particularly those who serve the mass retail market), they tend to have high turnover rate, low client coverage ratio and limited understanding of the client. In fact, most firms today who serve mass retail market will use a Customer Relationship Management system (in some sense – a “robo-advice” system for RM) to help human advisors to ensure consistency and continuity of client/advisor relationship.

If we compare robo-advice to this group of advisor population, we do not think this particular short coming is a specific problem for robo-advice, nor does it add more risk to the current system than the status quo. In fact, as we have argued, in such context that robo-advice is more likely to perform a better job in ensuring a large number of clients to enjoy consistent, unbiased, objective, continuous service.

Therefore, we would again highlight that in considering the regulatory framework for robo-advice, the SFC should compare the larger advisor population that focus on mass retail market, and not those “cream of the crop” that focus on High Net Worth population.

The following are suggestions on areas which the SFC may also wish to consider addressing:

### ***Type of advice/Suitability***

As the SFC rightly mentions, there are a number of different types of robo advice from goal based to pre-defined model portfolios. We believe there is a strong need for the industry to adopt customized strategic asset allocation/benchmark for individuals and serve that as a holistic goal/guidance to the client investment journey. A relevant concept has already been implemented in the MPF space with the introduction of Default Investment Strategy (DIS) where the “reference benchmark” will change as the participant ages. We believe such concept should be an integral part of robo-advice industry standard.

The current retail framework is still very much “product” based i.e. whether the individual investment product is suitable as opposed to “portfolio” based suitability check. Having a framework that consolidates a client’s investment objective, investment horizon, goals and present them in the notion of portfolio benchmark will be very beneficial to the industry in helping clients to reach their long term financial goals.

### ***Algorithms***

Every model or algorithm will have its own set of assumptions and shortcoming - no model can guarantee returns for investor. In our opinion, much like the SFC’s core principle, the key is transparency - proper disclosure on methodology, limitations and assumptions should be provided to investor so that they can make their own judgement on the quality of the advice.



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**6. Do you have any comments on the guidance on the Suitability Requirement to be provided in the Proposed Guidelines?**

We agree with the general guidelines regarding when the Suitability Requirement will be triggered.

In the guidelines, it is mentioned that mechanically matching a product's risk rating with a client's risk tolerance level might not be sufficient to discharge the suitability requirement. However, it is worth noting that ultimately in any Robo-advice settings (or even offline setting), such objective matching mechanism has to exist in order to ensure consistent and fair recommendation. The focus should therefore be put on ensuring a vast array of inputs/dimensions are fed into the systems in evaluating client risk tolerance level and product due diligence.

The SFC should also consider adopting a "portfolio based approach" for suitability to retail investor (similar to suitability process for PI) as most robo-advice provide portfolios where the underlying products could be risky but in a portfolio context, could be calibrated appropriately to the investor risk level and objective. For example, a diversified portfolio that contains a carefully calibrated exposure to a commodities fund can actually be considered less risky than a portfolio that only contains fixed income funds due to diversification effect.

**9. Are there any examples not mentioned above that may suggest that the content or presentation of materials would amount to a solicitation or recommendation? Please explain your view.**

Agree with the general rules that factual, fair and balanced product specific materials will not amount to solicitation/recommendation nor trigger suitability requirement.

Some platform operator might have pure "advertising space". As long as it is clearly defined as such then that should not trigger suitability requirement.

**10. Do you have any view on how risk analysis assessments and client profiling should be conducted and the quantitative and qualitative factors that any risk methodology should take into account?**

Client profiling should consider both the subjective and objective dimensions of a client's tolerance level. Techniques from Behavioural Finance can be adopted to better profile client risk appetite.

Platform Provider should also ensure the User Interface (UI) and User Experience (UE) design quality of online risk assessment. This is actually an advantage against offline paper questionnaire. Good quality UI and UE design will help users to better represent their true risk profile and hence be recommended solutions that are more tailored.

**11. Do you have any comments on the definition of a complex product, and the considerations that should be taken into account in determining whether a product is complex?**



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We understand from Items 108, 109 and 113 of the consultation paper that the SFC is drawing the line on complex products based on whether the product features could be understood by investors easily and whether average investors need further explanation. Given this, we believe the SFC should consider whether the following should be determining factors (Chapter 6: Complex Products - Section 6.1 of the proposed guidelines) in deciding whether a product is complex:

- (ii) whether there is a secondary market is available for the product at publicly available prices;
- (iv) whether there is a risk of losing more than the amount invested; and
- (vi) whether any features or terms of the product might render the investment illiquid.

**15. As the SFC's concern arises from the sale of complex products, do you agree that the same requirement to ensure suitability should also apply to offline sales of complex products? Please explain your view.**

We believe that suitability requirement should be triggered in both online and offline environment given the nature of these complex products. In certain scenarios, an investor in an offline environment could purchase such products incorrectly due to the pressure imposed by sales representatives.

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

Information disclosure and investor education are still the key to protect investors. We believe a combination of warning statements to clients, disclosure of risks and a knowledge assessment pertaining to the product in question would offer some measure of protection to investors for the sale of complex products online.

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

With respect to 'minimum information' to be provided we wonder whether a key facts statement approach used for investment funds would be an approach to consider albeit this would obviously raise the question on who would be responsible for the provision of the key fact statement i.e. product issuer or platform operator. Additionally as mentioned above, we believe for complex products, provision of scenario analysis/working examples to investors for them to understand the features of a complex product may enhance the minimum information requirements.

With respect to "6. Any penalty for early exit", the SFC may wish to consider the clarification of whether the penalty includes any "economic losses" as result of early exit.



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**19. Do you have any comments on the proposed warning statements set out in Appendix 4 that should be made on an online platform?**

We suggest consideration to add "Investors should read the product materials provided carefully before making any investment and where necessary consult his/her financial, legal and/or tax advisor."

We also think any products that could potentially make investors lose more than their principal invested should be specifically mentioned.

**20. Do you think a 12-month transition period is appropriate? If not, what do you think would be an appropriate transition period? Please set out your reasons.**

We agree that 12 months is an appropriate transition period.

Yours Faithfully,

**For and on behalf of Yunfeng Financial Group**