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Consultation Conclusions on the Proposed Amendments to the Professional Investor Regime and Further Consultation on the Client Agreement Requirements (25 September 2014)

By e-mail to: client_agreement@sfc.hk

To: Intermediaries Supervision Department
From: Cordium Asia Limited

***BACKGROUND**: Cordium is a leading international provider of regulatory compliance consulting, software, accounting and tax services to the global asset management and financial services industries. Cordium currently supports investment businesses from its offices in London, New York, Boston, San Francisco, Malta and Hong Kong. Cordium Asia Limited is under the corporate umbrella of Cordium and has been incorporated in Hong Kong as a private limited company since 7 February 2013.*

In this submission, we are going to provide our considerations and concerns relating to the proposal of incorporating the following New Clause into the Client Agreement for intermediaries: -

"***If we [the intermediary] solicit the sale of or recommend any financial product to you [the client], the financial product must be reasonably suitable for you having regard to your financial situation, investment experience and investment objectives. No other provision of this agreement or any other document we may ask you to sign and no statement we may ask you to make derogates from this clause.***"

The proposal is relatively wide and the rest by the Commission for comments is also wide and therefore we are providing a broad scope of considerations with a view to assisting the regulator and the industry in finding an appropriate balance of investor protection, while protecting investor choice as it would be detrimental to investor/consumer needs for the clause to operate in a way that reduces Hong Kong investors with access to appropriate investment options.

Perspective of Buy Side firms that mainly distribute directly

We highlight that we are providing a point of view of our clients who are primarily buy side managers who operate in the industry in Hong Kong and elsewhere and while the definition of intermediaries includes managers, as the manager is normally contracted only to the fund and normally only provides services to investors on behalf of the fund, the imposition of the proposed clause provides a number of legal, technical and practical challenges which will need to be considered in the course of the determination of these new requirements.

Flexibility of Regulatory Approach

While the proposed wording provides for a certain amount of flexibility on how the contractual obligations will be interpreted, we are concerned that that this flexibility will introduce a certain amount of risk for smaller operators with respect to how they will be able to distribute funds to potential investors until a clear understanding of "reasonable suitability" is established.

While the flexibility is to be applauded as it provides the industry with a certain amount of leeway to find compliant solutions, in certain circumstances, leaving such matters to be resolved by the courts in civil actions puts firms with less resources to find ways to effectively distribute their products at a significant disadvantage until industry consensus is reached.

Comparative regulation and global development

We highlight that in most jurisdictions that we support, the manager provides information on behalf of the funds that they manage to prospective professional investors. The contractual relationship remains between the investor and the offshore fund. The offshore manager normally has directors who are responsible for ensuring that the onshore manager operates the funds in the interests of the investor. The manager has a contractual relationship with the offshore manager and its board of directors who have the fiduciary responsibility to protect the interests of the investors and the investor has recourse to the directors where this responsibility is not undertaken appropriately. Significant developments in international standards relating to director duties has meant that these responsibilities are being laid out in detail and in certain jurisdictions, regulators are mandating standards of oversight which improves investor protection.

Generally, and unless the manager provides a direct advisory service to the investor, there is no direct contractual relationship between the investor and the manager and these proposals will significantly distinguish Hong Kong from its peers. In the UK, the investor is only treated as a client of the manager with respect to determining whether they are a professional investor for the purposes of determining whether they are an appropriate recipient of an advertisement that is directed only at professional investors. Otherwise in general the investor is purchasing a product based on its description and risk profile. In the US, (under both the Securities Exchange Commission, and the Commodity Futures Trading Commission) the manager (both the offshore manager and the onshore one) is provided by the regulations with a fiduciary duty to the investors through the fund with respect to the management of the investors assets but the contractual relationship remains with the fund.

In all such instances, there is no direct contractual relation between the investment and the fund manager unless the manager provides additional advisory services. Managers of professional investment funds normally choose to provide such services on an execution only basis and leave it up to the professional investor to make their own decisions based on the information provided. Generally, regulators ensure investor protection for professional investors by focusing on ensuring that the manager has appropriate controls in place. In certain jurisdictions they make the contracts unenforceable if marketing takes place to investors that do not satisfy the professional investor standards and outside a firms licencing conditions. As you know in Europe, if marketing takes place, without having appropriate controls in place, such as registration and reporting, the investor can sue to be recompensed for any of the losses incurred.

Contractual Relationship/Competitive Position of Distributing Managers/Investor Choice

The proposal, as currently presented will significantly alter the relationship between the manager and the Hong Kong investor, as it imposes additional obligations on managers who will in future have to make a choice relating to the extent to which they will be willing to take on the risk that they will be sued for failure to ensure that the investments meet the imposed suitability obligations as they may be laid out and determined now, and through an internal study and further public consultation by the Commission. This uncertainty makes it very difficult to provide constructive comments as we do not have a clear idea of how the new requirements will affect the way business will be conducted. However, we feel it is important to consider some of the implications for our clients.

Our understanding and experience is that it can be relatively difficult for the smaller managers who are trying to enter the industry, to require investors to provide significant detail about their financial status, experience and objectives, unless this process can be made fairly straight forward, simple and standardised across the industry. The investor will need to understand that the standards being applied are standardised across intermediaries but this is likely to take some time due to the flexibility of interpretation being inbuilt into the current proposal.

In a lot of cases, investors will only provide an investment manager with access to a limited number of pieces of information with regard to their total portfolio (in terms of investment diversification, product variety and AUM, etc.) but the manager will be subject to this new requirement in order to be put in position to grow their business and operate effectively. The investor may already have a relationship with an adviser or bank that is providing it with appropriate overall services in relation to its wealth management needs and incurring an overly extensive suitability requirement will be to introduce a second and potentially unnecessary process to their investment needs.

Either the requirements will introduce additional costs to firms with respect to the implementation of a process, as they are unlikely to pass these costs onto investors, or it will reduce choice for professional investors as international managers potentially choose to withdraw further from the provision of access to Hong Kong individuals due (a) to the standards of care that the contractual obligation will impose and (b) the uncertainty of the application of the rules. Indeed international managers may decide not to offer products directly to Hong Kong investors due to these issues and that will ultimately harm their choice in particular where they may be interested in global diversification.

It needs to be recognised that fees for management services are usually inbuilt into the management charge and due to the nature of how distribution networks are established, there is limited incentive for an adviser or bank to provide their clients with access to independent managers who may provide the investors with more suitable investments that may be offered within the bank's or adviser's investment universe.

This proposal has the possibility of inadvertently raising the barriers for entry for managers and simultaneously making it difficult for them as they balance the desire to get cooperative investors which satisfy the tests and potential investors who may not wish to provide sufficient information, or incomplete information to a manager that is undertaking a suitability assessment. In absence of such information there is a high risk that managers will be forced to take extraordinary measures just to establish their own fund as a suitable product for investors who are not willing to deliver sufficient information on their own financial situation to managers that are only offering one product.

Conflicts of Interest

Additionally, it has been traditionally important that the manager maintains this distance of relationship from the investor and to keep the fiduciary as the investor's representative when it comes to matters of services. It is usually considered to be a conflict of interest for a manager to take on the responsibility of ensuring that the investment by the investor is suitable with respect to the investors overall portfolio and objectives as managers do not normally provide advisory types of services and even if they did provide such services, it would be difficult to make a suitability assessment in absence of being provided with the additional information held by the client with other fund managers or advisers if the contractual suitability obligation was interpreted widely.

We recognise that the change in guidance will require managers to ensure that products distributed are reasonably suitable for potential investors and identify the clear distinction with the current regime which is limited to ensuring that the recipient of the marketing information has the experience, expertise and understanding of the risk of the investment. In the future regime intermediaries will be expected to ensure reasonable suitability with regards to financial status, investment experience and investment objectives.

We further highlight that the completion of a retail style suitability assessment provides the investor with the impression that the manager is delivering investment advice where the assessment goes into the detail proposed, even where they are only soliciting an investment or merely distributing own funds.

Again our experience is that managers cannot determine the suitability of a transaction without completing detailed due diligence and suitability is generally deemed to be service provided by firms that provide individual portfolio management services on a one to one basis or where a service provider supplies advice. Therefore by requiring contractual suitability for investment managers that can only distribute one product, which is managed by them creates a conflict of interest as they are only able to supply one product which is managed by themselves.
This is the paradox that the requirements will create for managers that distribute own funds.

Further challenges presented by the proposed approach

With regards to the creation of a contractual obligation between the issuer and the recipient of marketing information before there is any provision of services, we would highlight the following challenges will arise. Again we believe that it is important to present these challenges in helping the stakeholder community understand how to tackle them and any assistance from the regulator in altering the application of the requirements to directly provided access to professional funds would be appreciated by the industry and investors.

Until the investor decides to invest, there may be no contractual relationship at all in place between the manager and the investor. I.e. no services are provided and no payments made. Managers should only distribute information about funds that are reasonably suitable for the recipients but only offer subscription where the new contractual requirements are met.
It would not make sense to have firms put contractual terms in place before selling one product to a client in which the investor signs up to separate terms with the fund.
We would expect that subject to your conclusions, the solution will be the inclusion of the contractual obligation into the terms laid out in the subscription agreements or private placement memorandum. We would expect that legal experts will provide their views in this respect through this consultation process.

We respect the Commission in revamping the professional investors' regime in a way to increase the level of investors' protection. In practicality, it will impose obstacles to Investment Managers whose new start-up is challenged by tighter budget control. Professional investors having the relevant investment experience, investment knowledge and understanding of relevant risk factors will seek for alternative ways to diversify their investment other than wealth management services provided by banking institutions.

In any case, the Investment Managers owe the fiduciary duty to disclose all the relevant risks to their prospects through private placement memorandum (**PPM**) and other offering documents in a true, accurate and not misleading presentation. However, being a responsible and mature investor, PIs should also undergo self-assessment and/or consult financial advisors for independent judgment before making any informed investment decision. There is no one-size-fits-all model/measurement which investors can rely upon even having regard to potential investors' financial situation, investment experience and investment objectives to be reasonably suitable for the fund products managed by the Investment Managers.

We must emphasise the potential impact of the unintended consequences of requiring managers to be responsible for the suitability of an investment where they have a direct relationship and we request that the SFC consider distinguishing the treatment of how independent investment managers engage with potential professional investors as the clause could put managers at a disadvantage to other types of service providers and have the overall effect of reducing the choice available to investors.

From our point of view, for investment managers that distribute their own funds, the New Clause should eliminate the element of "… *having regard to your financial situation* …." as it is not the sole and ultimate responsibility of the Investment Managers to ensure and duly check that prospects' financial situation as the PIs should equally undertake this ultimate consequence of bearing the brunt of this investment opportunity prior to fund subscription.

As long as the factual descriptive representations by the Investment Managers entail all the risk factors disfavouring this investment, PIs must exercise due consideration in their own financial circumstances and risk tolerance level and risk appetite.

Effect on investor choice

We highlight from experience why high net worth investors choose direct investment in collective investment schemes run by professional investment firms over and above, advisory services, individual portfolio management services, and retail products provided by other intermediaries.

Some professional investor products have higher risk profiles than retail products because the managers have more freedom with respect to what they can invest in. They are normally run by managers who have successful track records in the markets that they are willing to operate and they are normally supported by service providers and infrastructure that delivers enhanced risk management that is appropriate for the higher risk profiles.

HNWI face many choices when determining what to invest in and should still be provided with a right to choose which approach is best and be given access to best investment products which are available.

- Mutual Funds
- Property Investments
- Direct Private Equity

- Stock Market Investments
- Exchange Traded Products/Funds

They can invest in mutual funds and exchange products through regulated intermediaries. Mutual Funds may be accessed through IFAs on an advised or execution only basis. Securities (including Collective Investment Schemes) may be accessed through regulated intermediaries on an advised or execution only basis. Professional Products may be accessed by retail investors where the intermediary can demonstrate that they have done an appropriate suitability assessment in relation to a specific investment prior to making it available to them, whereas the investment manager professional investors should be able get access to those investments with less of a process.

In such cases, there would traditionally be a customer relationship set up prior to the investment and payment for additional services rendered. In addition, professional firms will need to put processes in place to ensure that suitability assessment takes place prior to investment and this is appropriate.

All of these options have different cost schedules and protections. However, as we have seen a lot for our clients, their investors are usually very sophisticated and may invest into assets in a number of different ways using different service providers and investment products, some of which require advisory support and some of which are offered on an execution only basis.

However, in certain cases, investors may choose primarily to invest their net assets into a handful of professional investment managers which they trust and indeed some investors only occasionally invest in professional investor funds rather than spend time with other financial service providers or products which might require them to spend more time analysing the relative performance of underlying investments.

The recent conclusions put professional investors on the same footing but for the fact that they should have more experience, understanding and expertise and this should be established through the initial registration process.

The contractual proposals should not operate to frustrate a professional investor's access to investment choice either by dis-incentivising investment managers from operating in Hong Kong or creating additional costs to managers/investors which duplicate services provided by other means.

Options

Although as highlighted the clause has been left open to interpretation for firms and that firms can choose to take a legal risk on the extent to which reasonable suitability will be defined, this provides the market with a bit of an issue. Again, small firms and recently launched firms will be provided with a conflict of interest in that they will have a subjective choice in marginal situations to determine whether the investment is suitable and an interest in wanting the fund to satisfy the investment profile of the investor.

This conflict has always been difficult to manage but again this is one of the areas where by abstaining from making any recommendation or suitability assessment, the manager avoids the conflict as by the nature of being the manager, they need to leave it to an independent firm to make a determination or allow the investor to make up their mind themselves based on the information provided on an arms- length basis. This is what makes the imposition of a suitability clause inconsistent with the operation of the market in that the manager needs to disclaim any advisory relationship between the fund and the investor and encourage investor to seek the advice of an appropriate third party.

In short, once the issues relating to the legal matters are resolved, the imposition of the suitability clause should take into account that the professional investor should have the necessary experience, expertise and understanding of risk to make a final determination about the suitability of the investment within their portfolio. The manager's job will be primarily to ensure that the fund is consistent with the investor general and stated investment objective, that the investor has an appropriately diversified portfolio such that a loss in the investment would not materially affect their net worth, that they receive regular reviews of their portfolio of investments by their financial advisors and they have appropriate experience in investing in similar products or products that have similar underlying investments such that they can demonstrate experience with the funds that they are purchasing.

Due to the nature of this being the imposition of a specific clause, it will be important that the definition of what reasonable suitability will be, prior to managers taking the risk of selling a product to an individual investor. While we recognise that regulator is providing the industry with some flexibility with respect to the definition of suitability, this is inviting investors to participate in regulatory roulette should investments which were considered to be suitable at the time of investments not meet investor expectations and they wish to determine compensation based on how the product has been sold to them.

For firms and investors with sufficient resources to engage in legal battle with respect to these requirements, the establishment of precedent in these matters through the courts may not be the most efficient way to address the market issue and could be predjudicial to smaller managers and investors who do not have the capacity or appetite to assist the market in making a determination of what the standards should be.

Therefore, subject to the comments made above we are comfortable with the imposition of the clause requirements and the anti-avoidance measures under the following circumstances.

A: Reasonable suitability does not allow investors to transfer all of the responsibility for suitability of an investment to a the distributing manager.
B: Prospective Investors will be allowed to waive a requirement to provide full details of their wealth information, in particular, where they already have advisory relationships with third party service providers that deliver appropriate overall wealth services.
C: Managers are not mandatorily required to review a person's detailed portfolio position in order to determine whether the specific investment objectives of a fund fit into their overall portfolio. The suitability required by a manager will be limited to the extent necessary that their interests have been protected but will not operate to give potential investors with the impression that they will have an option tosue for compensation in circumstances where the investment was poorly performing rather than unsuitable at the time of the investment. We would recommend that the financial status of the test be altered with respect to managers that are distributing their own funds on an execution only basis..
D: The regulator assists the industry in coming up with a more objective test by providing more granular industry guidance for suitability to the standards that it desires in safeguarding the interests of individual professional investors and corporate professional investors which are managed by trusts or family offices that have been put under the radar of the Commission.
E: The regulator engages with asset management industry bodies to assist with the determination of the application of these rules to distributing asset managers.

We re-iterate the general industry objections to imposing a direct suitability clause to distributing managers in the first place but where the SFC determines that such clauses are a necessity for investor protection we request that they are not implemented in a way that is detrimental to the asset management industry and ultimately to the choices available for professional investors.

We provide these comments in an effort to ensure these changes achieve their objectives.

Regards

Cordium Asia Limited