SALES INDUCEMENTS IN ASIA PACIFIC

A review of the sales and distribution of mutual funds in selected Asia Pacific markets

CFA Institute

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1. Executive Summary

Sales commissions paid by manufacturers of investment products to financial advisers, intermediaries or product distributors create a conflict of interest.[1] Commissions and other inducements (monetary or non-monetary) can generate incentives for financial advisers to promote products that bring them the highest reward rather than encourage them to recommend products that best meet customers' needs. Sales commissions also can incentivize the churning of portfolios. Such behavioural biases, coupled with lack of transparency in fees and other disclosure-related issues, erode the public's trust in the financial advice industry, especially when mis-selling scandals result.[2]

In the global context, several jurisdictions have taken measures to address this conflict of interest. Australia, the Netherlands, South Africa, and the United Kingdom have banned all sales commissions paid to advisers,[3] requiring advisers to rely on a pay-for-advice model for revenues. India introduced a ban on upfront commissions in October 2018,[4] after it had banned front-load fees in mutual funds in 2009. As a minimum requirement under Markets in Financial Instruments Directive II (MiFID II) EU nations implemented a ban on commissions that applies to independent financial advisers (IFAs). Similar regulation has been put in place in South Korea.[5] Taiwan recently eliminated commissions paid to fund distributors for investor marketing campaigns.[6] Financial reforms introduced in Australia in the "Future of Financial Advice" Act of 2012 banned all conflicted remuneration, including trailer fees, and also required mandatory fee disclosures.

Although the global regulatory focus on commission bans has been growing over the past decade, their broader effect on the financial industry remains to be seen. The total ban

[1] J. Burke, A. Hung, J. Clift, S. Garber, and J. Yoong, "Impacts of Conflicts of Interest in the Financial Services Industry," RAND Working Paper Series WR-1076 (2015), https://ssrn.com/abstract=2794246

[2] C. Fargeot and M. Orsagh, "Restricting Sales Inducements," CFA Institute (2013), https://www.cfainstitute.org/-/media/documents/article/position-paper/restricting-sales-inducements-availability-quality-of-financial-advice.ashx

[3] PwC, "Economic Impact Assessment of Banning Embedded Commissions in the Sale of Mutual Funds" (June 2017), https://www.ific.ca/wp-content/uploads/2017/07/Economic-Impact-Assessment-of-Banning-Embedded-Commissions-in-the-Sale-of-Mutual-Funds-PwC.pdf/17715/

[4] Securities and Exchange Board of India, "Total Expense Ratio (TER) and Performance Disclosure for Mutual Funds" (22 October 2018), https://www.sebi.gov.in/legal/circulars/oct-2018/total-expense-ratio-ter-and-performance-disclosure-for-mutual-funds_40766.html

[5] PwC, "Economic Impact Assessment."

[6] Selena Li, "Taiwan Bans Marketing Commissions Paid to Distributors," Ignites Asia (2018), http://ignitesasia.com/c/2100403/249183/taiwan_bans_marketing_commissions_paid_distributors

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on commissions in the United Kingdom is thought to have contributed to an increase in professionalism of advisers, a reduction in recommendation biases,[7] and downward pressure on retail product charges.[8] In contrast, evidence also suggests that the cost of advice has increased and that firms have moved away from catering to the mass-market segment of investors, creating an "advice gap" — that is, a reduced availability of financial advice — which many have raised as a concern when considering a ban. This scenario has created an opportunity for more low-cost, execution-only services.[9] Such re-alignment of the business model has reportedly led to significant layoffs among financial advisers.[10, 11]

In 2013, CFA Institute published a report entitled "Restricting Sales Inducements" that explores the issue on a global level and the efforts of policy makers and regulators to address it.[12] This report updates the 2013 report and examines the issue of inducements in the sale process as well as how regulatory changes have affected the industry in four key Asia-Pacific markets: Australia, Hong Kong SAR, India, and Singapore. In the appendix, we provide an overview of the changes in regulation in select global markets, including Canada, mainland China, the European Union, Japan, New Zealand, the United Kingdom, and the United States.

In the four key Asia-Pacific markets we reviewed, Hong Kong SAR and Singapore have not banned commissions, India banned upfront commissions and front-load fees, but allows trailer fees and is actively pushing the industry toward a pay-for-advice model, and Australia has banned commissions since 2012. In markets where commissions have been banned, we have explored the following:

- if and how commission bans have reduced conflicts of interest and unethical behaviour in the distribution channel;
- if the industry and investors have experienced unintended consequences as a result of a commission ban; and

[7] Europe Economics, "Retail Distribution Review Post Implementation Review" (16 December 2016), https://www.fca.org.uk/publication/research/rdr-post-implementation-review-europe-economics.pdf
[8] J. Beard and J. Garcia-Zarate, "The Effects of the Retail Distribution Review on Fund Fees in the UK," Morningstar Manager Research Services, EMEA (2018).
[9] Europe Economics, "Retail Distribution Review."
[10] W. Robins, "RBS Cuts 600 Jobs from Financial Advice Arm Due to RDR," Citywire (19 June 2012), https://citywire.co.uk/investment-trust-insider/news/rbs-cuts-600-jobs-from-financial-advice-arm-due-to-rdr/a597282?section=new-model-adviser
[11] Gary Corcoran, "HSBC Sheds Jobs as RDR Impact Bites," Portfolio Adviser (26 April 2012), https://portfolio-adviser.com/hsbc-sheds-jobs-rdr-impact-bites/
[12] CFA Institute, "Restricting Sales Inducements" (December 2013).

- if such consequences were positive or negative, as well as how any negative consequences could be mitigated.

Although regulators in Hong Kong SAR and Singapore have opted against a commission ban, they have adopted measures to improve fee transparency and to mandate disclosure of potential conflicts of interest. In these two markets, in which the commission models have remained dominant, emphases have been placed on enhancing point-of-sale transparency. In these markets, we have examined the following:

- if these disclosures have been effective in increasing investors' awareness of product costs and advisory fees; and
- if investor outcomes have improved as a result of such disclosures.

To answer these questions, we carried out a literature review and conducted 45 interviews with industry participants, including regulators, intermediaries, distributors, financial advisers, private bankers, robo-advisers, investors, fund supermarkets, and academics. Our focus has been on the sale and distribution of mutual funds, although we acknowledge that the sale and distribution of insurance and other complex alternative products may potentially be problematic.

The possibility of a commission ban or a move toward a pay-for-advice model has triggered significant resistance among investors and practitioners in some of the Asia-Pacific markets. In this report, we review the strength and the motivation behind such resistance.

Sales commission bans do not fully eliminate conflicts of interest if advisers continue to receive trailer fees. Firms may offer other forms of incentives that can affect the adviser's judgment to drive sales. Although no overarching model would work across all markets, we draw on applicable lessons and provide recommendations to strengthen investor outcomes.

Market Highlights

Australia

- The financial advice and fund distribution industry in Australia is encumbered by the legacy of a sales-oriented, commission-driven culture of life insurance sales. The 2012 Future of Financial Advice legislation was originally intended to shift a commission-driven culture toward a consumer-oriented approach, by banning

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conflicted remuneration, imposing a best interest duty, and mandating fee disclosures. Its effectiveness was weakened, however, by allowing trailer fee arrangements to be grandfathered. The best interest duty includes a "safe harbour" provision, which has been reduced to a box-ticking exercise for many advisers.

- Numerous inquiries have been held to diagnose systemic issues in financial services and to chart a path toward better consumer outcomes while also providing fair remuneration for advisers. Nevertheless, misconduct and mis-selling continue to be rampant, as exposed by the 2018–19 Royal Commission into Misconduct in the Banking, Superannuation, and Financial Services Industry (Hayne Royal Commission). The most common cases involved charging fees for services not provided and delivering poor advice. Vertical integration in the financial advice industry was blamed for creating these mis-selling incentives.
- Australia lacks an individual licencing regime for financial advisers. Licenced firms often struggle to monitor appropriately the conduct of their representatives. Offenders find it relatively easy to continue practicing, by switching firms and registering with different professional organizations. These issues were raised in the Hayne Royal Commission, and changes are happening, for example, in relation to individual licensing and establishing a code of ethics which will raise the overall professionalism of the industry.

Hong Kong SAR, China

- In the Hong Kong market, investors lost a great deal of wealth through their holdings in Lehman Brothers mini-bonds and other structured products during the global financial crisis. Many investors claimed that these products were mis-sold. This led to regulators tightening standards and introducing new regulations and guidance on the selling process, suitability assessment, client profiling, fee transparency, and disclosures of conflicts and benefits.
- The Securities and Futures Commission (SFC) also considered a ban on commissions and a move toward a pay-for-advice model. Survey results, however, suggested that most investors in the Hong Kong market were willing to pay only a token sum for advice,[13] and IFAs accounted for only 2.1% of retail fund distribution[14]. As a result, the SFC decided against banning commissions and instead placed its regulatory focus on reducing and managing conflicts of interest and enhancing point-of-sales disclosures.

[13] Securities and Futures Commission, "Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency" (23 November 2016), https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=16CP5

[14] Cerulli Associates, "Asian Distribution Dynamics 2019" (June 2019).

- The fund distribution channel in the Hong Kong market is dominated by banks with an estimated market share of approximately 69%.[15] In one estimate, the bulk of investment funds (about 70%) are sold through just three banks.[16] In the sale and distribution of mutual funds, banks typically are remunerated with a subscription fee, paid by investors, and a trailer fee from fund management companies. All fees and potential conflicts of interest have to be disclosed to investors at the point of sale.

India

- The investment landscape in India has for a long time been dominated by mutual fund distributors who received upfront sales commissions. In 2013, the Securities and Exchange Board of India (SEBI) launched a set of reforms, creating a new and distinct market for registered investment advisers (RIAs), in addition to a commission-driven mutual fund distribution channel. RIAs are only allowed to charge fees for advice. In 2018, SEBI banned upfront commissions, forcing distributors to rely on trailer fees. This has caused a transition in the industry with which many practitioners struggle, as financial advice is not yet commonly valued in the market in which the level of financial knowledge is generally low.
- Elimination of upfront commissions on mutual funds and subsequent capping of trailer fees has caused many distributors to refocus on other products, such as insurance, which are regulated separately and pay higher commissions. Those catering to wealthy clients have also moved to sell unregulated alternative investment funds and portfolio management services that pay higher commissions.
- To improve the financial advisory and distribution regulatory framework, SEBI is in the process of establishing self-regulatory organizations (SROs) for advisers and distributors. The SROs will be charged with curbing malpractices and improving industry standards, conduct of intermediaries, and consumer outcomes.

Singapore

- Similar to Hong Kong SAR, the Lehman Brothers mini-bond crisis had a devastating effect on the Singapore market. Since the crisis, the Monetary Authority of Singapore (MAS) has strengthened its regulatory framework, putting in place rules and regulations that impose management accountability in financial institutions to achieve fair

[15] Cerulli Associates, "Asian Distribution Dynamics 2019".
[16] Ashley Alder, "Update on the SFC's Asset Management Strategy for Hong Kong," Securities and Futures Commission (19 September 2018), https://www.sfc.hk/web/EN/files/ER/PDF/Speeches/Ashley_20180919.pdf

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dealing outcomes, enhance disclosure and transparency, improve the knowledge and skills of financial advisers, create a balanced scorecard integrating non-sales key performance indicators (KPIs) as a basis for remuneration, and assess ways to improve culture at an organization.

- The MAS conducted an online survey of consumers in Singapore about their receptiveness of a fee-based model and the results revealed that 80% of consumers were not prepared for a pay-for-advice regime. Concerns arose that a switch may result in segments of consumers being underserved.[17] The Financial Advisory Industry Review (FAIR) panel considered, but ultimately rejected, a ban on commissions.
- The number of high-net-worth individuals continues to increase in Singapore on a yearly basis. The MAS recently updated its regulatory framework for accredited investors by (i) revising the asset and income criteria and (ii) requiring accredited investors to give consent to opt-in to be treated as such or otherwise to be treated as retail clients. A financial institution is subjected to lighter regulatory requirements when serving accredited investors. An accredited investor has access to a wide range of products, including risky and complex products that would not be available to a retail investor.

Summary of Findings

Fees versus commissions

- Banning commissions does not automatically safeguard investor outcomes, as seen in Australia. This is the result of many factors, including, for example, dilution of original legislation, grandfathering arrangements, and weak enforcement. To achieve the legislative intent of eliminating conflict of interest and safeguarding investor outcomes, it is equally important to have strong systems in place to monitor, surveil, and enforce.
- Banning upfront sales commissions removes the incentive for portfolio churning, but if trailer fees are allowed, the potential for product bias and mis-selling remains. Reducing the reliance on trailer fees and mandating their disclosures would go one step further in reducing mis-selling incentives.

[17] Lee Chuan Teck, "Presentation of Financial Advisory Industry Review Panel Report,", Monetary Authority of Singapore (16 January 2013), https://www.mas.gov.sg/news/speeches/2013/presentation-of-financial-advisory-industry-review-panel-report

Client and product segmentation

- Investment products cover a broad category and include more than mutual funds, such as structured products, fixed income, investment-linked insurance products, or wrap accounts. When commissions are removed from one product type (such as mutual funds), distributors tend to redirect their focus toward other product types that still pay commission. A consistent regulatory approach across all products is important to prevent regulatory arbitrage.
- Although the concept of high-net-worth investors is generally accepted and well practiced, Hong Kong SAR is one of the few markets in which the same investor protection measures apply to both high-net-worth investors and retail investors. In other markets, the level of protection for high-net-worth individuals is lower, because they are assumed to be financially savvier and better able to judge investment risks. Just because an investor is relatively wealthy, however, it does not necessarily mean that they are more financially sophisticated or knowledgeable and that the duty of care should be lower. If the level of protection is lower for one segment of the market, and commission bans are placed on some products, the client segment that has lower protection faces the risk that mis-selling issues will surface in the sale and distribution of products that are not subject to a ban.
- In markets where funds are "sold not bought" and where intermediaries are remunerated based on commissions, the shift to low-cost passive investment products – index funds and exchange-traded funds – has been much slower.

Fund distribution channels

- In Hong Kong SAR and Singapore — and to an extent Australia — the fund distribution channels of these markets are extremely concentrated and dominated by large banks. The lack of diversification in distribution channels has led to a number of concerns, such as high distribution costs, lack of product innovation, and limited investor choice. Perversely, the increased regulatory burden placed on the selling process has meant higher costs of service provision, and smaller players may not have the resources to make the necessary investments in systems and processes to stay in business.
- The fragmentation of fund distribution channels brings its own sets of problems. In India, the proliferation of subscale and individual distributors has made regulatory monitoring and enforcement difficult and problematic.
- Although many remain hopeful of the prospects of robo-advisers and online fund platforms, such intermediaries represent a relatively small part of the fund distribution market in the four markets we examined. Interestingly, technology may have a bigger role to play in emerging markets where businesses and investors are less beholden to entrenched systems.

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- Mandatory pension schemes provide additional sources of demand for fund products. In some markets, regulators are far more focused on the costs and expenses of funds available to savers and investors in these mandatory pension schemes. Such downward pressure has led to a higher awareness of, and more competition in, fund fees in general.

Selling process

- The mis-selling problems that surfaced during the global financial crisis have led to a tightening of regulatory requirements in the selling process. The requirements to assess client suitability, including know-your-client and know-your-product assessments, are necessary both at the point-of-sale and throughout the client relationship. These assessments are particularly robust in Hong Kong SAR and Singapore, with active regulatory supervision and monitoring, and go a long way toward mitigating the threat of systemic mis-selling. Not all markets, however, have placed as explicit an emphasis on the selling process.

Remuneration

- Sales incentives built into the remuneration system may create conflicts of interest that lead to mis-selling and misconduct. Industry and regulators are increasingly cognizant of that problem and are moving to de-emphasize sales as the one and only metric for performance evaluation (and pay determination) of frontline, client-facing employees. In Singapore, for example, the regulator issued guidelines for a balanced scorecard approach in which frontline employees as well as their supervisors and managers are evaluated on a combination of financial and non-financial metrics.

Transparency and disclosure

- Regardless of one's position on fees versus commissions, more transparency surrounding the fee structure, cost to investors, and the potential conflicts of interest is desirable. Investors need to be informed about all fees that they are paying as well as the recipients of such fees. This information must be meaningful, which is not always the case. For example, fees are frequently disclosed as a broad range, which is roughly the same for all products and hence reduces its usefulness. A number of markets in the Asia-Pacific region and globally have increased the point-of-sale disclosure requirements to enable investors to make better, more informed decisions.

Independent advisers

- Regulators have sought to reduce investor confusion over the relationships with their financial advisers by tightening the requirements for if and how advisers can represent themselves as independent. Each market has its own emphases. For example, in Hong Kong SAR, an IFA is someone who does not receive any fees, commissions, or monetary benefits paid for or provided in relation to product distribution. Conversely, in Singapore, an adviser can be considered to be independent if they receive commissions or other benefits from issuers, provided that the amount received is the same from other similar products and is insignificant. RIAs in India provide advice for a fee and may not collect any product commissions or incentives.

Culture

- An organization's ability to promote good conduct and behaviour is closely correlated to its culture, whereby employees see what is valued and rewarded at the organization and act in a similar way to be successful. Therefore, culture drives behaviour, which in turn drives how employees treat customers. Although the tone set by senior management is critical in championing messages of good culture across the organization, it is important that managers across all levels promote good cultural values throughout the company. Regulatory initiatives focusing on individual accountability have helped to strengthen culture at financial firms through clear identification and ownership of roles and responsibilities within business functions and units. In the Asia-Pacific region, the SFC in Hong Kong SAR implemented the Manager-in-Charge regime in 2017 and Singapore MAS is currently finalizing its individual accountability and conduct guidelines.

Investor education

- Notwithstanding enhanced disclosures and regulatory safeguards designed to protect investors, the ultimate responsibility of making investment decisions and selecting an adviser rests with the investor. Investors need to be educated on an adviser's level of obligation to act in the client's best interest (duty of care), how the adviser is remunerated, and how to identify potential conflicts of interest. Investors also should be able to ask relevant questions and to understand the fees they are paying and what services they are getting in return.

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Recommendations

CFA Institute believes that a healthy, well-functioning market should have the following attributes:

- sound investor protection;
- access to affordable, quality advice and products;
- a high degree of professionalism;
- transparency on fees;
- avoidance, mitigation, management and disclosure of conflicts of interest, as appropriate; and
- a culture of accountability.

Such a market can support a range of different fee- and commission-based business models. Several prerequisites, however, must be met before such a market can be developed. Therefore, we recommend the following:

- **Investor protection:** Regulatory arbitrage may arise when different standards apply to different client segments. It is important for regulators to adopt a holistic approach and minimize such arbitrage. In this regard, the treatment of and protection accorded to investors with a larger amount of investable assets should not be different from that given to retail investors.
- **Holistic approach:** Similarly, consistent regulatory principles should apply to advice on all investment products, covering such aspects as incentives, licensing of firms and individuals, disclosures, product authorization, and duty of care in the selling process.
- **Duty of care:** Advisers must be upfront and clear to investors as to the duty of care the investors are owed — whether the adviser is acting as a fiduciary and in the client's best interest, or adhering to a suitability standard, or acting as a salesperson who is relatively more transactional. This enables advisers to differentiate their offerings to better service investors with diverse needs.
- **Disclosure:** Regulators should set a clear standard to ensure that pertinent information is provided and that advisers explain such information to their clients. In addition, for disclosures to be useful to investors, it is important to make them meaningful, clear, simple, complete, and user-friendly. In designing disclosures and standard product factsheets, regard should be made to behavioral insights to enable better understanding and decision-making ability.

- **Investor education:** The importance of financial literacy should be emphasized. Regulators should continue to promote investor education and awareness. An educated investor has a better ability to distinguish, differentiate, and assess the different product offerings available and to select the one that is most suitable to his or her needs.
- **Remuneration:** The move in some markets toward a balanced scorecard approach in evaluating frontline performance is a welcome development. When the remuneration of both advisers and senior executives is aligned with the long-term interests of clients, the chances of achieving better investor outcomes are much higher.

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2. Australia

Introduction

Australia's fund management industry is the largest in Asia Pacific and the sixth largest in the world,[18] with AUD3.6 trillion (USD2.5 trillion) of assets under management (AUM) as of 31 March 2019.[19] The introduction of compulsory superannuation (retirement savings) for employees in the early 1990s initiated a long period of steady growth. The market for open-end retail funds is highly developed and heavily regulated.

Financial advice in Australia grew out of a culture dominated by life insurance sales. After nearly three decades of evolution, that legacy can still be seen in the traditional sales-oriented, commission-driven mentality, which is common in the industry. Despite efforts to promote modern, outcomes-oriented, customer-focused portfolio management and financial advice models, old attitudes persist in how products are sold and how fees for services are charged.

Today's financial services industry in Australia is defined by the Future of Financial Advice (FOFA),[20] a package of reforms of the financial industry enacted in 2012. Its objective was to "improve the trust and confidence of Australian retail investors in the financial services sector and ensure the availability, accessibility, and affordability of high quality financial advice."[21] FOFA banned conflicted remuneration structures (i.e., commissions), imposed the best interest duty, introduced an opt-in obligation for renewing fee agreements, and mandated an annual fee disclosure.

Despite being generally well served by firms with sophisticated financial infrastructure, consumers of Australia's financial services have experienced mis-selling and overcharging—issues that have been identified many times in as many as 70 public inquiries over the past decade. Cases of fraud and misuse of client funds range from retail banking to

[18] Australian Government and Australia Unlimited, "Australia's Manged Fund 2017 Update" (April 2017), https://www.austrade.gov.au/ArticleDocuments/5720/2017_Australias-Managed-Fund-Update.pdf.aspx
[19] Australia Bureau of Statistics, "Managed Funds, Australia, Mar 2019" (6 June 2019), https://www.abs.gov.au/ausstats/abs@.nsf/mf/5655.0
[20] Australian Government, Corporations Amendment Act 2012 (Future of Financial Advice), No. 67 (2012), https://www.legislation.gov.au/Details/C2012A00067
[21] Australian Government, The Treasury "Future of Financial Advice," http://futureofadvice.treasury.gov.au/Content/Content.aspx?doc=home.htm

insurance and financial advice. Financial advice, the area of the industry most pertinent to this report, has seen many cases of investors being charged advice fees in cases in which no service was provided, or been given poor advice, which left them worse off.[22]

The numerous inquiries and reviews have led to a long list of recommendations, including proposals for structural reforms, policy changes, remuneration framework, establishment of new regulatory bodies, and improvement in the industry's professionalism and education standards. The most recent inquiry was conducted by the Hayne Royal Commission. The year-long process led by Commissioner Kenneth Hayne involved as many as seven rounds of public hearings, more than 130 witness testimonies, and more than 10,000 public submissions. It culminated in the publication of a final report in February 2019, which exposed a range of problems and presented a list of 76 recommendations.[23]

The issues surfaced included, for example, advisers not acting in the best interest of their clients, charging fees for services not provided, conflicted remuneration structures, and firms putting their interests before those of their clients.

The picture that has emerged during our research is one of an industry whose culture and modus operandi lag behind markets of similar size, maturity, and heritage, such as in the United Kingdom or Canada. Efforts to reform the industry and re-orient it toward customer outcomes have been undertaken and have led to some improvements, but they have not yet fully achieved the original regulatory intent of protecting the investors and improving consumer outcomes.

Note that Australia's financial services have been under unusually thorough scrutiny, due to the many inquiries. The other three markets we analysed have never found themselves under such a microscope. The prevalence of well-documented cases of misconduct in Australia and their relative absence elsewhere does not necessarily mean that the other markets are perfect. Comparing the effectiveness of the four regulatory regimes solely on this basis would not be fair.

[22] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, "Final Report" (2019), https://financialservices.royalcommission.gov.au/Pages/reports.aspx
[23] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, "Final Report" (2019).

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Hayne Royal Commission

The Hayne Royal Commission was established in December 2017 with wide terms of reference[24] that sought to examine, among others, if and how:

- any business practices amounted to misconduct by the industry and fell below community standards;
- redress mechanisms were effective;
- existing laws and policies, industry internal systems, or industry self-regulation were adequate; and
- criminal and legal proceedings should be brought.

The Commission uncovered evidence of misconduct by Australia's major banks and financial planners, including "alleged bribery, forged documents, repeated failures to verify customers' living expenses before lending them money, and mis-selling insurance to people who can't afford it."[25] In relation to financial advice; revenue generation was prioritised over clients' best interests; fees were deducted from accounts even when no service was rendered; monitoring and supervision systems were inadequate; and, in a number of cases, the advice given was inappropriate, leaving the customers worse off.[26] Vertical integration, in which product manufacturing, distribution, and financial advice were provided by the same corporate entity, was also cited as an issue because it eroded competition.

The Hayne Royal Commission also found that the Australian Securities and Investment Commission (ASIC) was ineffective in enforcement. To penalise wrongdoing, ASIC relied heavily on enforceable undertakings rather than bringing on civil or criminal proceedings. The consequences of breaches were relatively minor and not sufficiently severe to act as a deterrent to bad behaviour.

[24] Governor-General of the Commonwealth of Australia, "Letters Patent" (14 December 2017), https://financialservices.royalcommission.gov.au/Documents/Signed-Letters-Patent-Financial-Services-Royal-Commission.pdf

[25] Gareth Hutchens, "Banking Royal Commission: All You Need to Know — So Far," *The Guardian* (19 April 2018), https://www.theguardian.com/australia-news/2018/apr/20/banking-royal-commission-all-you-need-to-know-so-far

[26] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, "Interim Report" (28 September 2018), https://financialservices.royalcommission.gov.au/Documents/interim-report/interim-report-volume-1.pdf

The 76 recommendations in the final report addressed a number of areas, including banking; financial advice; superannuation; insurance; culture, governance, and remuneration; and regulators.[27] In relation to financial advice, the focus was on the removal of conflict of interest, increased quality of advice, and professional discipline of financial advisers. Recommendations were made with respect to remuneration and regulatory enforcement. Some of the most relevant recommendations are as follows:

- **Independence of financial advisers:** an adviser who is not independent must explain to a client why he is not independent, impartial, and unbiased (recommendation 2.2).
- **Conflicted remuneration:** grandfathered commissions should be removed as soon as practicable (recommendation 2.4).
- **Misconduct by financial advisers:** an employer must check the references of financial advisers they employ (recommendation 2.7); report serious compliance concerns to ASIC (recommendation 2.8); and investigate an adviser's misconduct and inform and remediate affected clients promptly (recommendation 2.9).
- **Remuneration:** In conducting the prudential supervision of the design and implementation of remuneration systems, the Australian Prudential Regulatory Authority (APRA) should have in mind the sound management of not only financial risks but also misconduct, compliance, and other non-financial risks (recommendation 5.2).
- **Remuneration of frontline staff:** all financial service entities must ensure that the design and implementation of remuneration systems focus not only what staff do but also how they do it (recommendation 5.4).
- **ASIC's approach to enforcement:** ASIC should consider as a starting point whether to use the court to determine the consequences of a contravention (recommendation 6.2).

Several chief executive officers and chairs of large financial institutions have resigned or otherwise left their positions as a direct result of the Hayne Royal Commission. ASIC and APRA have been given new powers and additional funding. However, some issues, such as the removal of grandfathered commissions, remain controversial and it is not clear how many of the 76 recommendations would be implemented.

[27] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, "Interim Report".

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Regulatory Landscape

Australia's financial industry is regulated primarily by two bodies — ASIC and APRA — in an arrangement often called a "twin peaks" model.

ASIC is the conduct regulator of the financial services industry. It issues operating licences; enforces laws and regulations; and is responsible for protection of consumers, investors, and creditors. APRA is the prudential regulator, responsible for licencing and prudential supervision of banks in their deposit-taking capacity, insurance companies, and superannuation funds. The two bodies are separate and independent, but they work closely together.

The Hayne Royal Commission inquiry found a large number of misconduct incidents and concluded that Australia's financial regulators, ASIC in particular, have failed in their remit of protecting the consumers. Commissioner Hayne blames this failure on ASIC's lack of ability or will to enforce regulations and to punish wrongdoing adequately. The regulator has been too accommodating toward the firms it regulates, relying on them to report issues and to fix them. For example, ASIC has routinely accepted enforceable undertaking agreements with the firms, rather than imposing penalties. When penalties have been imposed, they did not reflect the severity of the damage and loss suffered by the clients. Pursuing punishment for wrongdoing through courts was rare and was directed only at individuals, never at firms.

The situation is changing. In February 2019, a bill was passed that allows ASIC to pursue harsher civil penalties and criminal sanctions against banks and their executives. The regulator also has been given additional funding to enhance on-site supervision of larger institutions and to expand the scope of regulation in accordance with the recommendations of the Hayne Royal Commission.

APRA has received additional funding to extend the Banking Executive Accountability Regime (BEAR) to insurers and superannuation funds; to boost supervision of superannuation funds with a focus on member outcomes; and to enhance the supervisory framework for governance, culture, and remuneration in the institutions it regulates.

Best interest duty

Financial advisers in Australia are under the obligation, imposed by FOFA, to act in the best interest of the client in relation to the advice they provide and, in the event of a conflict, must give priority to the client's interest when giving advice.

The Hayne Royal Commission, however, uncovered numerous cases of mis-selling in which advisers failed to act in the best interest of clients. Some common cases involved firms charging on-going advice fees when no service was provided, or even when no adviser was assigned to the account. In many cases, customers were given inappropriate advice, which was of little benefit to the client but that generated fees for the adviser. Other cases involved improperly using customer funds, misleading customers regarding the adviser's qualification or authorisation, and falsifying documentation.

A major issue with the current operation of the best interest duty highlighted by the Hayne Royal Commission concerns the "safe harbour" provision, which lists steps an adviser needs to follow to satisfy the best interest duty. The prescriptive character of the provision has allowed many financial advisers to see the best interest duty as no more than a box-ticking exercise. Moreover, ASIC investigations have shown that some advisers ignore the rules altogether. For example, they might carry out an assessment of a client's needs and risk profile, but then fail to consider the appropriateness of the client's existing holdings.

ASIC's January 2018 report, "Financial Advice: Vertically Integrated Institutions and Conflicts of Interest" found the following:

- In 75% of the files reviewed, the adviser did not demonstrate compliance with the requirements of Section 961G of the Corporations Act to give appropriate advice.
- In 75% of the files reviewed, the adviser appeared to have prioritised the adviser's own interests.
- In 10% of the files reviewed, ASIC had "significant concerns about the impact of the noncompliant advice on the customer's financial situation."

In his final report, Commissioner Hayne opted not to recommend strengthening the best interest duty or removing the "safe harbour" provision, even though such steps would go a long way toward remedying the situation. Better enforcement of the existing interest duty is important in the short to medium term. Adoption of the stronger fiduciary duty standard and a principle-based approach to relationships between clients and advisers may be considered as part of the long-term reform of the financial industry.

Recourse available to investors

The first course of action for anyone who believes they have a claim or have been mistreated is to approach the institution with which they are dealing. All licensed financial institutions in Australia are required to have a formal complaints process and one that is accessible to clients (e.g., through an online form or a dedicated phone number).

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Despite such arrangements being in place, the process is not easily available to most customers. According to media reports, ASIC believes that the opaque and often confusing approach to how complaints are handled discourages customers from lodging complaints and leads to one in five complainants abandoning the process partway through.[28]

Proposed new guidelines contained in ASIC Consultation Paper 311 include a strict set of rules for the acceptance, treatment, and reporting of customer complaints, which the regulator expects will help not only consumers but also the firms.

ASIC wants banks, superannuation funds, and insurance companies to slash turnaround times for customer complaints. For complaints that do not pertain to superannuation, ASIC is proposing that financial institutions respond to complaints within 30 days rather than the current 45 days.

Distribution Channels and Competitive Landscape

Australia's financial advice industry is highly concentrated, dominated by four major banks (National Australia Bank, NAB; Commonwealth Bank, CBA; Australia and New Zealand Banking Group, ANZ; and Westpac, WBC), and a non-bank financial services firm AMP. As of late 2017, these five entities collectively held a market share of about 48% by industry revenue. About 30% of financial advisers on ASIC's Financial Advisers Register worked for one of the major banks, and 44% of advisers — aligned and non-aligned — operated under a licence controlled by the largest 10 financial institutions.[29]

Broadly speaking, Australian wealth management firms offer both advisory and discretionary services. Under the advisory model, the adviser guides or advises the investor and often suggests a model portfolio or similar selection. Under the discretionary services model, the investor pays a fee (usually a percentage of AUM) and allows the adviser to make decisions on how funds are invested. Even before the FOFA ban on commissions was implemented, some firms had established genuinely independent advice businesses that did not charge commissions or product fees and that provided full rebates on any monetary benefits they received from product providers to their clients. Many of these firms have successfully grown and are profitable, suggesting that this business model can work well.

[28] James Frost, "ASIC Gets Serious on Complaints," *Financial Review* (15 May 2019), https://www.afr.com/business/banking-and-finance/asic-gets-serious-on-complaints-20190515-p51nkf

[29] Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry, "Interim Report".

Conflict of Interest and Vertical Integration

Even though the five major institutions dominating Australia's financial services are household names, they use many sub-brands for their wealth management businesses. For example, AMP's associated dealer brands include AMP Financial Planning, Charter Financial Planning, Hillross Financial Services, IPAC Securities, and SMSF Advice.

Consumers in Australia are often confused as to the independence of the adviser or advice firm they are dealing with. The use of different brands and unclear disclosure of ownership or affiliation can mislead the consumer. Advisers and their firms might propose a restricted offering to consumers, who would not realise that the restriction is due to the affiliation of the adviser.

The 2014 Financial System Inquiry[30] put forward a recommendation to "require advisers and mortgage brokers to disclose ownership structures." Despite this recommendation, many firms continued to operate under names that provided no clues to their ultimate ownership, leaving consumers erroneously believing they are dealing with an independent adviser. Commissioner Hayne has recommended that advisers who are not truly independent be required to give the client a statement explaining why they are not.

Licensees may and often do include third-party manufacturers of products on their approved product lists (including the approved product lists maintained by platforms) but advisers often recommend that clients select products that are manufactured by entities associated with the advice licensee with which the adviser works.

Treasury noted in its submission to the Hayne Royal Commission[31] that the proliferation of in-house products in client portfolios is often due to factors such as "a tendency for advisers to identify with a firm and its products." This bias toward in-house products is not solely or even always driven by sales commissions or remuneration practices. Treasury noted that factors such as career progression within an organisation and simply the ease of access to products and the ability to gather more information on in-house products are also important.

[30] Australian Government, The Treasury, "Financial System Inquiry: Final Report" (2014), http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf

[31] Australian Government, The Treasury, "Submission on Key Policy Issues to the Royal Commission into Misconduct in the Banking, Superannuation and Financial Services Industry," Background Paper No. 24 (13 July 2018), https://financialservices.royalcommission.gov.au/publications/Documents/Treasury-background-paper-24.pdf

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These factors cannot easily be negated in a vertically integrated business. Advisers working for large integrated firms are likely to feel a connection with their employers and have biases toward their employers' products.

Vertical integration of Australia's financial services industry has been highlighted as a major contributor to the problems of misaligned incentives. Although major institutions involved in the industry argued before the Hayne Royal Commission that vertical integration was not the cause of most of the identified problems, several large Australian banks have now begun moves to separate their asset management arms. This suggests a tacit acknowledgement that vertical integration does not sit easily with the ability to provide genuinely independent financial advice.

All four big banks have announced that they will spin off or exit completely their financial advice businesses. This is largely a result of the findings that came out of the Hayne Royal Commission, as well as the increasing cost of compliance and difficulty in managing effectively the inherent conflicts of interest. Several large institutions have either exited or are looking to exit their asset management businesses that manufacture investment products.[32]

Remuneration

Until recently, the Australian financial advice and fund distribution industry had been based significantly on commissions and incentives for "product pushing". Such incentives have biased advisers to recommend products that pay higher commissions rather than those that are most suitable for clients. This system also encourages excessive churning of client portfolios. The FOFA reforms in Australia were designed to remove such incentives, but based on the Hayne Royal Commission findings, they have achieved only partial success.

An alternative way of charging clients for financial advice is to collect a percentage of AUM. Although this approach is preferable to commissions, because it removes the bias described previously, there could still be issues. For example, an adviser might be biased against steering clients to add to cash holdings if those holdings are not considered part of the asset base for charges. This strategy could lead to a bias toward financial assets over real assets, such as property, or against recommending a strategy of debt reduction for a client.

[32] Michael Janda, "Commonwealth Bank Sells Colonial First State Global Asset Management for $4.1b," *ABC News* (31 October 2018), https://www.abc.net.au/news/2018-10-31/commonwealth-bank-sells-colonial-global-asset-management/10450524

Facing regulatory and reputational pressure as a result of the many uncovered cases of misconduct, many of large institutions in Australia are now moving to a salary-based remuneration structure for advisers with incentives based on broader criteria rather than just sales volumes.[33]

Fees and commissions

Several fee models co-exist in Australia's financial advice sector. Some advice firms charge a fixed amount for advice. They might charge a smaller fee for an initial consultation, followed by a more bigger fee in return for a detailed financial plan. Annual or semi-annual consultations to review investments would also incur a fixed charge. These firms generally do not receive product fees or commissions.

Charging a percentage of AUM is also a common practice in Australia, as it is in other mature markets, such as the United States, the United Kingdom, and Canada. Often, this would involve a fixed administration charge and then a percentage of AUM. Sometimes the percentage would decrease for larger amounts invested. Again, these firms generally do not receive commissions or product fees from the product manufacturers.

Another payment that has been common in Australia is trailing commissions (or trailer fees, i.e., payments that continue for the life of a product or investment). FOFA intended to eliminate conflicted remuneration, including trailer fees. The effectiveness of the reform was diluted, however, by the introduction of a grandfathering provision for prevailing trailer fee arrangements. Under this provision, trailer fees may continue to be collected from products already held in clients' portfolios, but could not be levied on products sold after 1 July 2013.

As a result of this provision, some advisers have been reluctant to sell grandfathered products in clients' portfolios, even when such action is warranted. Recent press reports and industry surveys have suggested that more than 40% of advisers still rely on grandfathered commissions for at least 15% of their revenues and that, for a significant proportion of the industry, grandfathered commissions still represent a meaningful portion of revenue.[34]

Commissioner Hayne in his final report recommended that grandfathering be abolished "as soon as reasonably practicable" (recommendation 2.4). Some larger institutions have already announced that they will cease to pay grandfathered fees to their advisers.

[33] International Investment, "Senior advisers in Australia make an average A$120-160,000", 11 April 2019, https://www.internationalinvestment.net/news/4001782/senior-advisers-australia-average-usd120-160
[34] Tahn Sharpe, "Advisers Not Pre-empting Commissions Ban," *Professional Planner* (11 December 2018), https://www.professionalplanner.com.au/2018/12/advisers-not-pre-empting-commissions-ban/

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According to *Professional Planner*, Macquarie Group, National Australia Bank, CBA, and ANZ have all announced they will cease paying grandfathered commissions to their salaried advisers.[35]

Faced with a reduction in revenue, many financial advice firms in Australia have found a backdoor to bypass the FOFA ban on commissions, in the form of platform fees. Platforms (also labelled as "wraps") are one-stop-shop investment solutions offering customers access to a range of funds and securities, designed to simplify the administration, management, and reporting of the increasingly complex portfolios investors have today.

Clients pay platform fees either directly or through the advisers to the platform providers. From our discussions with senior executives in the industry, however, it appears these platforms often rebate a portion of such fees to the adviser. This creates a new area of potential bias, in which the financial adviser may be swayed by the kickbacks they receive from the platform provider. The regulatory regime treats platforms as financial products and, hence, best interest must be observed when one is recommended.

Disclosures of fees charged for financial advice services remain inadequate. Although annual disclosures are mandated, they are often opaque and do not provide a detailed picture of what fees customers pay and which party charges them. This opens the door to hidden product fees, rebates, and kickbacks to the advisers.

Remuneration of senior executives

To reduce the conflict between advisers and their clients, the industry has been moving away from commission- and sales-based remuneration toward broader-based schemes — "balanced scorecards". This approach takes into account client outcomes, compliance, and ethical behaviour, which apply at all levels.

The change is meant to address the issue of senior executives suffering little impact on their remuneration when frontline employees and advisers have been found to be doing the wrong thing or not putting clients' interests first. The Hayne Royal Commission has recommended that firms "design remuneration to encourage management of non-financial risks" and that they "set limits on financial metrics in long-term variable remuneration" (recommendations 5.3 and 5.4). It is not the first time such recommendations have been made. The 2017 Sedgwick

[35] Professional Planner, "Advice in the wake of Hayne", October 26, 2018, https://www.professionalplanner.com.au/2018/10/post-hayne-advice-in-the-new-world-order/

Review[36] recommends that "banks remove variable reward payments and campaign-related incentives that are directly linked to sales or the achievement of sales targets (including, but not limited to, cross sales, referral targets, and profit and revenue targets)."

In addition, Treasury has suggested that the BEAR could be broadened to cover other sectors such as financial advice. The BEAR regime is intended to ensure that directors and senior executives face clear consequences if the institution fails to meet expectations on accountability.

Licensing and Professionalism

Under the current system, financial advice firms in Australia are licensed by ASIC. A firm is granted an Australian Financial Services Licence, and individual advisers within the firm act as representatives of the firm under that licence. The Hayne Royal Commission report made it clear that firms have struggled to appropriately monitor the behaviour of their advisers. Even the largest corporations in Australia have had advisers who acted in a manner that severely damaged the interests of clients on whose behalf they should be acting. This has occurred despite the fact that larger firms have detailed compliance policies and procedures in place as well as layers of reporting and management.

Even in cases in which misconduct has been uncovered and punished by dismissing the adviser, within the current licencing environment, nothing prevents the individual from seeking and gaining employment at another firm. In fact, such cases appear to be common, because firms do not share information on their employees and no central body monitors and records cases of misconduct.

Commissioner Hayne identified the lack of an individual licencing regime as an underlying cause of low accountability for misconduct, and an implementation of individual licences is one of his core recommendations. The rationale is that individual licencing will make it easier to call advisers into account for inappropriate behaviour, to sanction them, or to ban them from the industry. At the same time, consumers would still have the right to seek redress against the firm that they have dealt with.

To practice as a financial adviser, an individual must be a member of a professional body, operating under a Professional Standards Scheme. Although no fewer than 15 recognized

[36] Stephen Sedgwick, "Retail Banking Remuneration Review: Report" (2017), https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf

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professional bodies of financial advisers exist,[37] none has the exclusivity to grant a financial adviser licence. An adviser who has been reprimanded or banned by one professional body can, in practice, easily join another.

In an effort to professionalise the financial advice industry, the Financial Adviser Standards and Ethics Authority (FASEA) was established in April 2017 to set the education, training, and ethical standards of licensed financial advisers in Australia. Under the Corporations Act 2001, FASEA was authorised to establish qualifications standards, continued professional development (CPD) requirements, and a code of ethics for the industry.

Section 1546B(1) of the Corporations Act states that by 1 January 2024, existing advisers need to have either "(a) met the education and training standard in subsection 921B (2)" or "(b) completed one or more courses determined by the standards body FASEA to give the provider qualifications equivalent to that standard."[38] New advisers entering the industry on or after 1 January 2019 are required to have an approved bachelor's degree.

In CFA Institute's report "Professionalising Financial Advice," we argue that the financial advisory industry needs to become valued as a profession like other professions, such as lawyers or doctors.[39]

The FASEA legislation goes some way toward achieving this goal by mandating minimum academic qualifications for registered financial advisers and introducing compulsory ethics training for financial advisers. This effort supplements ASIC's ability to ban financial advisers under Section 920A of the Corporations Act of 2001.

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[37] Association of Financial Advisers (AFA), Association of Independently Owned Financial Professionals (AIOFP), Association of Superannuation Funds Australia (ASFA), Australian and New Zealand Institute of Insurance and Finance (ANZIIF), Australian Institute of Superannuation Trustees (AIST), Chartered Accountants Australia and New Zealand (CA), CFA Institute, CPA Australia (CPA), Financial Planning Association of Australia (FPA), Independent Financial Advisers Association of Australia (IFAAA), Institute of Managed Account Providers (IMAP), Institute of Public Accountants (IPA), National Insurance Brokers Association (NIBA), SMSF Association, and the Stockbrokers Association of Australia.

[38] Commonwealth Consolidated Acts, Corporations Act 2001 (SECT 1546B), http://www5.austlii.edu.au/au/legis/cth/consol_act/ca2001172/s1546b.html

[39] D. McDonald, M. Leung, L. Carroll, and P. Zembrowski, "Professionalising Financial Advice," CFA Institute, (2019), https://www.cfainstitute.org/-/media/documents/article/position-paper/professionalising-financial-advice.ashx

Culture

The 2018 APRA-requested Prudential Inquiry into the Commonwealth Bank of Australia[40] found a number of prominent cultural themes, including a widespread sense of complacency, a reactive stance in dealing with risks, insularity, an inability to learn from experiences and mistakes, and an overly collegial and collaborative working environment that lessened opportunities for constructive criticism, timely decision making, and a focus on outcomes. The inquiry noted that "CBA turned a tin ear to external voices and community expectations about fair treatment."[41] These criticisms are likely to apply to varying degrees to the other large institutions active in the sector.

Several inquiries have found that unfair consumer outcomes remain prevalent and that such state of affairs has a detrimental effect on the level of consumer trust in the industry and financial practitioners. The 2014 Financial System Inquiry[42] identified the need to enhance confidence and trust, lift adviser competency, and increase transparency in financial advice.

The final report of the Hayne Royal Commission recommended that banks implement all of the previous recommendations of the Sedgwick Review (recommendation 5.5). These included Recommendation 9: "Each bank formally examine its workplace culture and institute formal processes to redress any conscious or unconscious bias towards sales in preference to ethical behaviour and customer service."[43] APRA has issued an information paper suggesting it will apply additional operational risk capital requirements to institutions that do not take the issue of risk culture seriously.

[40] Australian Prudential Regulatory Authority, "Prudential Inquiry into the Commonwealth Bank of Australia: Final Report" (2018), https://www.apra.gov.au/sites/default/files/CBA-Prudential-Inquiry_Final-Report_30042018.pdf.
[41] Australian Prudential Regulatory Authority, "Prudential Inquiry into the Commonwealth Bank of Australia: Final Report" (2018).
[42] Australian Government, The Treasury, "Financial System Inquiry: Final Report" (2014), http://fsi.gov.au/files/2014/12/FSI_Final_Report_Consolidated20141210.pdf
[43] Stephen Sedgwick, "Retail Banking Remuneration Review: Report" (2017), https://www.betterbanking.net.au/wp-content/uploads/2018/01/FINAL_Rem-Review-Report.pdf

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3. Hong Kong SAR, China

Introduction

Leading up to the global financial crisis (GFC), the sale and distribution of investment products in the Hong Kong market was dominated by a push-driven culture, in which sales representatives would cold call potential investors and market an array of products, including those that were complex and risky. When the GFC erupted in 2008, Hong Kong investors lost a significant amount of wealth through their holdings in Lehman Brothers mini-bonds and other structured products such as accumulators. Many investors claimed that these products were mis-sold to them and made complaints to the authorities. For a period of time, organized protests were seen outside major distribution banks as well as at the regulatory authorities, including the SFC and the Hong Kong Monetary Authority (HKMA).

Even though a significant number of demands for compensation was granted, the experience has had a lasting impact on Hong Kong SAR in a number of ways: first, regulators tightened standards, introducing new regulations and guidelines on a range of activities, including client profiling, selling process, disclosures of conflicts and benefits, and suitability.

Second, the SFC moved to a more proactive, "front-load" regulatory approach in which it would intervene at an earlier stage when issues arise, with targeted actions designed to achieve faster, more impactful outcomes.

Third, enforcement toward mis-selling and intermediary misconduct is more rigorous. Indeed, the trend toward more significant sanctions is noticeable. For example, in 2017, HSBC Private Bank was fined a record sum of HKD400 million (USD51.2 million) for its systemic failures in relation to the sale of Lehman mini-bonds.[44] In early 2019, BOCI Securities (part of the Bank of China group) was fined HKD10 million (USD1.3 million) for internal system and control failures in its investment product selling practices.[45]

Even though the regulatory changes in Hong Kong SAR have been extensive, they have not included a ban on commissions as Australia and the United Kingdom have implemented. In this section, we examine how the SFC has strengthened investor protection and discuss the implications of these cumulative regulatory changes for the industry.

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[44] Securities and Futures Commission, "HSBC Private Bank (Suisse) SA Fined HK$400 Million for Systemic Failures in Selling Structured Products" (21 November 2017), https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=17PR138

[45] Securities and Futures Commission, "SFC Reprimands and Fines BOCI Securities Limited HK$10 Million for Regulatory Breaches in Selling Investment Products" (18 March 2019), https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=19PR17

Regulatory Landscape

In Hong Kong SAR, four key regulators oversee fund distribution:

- The SFC
- The HKMA
- The Insurance Authority (IA)
- The Mandatory Provident Fund Schemes Authority (MPFA)

The legal status of the distributing entity (whether it is a broker, a bank, or an insurance company) determines whose regulatory remit it comes under.

The SFC supervises and oversees asset managers and other intermediaries such as brokers and investment advisers. It is also responsible for the authorization and oversight of advertising, sales, and distribution of all investment products, such as unit trusts and mutual funds.

The HKMA regulates authorized financial institutions such as banks, which are the dominant fund distribution channel in the Hong Kong market.

Mutual funds and investment-linked products are a key feature of the Mandatory Provident Fund (MPF) and insurance industries. MPF intermediaries and insurance agents are not licensed by the SFC but are regulated by the MPFA and the IA, respectively.

The SFC and the HKMA work closely together to ensure the openness of the market, and "a level playing field for all intermediaries in the securities industry of Hong Kong [SAR]."[46] They may collaborate to issue joint consultation papers or undertake joint thematic reviews on licensed entities to ensure that all securities businesses are carried out properly.

Fees versus commissions

Motivated by an emerging international trend of moving to a fee-based advisory model (notably in the United Kingdom and Australia), and the need to reduce and better manage conflicts of interest, the SFC assessed the readiness of the market for a pay-for-advice model in 2016, when it launched a consultation to enhance asset management regulation and point-of-sale transparency. Market surveys cited by the SFC suggested that a majority of Hong Kong investors were willing to pay only a token sum for advice,[47] and that IFAs had only a 2.1% market share in retail fund distribution.[48]

[46] Hong Kong Monetary Authority, "Supervisory Co-operation" (1 August 2019), https://www.hkma.gov.hk/eng/key-functions/banking-stability/banking-policy-and-supervision/supervisory-co-operation.shtml
[47] Securities and Futures Commission, "Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency" (23 November 2016), https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=16CP5
[48] Cerulli Associates, "Asian Distribution Dynamics 2019" (June 2019).

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The survey findings prompted the SFC to rule out a ban on commissions at least for the time being. Instead, it focused on reducing and managing conflict of interest and enhancing point-of-sale disclosures, with the stated objectives of enhancing transparency, driving down investors costs, and promoting competition.

This is a recurring theme in our interviews with investors and market practitioners. Even though most people acknowledged that the pay-for-advice model would eliminate much of the conflicts of interest inherent in the sale and distribution of investment products, they also have said that it is not a suitable model for the Hong Kong market at present time. Some large global banks offer a pay-for-advice model to high-net-worth clients as an option; however, the overall feedback is nearly unanimous that the market, the customers, and some of the smaller distributors, are not ready for such a model.

The reasons cited include a simple tax system, the MPF system, and general scepticism that payment of advice will lead to better performance, higher levels of professionalism, or elimination of all conflicts. Some of our more optimistic interviewees felt that with education and preparation, the market may move in this direction. Others failed to see this model ever getting traction.

In any event, following the 2016 consultation, the SFC placed restrictions on the use of the term "independent" when it comes to financial advisory — an adviser or distributor taking any payments or benefits from a third party other than the client cannot call themselves independent. Disclosures were enhanced to cover fees that are not quantifiable at the time of the transaction, such as trailer fees.

Compliance with new regulations requires significant resources that put large financial institutions at an advantage over smaller ones, especially in relation to relatively complicated products, such as funds, and structured products, such as equity linked notes. This theme recurred throughout our interviews and is one that we will return to later.

The SFC Code of Conduct

The Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) is a key document that provides guidance to those carrying out SFC-regulated activities (such as the distribution of investment products) in terms of their conduct and behaviour. It covers key general principles, such as:

- acting in the best interest of clients;
- avoiding being motivated by commissions;
- treating one's clients fairly;
- disclosing affiliations;
- ensuring fee transparency; and
- avoiding conflicts of interest.

The Code of Conduct applies to intermediaries selling investment products whether they are employees of brokers regulated by the SFC or staff of banks regulated by HKMA.

The Code of Conduct was first introduced in 2001. Between 2001 and the GFC in 2008, two amendments were made to the Code of Conduct. During that time, sanctions for failing to fully discharge the obligations under the Code of Conduct were relatively mild, except in the most extreme cases.

As noted earlier, the GFC experience led to a fundamental reset of the way the SFC approached the issue of mis-selling. In the ensuing decade, every single process that would lead to an eventual product sale was scrutinized, including:

- know your client, which encompasses client due diligence, risk profiling, and anti-money laundering;
- know your product, which encompasses product selection and recommendation, and product due diligence; and
- sale processes, which encompass suitability assessment and disclosures.

This scrutiny was reflected in changes to the Code of Conduct — since the GFC in 2008, it has been updated 15 times. Although the key general principles have remained the same, the SFC has supplemented it with more explicit details to provide guidance on behaviour expected of intermediaries. The additional specificity made it easier to regulate and gave the SFC more latitude to sanction behaviour it viewed as unacceptable.

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Fund Distribution Channels

Banks

In Hong Kong SAR, funds are distributed to retail investors predominantly through banks, insurance companies, and financial planners. It has been widely acknowledged that banks dominate the distribution channels with an estimated market share of 69%.[49] In one estimate, the bulk of investment funds (~70%) are sold through just three banks[50] — this is despite a competitive banking sector with a large number of local, mainland Chinese, regional, and global players.

Banks' domination of the distribution channel is in part due to their branch networks, which are, for many customers, an accessible first point of contact for their investment needs. With access to customer account information, banks are best positioned to maximise cross-selling opportunities. They have more resources to handle client acquisition, onboarding and profiling, complaint handling, and changes in regulation.

The dominance of the distribution landscape by large retail banks raises a number of concerns, including "limited investor choice, lack of market competition, high barriers to entry, as well as high trailing commissions and costs."[51]

Some fund management houses have sought to build direct-to-customer channels, but in a market in which funds are "sold not bought," such channels have not been popular. Retail investors prefer using banks that have a menu of options (most banks offer open architecture) and where their holdings across different fund managers can be consolidated.

Insurance companies

Insurance companies, with their large, mobile sales forces, at one stage provided a promising alternative channel for fund distribution, especially when it came to investment-linked assurance schemes (ILAS), a relatively complex product that combines insurance and investment. The market share of insurance companies' in fund distribution is estimated to be around 24%.[52]

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[49] Cerulli Associates, "Asian Distribution Dynamics 2019".
[50] Alder, "Update on the SFC's Asset Management Strategy for Hong Kong."
[51] Alder, "Update on the SFC's Asset Management Strategy for Hong Kong."
[52] Cerruli Associates, "Asian Distribution Dynamics 2019".

Although ILAS products have to be authorized by the SFC, their sale and distribution, as well as the licensing and regulation of insurers and insurance intermediaries, are under the jurisdiction of the IA, an independent statutory body that regulates the insurance industry in Hong Kong SAR.

Before the establishment of the IA in 2015, the regulation of the insurance industry was carried out by the Office of the Commissioner of Insurance (OCI) along with three self-regulatory organisations that had a somewhat different approach to standard setting, minimum qualifications, and vetting of licensees compared with the SFC.

In 2013, the SFC implemented enhanced ILAS product disclosures whereby total fees and charges (as a percentage of the total premia paid) relating to a policy must be disclosed. In the following year, the OCI introduced new regulatory measures to bring ILAS products more in line with investment products, including:

- fair treatment of customers in respect of charges, which should be fair and commensurate with the protection offered;
- products must adopt a uniformed method for calculation and disclosure of the remuneration received by the intermediaries;
- intermediaries must perform suitability assessment for customers; and
- intermediaries should only recommend ILAS products to investors who have both investment and protection needs.

These tighter regulatory measures were one factor that led to a drop of the sale of ILAS products. In 2013, premium income derived from ILAS business was 22% of total long-term business but by 2018 it has shrunk to 7%.[53]

Notwithstanding the enhancement of requirements, in a mystery shopping exercise conducted in 2014, the SFC found that "sales staff who are both SFC-licensed representatives and registered insurance agents were inclined to recommend such insurance contracts ahead of other products." The SFC also noted the significant confusion among customers who believe that ILAS products are subject to the same SFC regulatory regime as other investment products.[54]

[53] Legislative Council Secretariat, "Statistical Highlights," (May 2019), https://www.legco.gov.hk/research-publications/english/1819issh26-insurance-industry-in-hong-kong-20190510-e.pdf
[54] Securities and Futures Commission, "Mystery Shopping Programme Findings," (December 2014), https://www.sfc.hk/web/EN/files/ER/Reports/Mystery_Shopping_Programme_Findings_2014_EN.pdf

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Technology to the rescue?

In view of the concentration in fund distribution, the SFC has been exploring the feasibility of an exchange-based, online fund distribution platform. The headwinds to this are significant, not least because of the potential upending of existing distribution arrangements, but also because of few successful precedents overseas. Some fund houses were particularly nervous about upsetting key distribution relationships on which they depend.

Technology and digital innovation often have been touted as one of the biggest potential disrupters of the fund distribution business. Many in the industry are optimistic that online selling and distribution of funds could lower distribution costs, deliver a more consistent client experience, provide better access for customers, and lower barriers to entry. Some intermediaries are investing in technology and building client interfaces that would better support their client interactions. Most industry practitioners CFA Institute spoke to did not feel threatened by the rise of robo-advisers or online fund supermarkets, both of which operate in the territory. The generation with investable assets still prefers human contact, whereas those who are more technologically savvy and open to such platforms (which tend to be younger investors) do not yet have sufficient wealth to move the needle.

One well-funded robo-adviser we interviewed offered a standardised approach to investments and combined other lines of businesses to ensure viability, including, for example, brokerage and research. It also licensed its platforms to smaller financial institutions that would white label such platforms for their own customers, effectively purchasing an off-the-shelf, packaged solution. In this regard, they were finding ways to complement existing players rather than competing with them head on.

The market in Hong Kong SAR contrasts with that in mainland China, where the fund management industry has been leveraging technological advances to facilitate interactions with investors, and investment products are marketed, bought, and sold online and on mobile phones, as a matter of course. Some industry practitioners that CFA Institute interviewed pointed out that technology has a bigger role to play in emerging markets such as mainland China. In a developed market such as Hong Kong SAR, where investor behaviour is entrenched and legacy systems have been long established, it has been difficult to change the way things are done. In this regard, some expressed concerns that the city risks being left behind.

IFAs: Is there a middle ground?

In 2017, the SFC tightened the requirements for intermediaries who hold themselves out to be "independent" by stipulating that an intermediary can establish her- or himself to be independent only if she or he is paid by the client and receives no payments from product manufacturers or other parties. An industry practitioner told CFA Institute that this rule change has rendered the

business models of independent advisers in the Hong Kong market challenging and many have since left the industry or rebranded — some businesses now offer overseas property investments as a product line. Those who remain typically occupy niche areas, for example, by focusing on the expatriate community, which requires specialist tax and pension advice.

For many small to mid-size firms, the cumulative changes in regulation over the past decade meant that it was increasingly difficult to supervise their sales forces and advisers and ensure that they fully comply with regulatory requirements. Even some large banks in the city have moved away from providing investment advice and recommendations to retail customers and operate on an execution-only model. Many small businesses are exiting the advisory business as a result and are redirecting their focus on a combination of execution-only services and fee-based portfolio management.

Mandatory Provident Funds

The MPF is a compulsory saving scheme for the retirement of Hong Kong SAR residents, which was implemented in 2000. All employees who meet a minimum income threshold, and all employers are required to make monthly contributions to plans managed by approved MPF providers, most of which are insurance companies. Through the MPF, many savers have access to a range of mutual fund products, ranging from low-risk, capital guaranteed options, to high-risk options that have the potential for greater growth but also higher volatility. As of March 2019, the net asset value of the MPF system was HKD893.3 billion (USD114.5 billion),[55] small relative to the city's GDP, to the size of its mutual fund industry, and compared with other mandatory savings schemes overseas. For example, in the calendar year 2018 alone, gross sales of retail funds in Hong Kong SAR amounted to USD87.3 billion.[56] As a percentage of the city's GDP, MPF assets amount to 43%.[57] In Australia, the accumulated superannuation assets amount to 131% the country's GDP,[58] while in Singapore the assets of the Central Provident Fund are roughly equal to its GDP.[59]

[55] Mandatory Provident Fund Schemes Authority, "Mandatory Provident Fund Schemes Statistical Digest" (March 2019), http://www.mpfa.org.hk/eng/information_centre/statistics/mpf_schemes_statistical_digest/files/March_2019_Issue.pdf

[56] Hong Kong Investment Funds Association Sales and Redemptions Survey, "Hong Kong Retail Funds: Trend Analysis" (June 2019), https://www.hkifa.org.hk/upload/Documents/Retail-Funds/Sales-Redemptins-Data/SnR_cht.pdf

[57] Thinking Ahead Institute, Willis Towers Watson, "Global Pensions Assets Survey 2018" (February 2019), https://www.thinkingaheadinstitute.org/en/Library/Public/Research-and-Ideas/2019/02/Global-Pension-Asset-Survey-2019

[58] Australian Government, Australian Trade and Investment Commission, "Australia has the Fourth Largest Pension Fund Assets in the World" (22 February 2019), https://www.austrade.gov.au/news/economic-analysis/australia-has-the-fourth-largest-pension-fund-assets-in-the-world

[59] Central Provident Fund Board, "CPF Statistics," www.cpf.gov.sg/Members/AboutUs/about-us-info/cpf-statistics

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Remuneration

The question of remuneration is key to the puzzle of inducements. Many distributors or investment advisers in the Hong Kong market, and indeed in other markets, are remunerated based on sales. They do not directly charge clients any advisory fees, rather they earn commissions from transactions based on sales value. Such commissions are often embedded in the actual investment products.

This commission model is the most direct way to incentivise a sales force and drive profitability — the more one sells, the more one gets paid — but this also may induce distributors and advisers to recommend and push products that come with higher commissions or encourage clients to trade more frequently, regardless of the client's investment needs and objectives.

If an investment adviser sells an investment fund to an investor, she or he will most likely receive the following commissions:

- Subscription fees (sometimes called upfront commission): This is usually a percentage of the investment amount and typically is embedded in the investment products and deducted from the value of the investment.[60] This is essentially a payment by the investor to the distributor/investment adviser and has the most direct impact on a distributor/investment adviser's take-home pay. Churning is thus an issue. A fund that a client bought, say, four months ago has done well, why doesn't the client take profit and rotate into another fund that is poised to take off?
- Trailer fees: Once the sale is completed, for as long as the client holds onto the fund, a fund management house pays part of its management fee to the distributor at an entity level.

Despite enhanced disclosure requirements, it may not be obvious to the investor that only a portion of the management fee goes to the asset manager. This practice could have a significant effect on the investor's overall perception of value.

[60] See, for example, the Chin Family, "Commissions on Investment Products and Potential Conflicts of Interest" (13 August 2018), https://www.thechinfamily.hk/web/en/financial-products/financial-intermediaries/financial-advisers/commissions-on-investment-products.html

De-emphasizing sales

To mitigate such conflicts, we have observed a variety of measures being adopted by some institutions:

Many frontline staff are now paid a salary plus a discretionary bonus. The determination of the bonus is based on a range of factors, including:

- whether the company as a whole has met its targets and objectives,
- whether the team has met its targets and objectives,
- whether the individual has met his or her targets and objectives.

Such targets and objectives now include more than just financial targets with both quantitative and qualitative KPIs, for example, including:

- number of client complaints,
- client satisfaction score,
- number of compliance breaches.

This is often referred to as the balanced scorecard approach, which was mandated by Singapore in 2016.

Another key feature is that bonuses are now often deferred and conditional upon there being no subsequent adverse outcomes linked to a frontline employee's behaviour. This motivates a more long-term approach and deters bad behaviour or taking compliance risks.

In the event that misconduct is identified, mechanisms now can claw back bonuses already paid (both at the frontline and at the senior level).

Although the SFC does not have specific regulation on remuneration for advisers and supervisors, there is an expectation for financial institutions to conduct sound sales and remuneration practices as set out in various SFC guidance such as the Code of Conduct, reports on findings of thematic inspection and reviews and FAQs.[61]

[61] SFC guidance can be found in some of the following:

Securities and Futures Commission, "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission" (September 2019). https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission.pdf

Securities and Futures Commission, "Report on the Thematic Inspection of Selling Practices of Licensed Corporations" (October 2012). https://www.sfc.hk/web/EN/files/IS/publications/Thematic%20Inspection%20Report%20Oct%202012.pdf

Securities and Futures Commission, "FAQs on Compliance with Suitability Obligations by Licensed or Registered Persons." https://www.sfc.hk/web/EN/faqs/intermediaries/supervision/suitability-obligations-of-investment-advisers/compliance-with-suitability-obligations.html#5

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Another trend that we have observed is the segregation of duties: the delineation of roles and responsibilities is now much clearer, with relationship managers providing client coverage, and product specialists having a more in-depth knowledge of the products on offer.

Trailer fees

In addition to upfront commissions, it is a common practice in the Hong Kong market for fund management companies to pay a trailer fee (also called retrocession) to the distributing entity on at least an annual basis. Such trailer fees usually are calculated based on a percentage of the time-weighted AUM at an aggregate level. From the perspective of fund management companies, client acquisition is costly and extending clients' holding periods makes good business sense.

From the perspective of the distributing entity (such as banks), the maintenance of a branch network and client relationships with associated regulatory and compliance burdens is expensive. Trailer fees go some way toward defraying these costs and allowing them to invest in the training of their staff who need to keep up with the latest regulations and product updates.

Looked at this way, the interests of the product manufacturers and distribution channels are aligned — both parties are keen to grow clients' aggregate AUM. If all fund houses pay similar trailer fees, then banks and distributors do not necessarily need to have a preference for one fund house's product over another's.

From the perspective of frontline client-facing staff, the consideration is slightly different. A switch to another product, offered by the same or another fund house, would still generate a commission. The balanced scorecard goes some way into addressing this, but it does not eliminate this conflict completely.

Another contention in relation to the trailer fee is that it adversely affects investor out-comes. After all, the trailer fee comes out of management expenses of the fund, and can be as high as 60% of these expenses. Investors may not always understand that and may blame fund managers for low value-for-money products, especially in challenging markets.

Account monitoring

Given the high regulatory burden, investment in automated systems may reduce human error and ensure consistency of approvals, provided such systems are designed properly. Some banks have invested significant amounts of money to analyse data and monitor sales margins and the cost of product offerings, both at an account level and at a product level. Accounts are tracked and monitored for abnormal indicators, such as the following:

- above-average profitability,

- above-average activity,
- above-average turnover, and
- concentration.

Deviation over a threshold will trigger a portfolio review by a separate function not otherwise involved in the sales process and acting as a second line of defence. In this regard, it appears that the relentless and ruthless pursuit of sales and profits have been at least partly tempered by regulation. At the very least, banks and distributors are being put on sufficient notice to take note and make meaningful change.

Disclosures and Conflict of Interest

Conflict of interest has been an issue that regulators have been aware of for a long time. As a result of the misconduct identified, conflict of interest issues such as when firms act as both principal and agent in their dealings with clients, or when firms receive benefits for selling a product, have been given greater focus. Similar to other markets, the SFC has placed a great deal of emphasis on its disclosure regime to improve transparency and to empower investors in making informed decisions. For the sale of investment funds, intermediaries have to disclose the maximum percentage of trailer fees they may stand to receive and where such fees are paid out (typically from the funds' management fees). Also, for discretionary account management services, intermediaries have to disclose the benefits they receive from product issuers as well as trading profits they make from products purchased from or sold to third parties for their clients.

The effectiveness of disclosures in driving decision making is not universally accepted. CFA Institute has heard a great deal of scepticism from intermediaries on the usefulness of disclosures — the level of detail that is now required is excessive, not conducive to decision making, and tends to be ignored by most investors. Although most practitioners accepted that it was necessary to provide information on how much fees and commissions an investor was paying, some felt additional information on how much an intermediary might be getting from a third party was superfluous and of no consequence to the investor.

We find this view self-serving — this is indeed the type of information that would allow investors to better gauge potential conflicts of interest. In the absence of a pay-for-advice model, our preference is for more complete disclosure. Even if not all investors would find such disclosures useful all of the time, at least the optionality should exist. We acknowledge that although regulators can set rules for disclosures (especially in relation to what to disclose, when and how), it is not always possible to define quality. Having disclosures that are complete, clear, simple, easy to understand, not buried in fine print, and accompanied by explanations will go a long way toward enabling informed decision making and building trust with service providers.

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Licensing

During the course of our study, market participants reflected that in Hong Kong SAR the entry point to the industry is low, resulting in a large variance in the quality and professionalism of practitioners in the market. The test of competence for individual licensed representatives currently consists of three options.[62, 63]

In one of the options, no academic qualifications are required — the individual has to possess relevant industry experience and pass the regulatory examination. One industry veteran noted that the exam could be improved, as the questions are repetitive and becoming outdated. Again, this plays into the hands of large, well-known financial institutions, whose brands and networks provide a level of assurance and advantage over smaller rivals. This also applies to continuing professional training (CPT) requirements. Individual license holders are required to undertake five CPT hours for each regulated activity to remain fit and proper, and it is their employers' responsibility to ensure that this is achieved.

It is important to also note that individual licensing requirements are different between a distributor bank and a securities or brokerage firm. Bank staff that distribute investment products are considered "relevant individuals" and are not required to be licensed with the SFC. However, their names are entered in a register maintained by the HKMA to enable the public to ascertain whether the bank staff is deemed as fit and proper and to ascertain the staff's registration details.[64, 65]

[62] Securities and Futures Commission, Test of competence for licensed representative. https://www.sfc.hk/web/EN/regulatory-functions/intermediaries/licensing/competence-requirements/test-of-competence.html

[63] SFC guidance can found in some of the following:

Securities and Futures Commission, Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (September 2019). https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission.pdf

Securities and Futures Commission, Report on the Thematic Inspection of Selling Practices of Licensed Corporations (October 2012). https://www.sfc.hk/web/EN/files/IS/publications/Thematic%20Inspection%20Report%20Oct%202012.pdf

Securities and Futures Commission, FAQs on Compliance with Suitability Obligations by Licensed or Registered Persons. https://www.sfc.hk/web/EN/faqs/intermediaries/supervision/suitability-obligations-of-investment-advisers/compliance-with-suitability-obligations.html#5

[64] Securities and Futures Commission, Licensing Handbook, Paragraph 1.2.3 (February 2019). https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/licensing-handbook/licensing-handbook.pdf

[65] Securities and Futures Commission, Test of competence for licensed representative. https://www.sfc.hk/web/EN/regulatory-functions/intermediaries/licensing/competence-requirements/test-of-competence.html

Investor Education

Investing always entails a certain amount of risk. When returns fall short, or when capital is lost, it does not necessarily mean that mis-selling was involved. Even with the best intentions, rules, regulations, and disclosures are not infallible protection for investors. Ultimately, the responsibility for making informed decisions rests with the investor and she or he needs to develop sufficient knowledge and a healthy attitude toward investing. Financial literacy and investor education are key parts of this equation and their importance should not be underestimated.

Hong Kong SAR established the Investor and Financial Education Council (IFEC) in 2012 as a subsidiary of the SFC to take the lead in improving public financial literacy. Formerly known as the Investor Education Centre, the IFEC provides comprehensive education on a broad range of money matters to help the public make informed financial decisions. The IFEC is supported by the Education Bureau and four financial regulators and remains an independent and impartial financial education platform. Key strategic focuses of the IFEC include the following:

- **Awareness:** increasing public awareness of the benefits of financial education,
- **Advocacy:** raising awareness of policy makers and stakeholders of how raising financial literacy level can support their policy areas and works,
- **Collaboration:** supporting collaboration among stakeholders for the delivery of more and higher quality financial education.

The IFEC acts as an important channel for investor education and supports the development of more responsible financial habits, behaviours, and decision making.

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Duty of care: suitability

A great deal of regulatory emphasis has been placed on customer protection through policies supporting client knowledge (including risk profiling and assessment), sales processes, and product selection. Under the Code of Conduct, licensed intermediaries owe a best interest duty to their clients, and in practice, they adhere to a suitability standard, where an intermediary can only solicit or recommend a product whose risk and return profile is commensurate with that of the client. The SFC has indicated that suitability obligations are a cornerstone of investor protection.

One of the central tenets of the suitability concept is risk matching. Put simply, risk-adverse clients would be shown relatively safe products, whereas relatively risky products would be shown only to those clients who have a risk appetite and experience with such products, as well as the capital to withstand potential losses. This means that intermediaries need to spend time on understanding a client's profile, including their investment objectives, horizon, return expectations, tolerance and appetite for risk, and ability to take losses.

More important, they have to document such profiles, assign a risk rating to clients and keep their profiles and risk ratings up to date. Records of conversations (call reports) along with product recommendations are made for supervisory and audit purposes. Furthermore, at the point of sale, many retail banks ask clients a list of questions to confirm the client's understanding of the trade in question, including the product's key features and risk profiles. Without such documentation, it would be difficult for banks and distributors to defend their recommendations in the event of a client complaint or when an investigation calls for further scrutiny. Banks and other intermediaries are encouraged to perform self-assessment, review their policies and processes, and self-report, if weaknesses are detected.

Risk matching is not the only factor, however. The SFC has also indicated that the consideration of suitability is not merely on the basis of matching a product's risk rating with client's risk tolerance level — a wholesale consideration of all relevant circumstances needs to be demonstrated as well.

Although the concept of suitability is now generally accepted and appears ubiquitous, it is worth pointing out that before the GFC, the suitability requirement was waived for professional investors[66]. The experience in GFC led to the conclusion that professional investors were not necessarily knowledgeable or financially savvy when it comes to investments.

[66] A professional investor in Hong Kong SAR is usually an individual having no less than HK$8 million (US$1.03 million) in investable assets. Hong Kong e-Legislation, "Securities and Futures (Professional Investor) Rules," https://www.elegislation.gov.hk/hk/cap571D?xpid=ID_1530079363765_001

Consequently, the waiver was removed and professional investors were accorded the same level of protection when it came to suitability assessment. In contrast, in Singapore and India, at present, suitability assessment is mandatory only for retail investors, even though some providers do so for all clients as a matter of best practice.

Finally, note that a suitable product does not have to be the cheapest product. Indeed, suitability does not always translate into value-for-money — a concept that the UK Financial Conduct Authority has been placing particular focus on.

Complex products

In the past, a suitability assessment was triggered when an intermediary solicited or recommended a product or transaction. Following a couple of rounds of consultation on the sale of complex products[67] in the online and offline environment, new rules were implemented to provide additional investor protection. Under the new rules, when complex products are traded:

- a suitability assessment is required,
- sufficient information (e.g., key nature, features, and risks) on the product is provided to ensure client understanding, and
- warning statements are provided.

The classification of complex products has thus become key and that responsibility lies with the intermediaries. Although the SFC has provided guidance on what constitutes a complex product, as well as an indicative list of the products that would be deemed complex, each intermediary is responsible for its own classifications.

From what CFA Institute has seen, banks in the Hong Kong market have taken different approaches to this new regulatory requirement. We are aware of at least one bank that has classified securities in all major asset classes as complex, effectively subjecting all unsolicited

[67] According to the SFC, a complex product refers to an investment product whose terms, features, and risks are not reasonably likely to be understood by a retail investor because of its complex structure. To determine whether an investment product is a complex one, consideration would include, for example, whether it is reasonably easy to understand by a retail investor, whether it contains derivatives, or whether it is liquid. See, for example, Securities and Futures Commission, "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission" (July 2019), https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission.pdf

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and execution-only transactions to a suitability assessment and necessitating the need to provide product information and warning statements. Others have taken a more selective approach and have classified only those products that have a high component of derivatives exposure and an illiquid secondary market as complex.

Product due diligence

For intermediaries, compliance with the suitability rule extends to include "know your product," in which a thorough understanding of investment products is necessary to explain each product's features, characteristics, and risks to the client, as well as to justify the basis of recommendation.

They also need to provide a selection of appropriate products, for which due diligence needs to be performed before onboarding, training, and on-going maintenance. This is costly and time consuming. For many regional and global banks, such due diligence is performed as part of a standardised process to ensure quality control and avoid product duplication. The considerations include:

- Product features:
  - track record,
  - investment horizon,
  - availability of credit,
  - expected risk-adjusted return and volatility,
  - complexity;
- Risks:
  - reputational,
  - market,
  - counterparty,
  - legal, compliance, and regulatory;
- Business case;
- Availability of training;
- Product maintenance.

Product approval committees are typically structured with representatives from both the business side and from the risk side to ensure a balanced view.

Given the amount of resources required, intermediaries would only initiate the due diligence process on those products that have a high probability of commercial success. Large, long-established managers with a track record and resources to provide on-going training are thus preferred.

As a result, small fund houses suffer. Unless they can offer something unique or have backing from a large, strong parent (with associated resources for training and on-going maintenance), their products may not find their way onto a distributor's shelf space. This has potential ramifications for the on-going healthy development of the ecosystem and will challenge creativity and product differentiation.

By the same token, fund managers also don't favour small distribution houses. Their client reach and market penetration is comparatively low, and servicing them represents huge opportunity cost.

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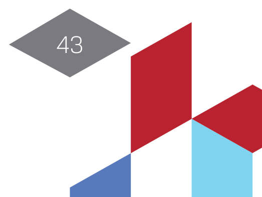

4. India

Introduction

Mutual funds were first introduced in India in 1963 with the government's establishment of the Unit Trust of India, which held a monopoly on unit trusts until the 1990s. The industry began developing in the mid-1990s, after opening up to competition. It experienced the first significant bout of growth after 2003, with the arrival of international fund companies and a slew of new products. Currently, India has 44 asset management companies or mutual fund manufacturers.[68] As of June 2019, the top five firms account for 58% of the industry's AUM.[69] Registration of foreign funds for sale to investors in India, as well as the amount of assets individuals can invest overseas, is strictly limited. Most investors only invest onshore, in funds domiciled in India.

In the past 15 years, the AUM of mutual funds grew 16-fold, reaching INR24.5 trillion (USD354 billion) as of 31 July 2019.[70] The number of distributors grew almost seven-fold, from 18,285 in 2004 to 124,000 in 2019.[71] Despite this growth, mutual funds account for only around 11% of the nation's GDP, compared with the world average of 62%[72] and 3% of household savings.[73]

A 2013 study *Penetration of Mutual Funds in India: Opportunities and Challenges*[74] noted a large untapped potential for growth in mutual funds, especially outside India's major cities. The study pointed to several structural problems of India's financial sector, including: a high share of population without access to banking services, poor financial

[68] Association of Mutual Funds of India, https://www.amfiindia.com/know-about-amfi

[69] Association of Mutual Funds of India, https://www.amfiindia.com/research-information/aum-data/average-aum

[70] Association of Mutual Funds of India, https://www.amfiindia.com/indian-mutual

[71] Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations in Securities Market" (1 April 2019), https://www.sebi.gov.in/reports/reports/apr-2019/consultation-paper-on-self-regulatory-organizations-in-securities-market_42573.html

[72] "Mutual Funds AUM in India Abysmally Low at 11% of GDP versus 100% in US; Stellar Growth on Cards?" *Financial Express* (9 January 2019), https://www.financialexpress.com/market/mutual-funds-aum-in-india-abysmally-low-at-11-of-gdp-versus-100-in-us-stellar-growth-on-cards/1438675/

[73] Deloitte, "Redefining Distribution: Converge, Digitize, and Achieve" (December 2017), https://www2.deloitte.com/content/dam/Deloitte/in/Documents/financial-services/in-fs-redefining-distribution-noexp.pdf

[74] Rajesh Chakrabarti et al., "Penetration of Mutual Funds in India: Opportunities and Challenges" (2013) https://www.sebi.gov.in/sebi_data/DRG_Study/OpportunitiesChallenges.pdf

literacy, extreme risk aversion and preference for "safe" assets such as gold or real estate, and poor distribution efficiency because of the high cost of acquiring new clients.

In 2014, the Ministry of Finance set up a committee, led by Sumit Bose, the former Union Finance secretary, to recommend measures curbing mis-selling and rationalising distribution incentives in financial products (the Bose Committee). The Bose Committee identified a number of factors as possible reasons for Indian households' low level of participation in financial markets, including a lack of trust and "a poor record of retail finance in servicing the interests of customers."[75] To this point, distribution of financial products was driven by upfront commissions and trailer fees that a distributor might receive, rather than a customer's interest. Typical complaints include:

- "Customers not been given correct information about products;
- Customers not shown the full array of products;
- Customers not told the exact amount of their contributions that will be diverted towards commissions and costs; [...] and
- Customers made to churn their portfolios without any apparent benefit to them."[76]

Other issues that the Committee identified as having an adverse impact on investor outcome included vertical integration, where banks had a preference to distribute their own in-house fund products, and lack of regulatory uniformity — mutual funds, insurance products, and pension schemes all had their own regulators with different requirements on fee structures, disclosures, and selling process.

In the years since the Bose Committee reported in 2015, a number of regulatory changes have strengthened investor protection and removed some of the conflicts of interest inherent in the remuneration structure in the mutual fund sector. In the rest of this section, we examine what these changes are, particularly in the relation to mutual funds, and how they have affected the industry in India.

[75] Ministry of Finance, Government of India, "Report of the Committee to Recommend Measures for Curbing Mis-Selling and Rationalising Distribution Incentives in Financial Products" (August 2015), https://www.finmin.nic.in/sites/default/files/Final_Report_Committee_on_Incentive_Structure_0.pdf
[76] Ministry of Finance, Government of India, "Report of the Committee to Recommend Measures."

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Regulatory Landscape

SEBI regulates mutual fund distribution and the provision of investment advice, among other areas of India's financial industry. The core regulations relevant to financial advice and mutual fund distribution are the SEBI (Mutual Funds) Regulations, 1996[77] and the SEBI (Investment Advisers) Regulations, 2013.[78]

In addition to SEBI, the Association of Mutual Funds in India (AMFI), an industry standards organisation, is involved in certain self-regulatory activities. Its members include all the asset management companies that are registered with SEBI. In addition, all intermediaries distributing mutual funds must register with AMFI and are subject to their code of conduct.

To enhance investor protection and outcome, SEBI has made a number of changes in relation to both fund manufacturing and fund distribution. In addition to a focus on reducing mutual fund costs and raising transparency, SEBI also introduced a pay-for-advice model, in which advisers were paid by fees not product commissions. These changes, taken together, signalled SEBI's intention to shift the industry away from a sales-and-commission-driven culture toward one based on long-term relationships between financial advisers and their clients. The goal is to foster an industry that provides comprehensive, outcome-oriented advice services. Highlights of pertinent changes are as follows:

- **Ban on front-load mutual funds:** In 2009, SEBI took the first step toward curbing high fees and mis-selling incentives by banning fund distributors from charging front-load fees, which were typically around 2.25% of investment.[79] At the same time, SEBI capped early exit fees at 1%.
- **Introduction of RIAs:** In 2013, SEBI issued Investment Advisers Regulations 2013,[80] which introduced RIAs, a new category of advisers, as distinct from other investment intermediaries. RIAs are only allowed to earn fees paid directly by their clients and cannot receive commissions from manufacturers of investment products, which is a significant departure from the sales model. The regulation also created a separate licensing regime for RIAs.

[77] Securities and Exchange Board of India, "SEBI (Mutual Funds) Regulations, 1996," https://www.sebi.gov.in/sebi_data/commondocs/mutualfundupdated06may2014.pdf

[78] Securities and Exchange Board of India, "SEBI (Investment Advisers) Regulations, 2013" (8 December 2016), https://www.sebi.gov.in/legal/regulations/jan-2013/sebi-investment-advisers-regulations-2013-last-amended-on-december-08-2016-_34619.html

[79] Manu Kaushik, "No Comeback for Entry Load," *BusinessToday* (26 June 2011), https://www.businesstoday.in/magazine/focus/ban-on-entry-load-for-mutual-funds-to-continue/story/16188.html

[80] Securities and Exchange Board of India, SEBI (Investment Advisers) Regulations, 2013.

- **Creation of "clean" mutual fund shares, or direct plans:** In 2013, SEBI introduced a new mutual fund share class with lower total expense ratios (TERs), called direct plans, following an initial proposal issued in 2012.[81] Mutual fund companies have to offer both direct and regular plan options for all their funds. Although fund management fees in both direct and regular plans are, in theory, the same, direct plans do not pay any commissions and hence their TERs are typically 100 basis points lower. Direct plans were designed for distribution by RIAs in the pay-for-advice model, by self-directed online investment platforms, and by asset management companies to institutional investors. Most individual investors, however, still hold regular mutual fund shares with distributors, in part to benefit from on-going services that distributors provide.[82]
- **Enhancements in disclosures:** In a circular published in March 2016,[83] and which was subsequently implemented in October 2016, SEBI required funds to improve the level of information provided to investors in their half-yearly consolidated account statements. New information to be disclosed included, among others, commissions and incentives (including payouts in the form of gifts and sponsored trips) paid to distributors, as well as the fund's TER.
- **Mutual fund re-categorization:** To provide investors with clear differentiation of mutual funds in terms of their investment characteristics, in late 2017, SEBI issued a circular in relation to categorization and rationalization mutual funds, classifying all funds into five broad schemes: equity, debt, hybrid, solution-oriented, and other schemes.[84] Each scheme was further classified into sub-categories. SEBI mandated that each fund house should have only one fund in each category. In early 2018, asset management companies re-categorized their funds. In categories in which an asset management company had more than one fund, those funds had to be consolidated or the additional funds shut down.
- **Ban on upfront commissions and lower caps on TERs:** In October 2018, SEBI issued a circular[85] in relation to the banning of upfront sales commissions for mutual funds, leaving trailer fees as the only source of revenue for mutual fund distributors. At the same time, fee structures were rationalised and TER caps were adjusted downward, which

[81] Securities and Exchange Board of India, Circular CIR/IMD/DF/21/2012 (13 September 2012), https://www.sebi.gov.in/sebi_data/attachdocs/1347547815927.pdf

[82] Kaustubh Belapurkar, "How Fund Distribution Is Evolving in India," Morningstar (2 August 2016), https://www.morningstar.in/posts/35579/how-fund-distribution-is-evolving-in-india.aspx

[83] Securities and Exchange Board of India, "Circular on Mutual Funds" (18 March 2016), https://www.sebi.gov.in/legal/circulars/mar-2016/circular-on-mutual-funds_31942.html

[84] Securities and Exchange Board of India, "Categorization and Rationalization of Mutual Fund Schemes" (6 October 2017), https://www.sebi.gov.in/legal/circulars/oct-2017/categorization-and-rationalization-of-mutual-fund-schemes_36199.html

[85] Securities and Exchange Board of India, "Proposal for Total Expense Ratio of Mutual Fund Schemes," https://www.sebi.gov.in/sebi_data/meetingfiles/oct-2018/1539576106009_1.pdf

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in turn limited the amount of trailer fees that a distributor could receive. Upfronting of trailer fees (i.e., fund companies advance the payment of trailer fees to distributors) was also banned.[86] The provisions in the circular became effective from April 2019.

- **Proposed reform on Portfolio Management Services (PMS) scheme:** In August 2019, SEBI issued a consultation paper seeking to strengthen PMS regulations by imposing a higher minimum investment threshold, a ban of upfront fees, caps on operating expenses and exit load, and stricter disclosures, among other requirements.[87]

As can be seen, a number of regulatory changes in the past few years have focused on reducing both distribution costs and fund expenses to better align the industry's incentives with customers' interest. According to market participants, mis-selling of investment products and churning of clients' portfolios were "rampant" in India before the implementation of these regulatory changes. Although the new rules have gone a long way toward enhancing investor protection, and have curbed mis-selling to some extent, the issue may have simply migrated to other parts of the industry. The banning of upfront commissions to move all distributors to a trail-only model had a particularly severe impact on distributors' income, especially for those who have not yet built a profitable book of clients. To protect their revenue, some distributors have changed their focus from selling mutual funds to selling alternative products, for example insurance, or other complex products such as PMS and alternative investment funds (AIFs). These alternative products do not have the same fee restrictions as mutual funds, and some of them are available only to high-net-worth investors who are deemed to be more financially savvy. Insurance products command a high upfront commission and do not come under the purview of SEBI. SEBI is aware of the regulatory arbitrage and has been trying to plug the gap, as can be seen from its recent consultation on PMS reforms (noted previously).

Self-regulatory Organization

Distributors are under contract or "empanelled" with one or more mutual fund companies to market and sell their products. These mutual fund companies are also responsible for the distributors' conduct. If the distributor is a bank, the conditions regarding conduct set out in the empanelment contract apply to the bank's employees. SEBI observed, however, that although mutual fund companies are responsible for the conduct of distributors empanelled with them, such oversight practices vary and more consistency is needed.[88]

[86] The only exception is for Systematic Investment Plan, a scheme that allow investors to invest a fixed sum in a mutual fund of choice at regular intervals. Upfront trail commissions may be made for inflows of up to INR5,000 per month per investor. The maximum upfront commission payable is capped at 1% for a maximum period of three years and the expense must be borne by the fund management company.

[87] Securities and Exchange Board of India, "Consultation Paper on SEBI (Portfolio Managers) Regulations, 1993" (2 August 2019), https://www.sebi.gov.in/reports/reports/aug-2019/consultation-paper-on-sebi-portfolio-managers-regulations-1993_43780.html

[88] Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations."

Recognizing the need for more effective regulation and monitoring, SEBI has been working toward establishing a self-regulatory organization (SRO) as a frontline regulator. SEBI expressed the intention of creating an SRO for investment advisers in its *Concept Paper on Regulation of Investment Advisers* in 2011.[89] An SRO for fund distributors would "ensure consistency in the practices, enforcement of code of conduct and take disciplinary action, if required, particularly in respect of alleged malpractices like mis-selling of products, churning of portfolio etc., and deal with investor grievances, in order to safeguard the interests of the investors."[90]

The process of selecting an SRO for fund distributors suffered a false start in 2014. An initial approval to start an SRO given to the Institution for Mutual Fund Intermediaries, a subsidiary of AMFI, was challenged by another applicant and ultimately nullified by the Supreme Court. The process was restarted in November 2018 with a court decision approving a new approach that does not involve applications but that does include recognition of an entity as an SRO "on nomination basis, after conducting due diligence" and "considering its experience and capability."[91]

In April 2019, SEBI issued a consultation paper noting that the time was now appropriate to initiate the formation of an SRO to oversee mutual fund distributors and RIAs.[92] Under the consultation, the SRO for fund distributors would combine four roles:

- Development: training members, creating investor awareness, and representing the industry in relations with SEBI;
- Licensing: granting membership in SRO, recommending SEBI to grant or renew certificates of registration for members, establishing a code of conduct, and conducting examinations for certification;
- Grievance redressal and dispute resolution: resolving grievances and disputes against members, and disputes between investors and members;
- Disciplinary: taking action in the event of violation of code of conduct or regulations, which may include suspension of membership, expulsion, and other non-monetary penalties.

Some market practitioners noted that an independent SRO, if implemented properly and managed with a high degree of transparency, would go a long way toward alleviating such concerns.

[89] Securities and Exchange Board of India, "Concept Paper on Regulation of Investment Advisers" (2011) https://www.sebi.gov.in/sebi_data/attachdocs/1317044891201.pdf
[90] Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations."
[91] Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations."
[92] Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations."

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Ministry of Finance Committee on Incentive Structure

In December 2014, the Ministry of Finance set up a committee, led by Sumit Bose, the former Union Finance secretary, under the Financial Stability and Development Council, to study incentive structures of financial products. The Committee's remit was to recommend measures that would rationalize incentives to curb mis-selling across a range of products, including mutual funds, insurance, and pension schemes, without favouring any of them. The Committee published its report and recommendations in August 2015. In the report, the Committee recognized the importance of reducing the potential of mis-selling by ensuring clean product structures, setting clear benchmarks, and aligning incentives for all stakeholders. The issue of conflict of interest arising from vertical integration and commission-driven business models was noted, as was the lack of a uniform regulatory regime.

The Committee made more than 100 generic and product-specific recommendations. The recommendations for mutual funds include:

- banning upfront commissions (but not for insurance products) and banning the upfronting of trail commissions;
- moving to a trailing fee model based on a fund's AUM;
- creating a level playing field for commissions across all cities;
- removing similar schemes from the same fund houses;
- ensuring flexibility of exit options, with limits on exit fees (back loads);
- enhancing disclosures by providing clear, one-page disclosures at the point of sale that include past returns, benchmark returns, and trail commissions;
- creating common regulation for distributors; and
- requiring mandatory registration of distributors in a single registry.[93]

Since the publication of the Bose Committee final report in 2015, SEBI has implemented many of the recommendations for mutual funds, including, for example, banning of upfront commissions, moving to a trail-only model, and recategorization of funds. Commissions are not yet uniform across the country, however, as distributors to retail investors in smaller cities are still allowed to earn a higher trailing fee. One-page disclosures at the point of sale have not

[93] Ministry of Finance, Government of India, "Report of the Committee to Recommend Measures…"

been mandated by the regulator, but asset management companies provide monthly one-page fund fact sheets, which are available at AMFI's website. Similar recommendations were provided for life insurance, unit-linked insurance products, and national pension schemes (NPS), with the goal of levelling the playing field, even though different regulatory bodies regulate these products. A common regulation standard has yet to be created for all distributors.

Licensing and Professionalism

Mutual fund distributors

Around 124,000 mutual fund distributors[94] are currently registered with AMFI. They include banks, non-bank financial institutions, partnerships, and individuals. AMFI registration is available to individuals who pass a National Institute of Securities Markets (NISM) certification. The curriculum is focused on mutual funds, including their categorization, structure, distribution, accounting, valuation, taxation, risk, and performance. It also includes the basics of financial planning, asset allocation, and how to select a suitable fund.

The NISM certification needs to be renewed every three years, upon fulfilment of continuing professional education requirements, which consist of one full-day training session. This is perceived by some practitioners as insufficient to keep the qualifications up to date.

Mutual fund distributors, who may also call themselves "agents," "brokers," "financial advisers," or "wealth advisers" (terms that are not covered by the RIA regulation) are allowed to provide only basic financial advice to their clients, pertaining to the products they distribute. All individual distributors have to register with AMFI through their employers and be allotted a unique number called the Employee Unique Identification Number (EUIN). This number stays with the individual throughout his or her career. This number can be used to track each sale back to the individual, ensuring that advisers are paid the commission due and can be held responsible for their actions.

[94] Approximately 124,000 as of 28 February 2019, according to Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations."

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Distributors are subject to the AMFI Code of Conduct, which consists of 27 provisions, including:

- Considering investor's interest as paramount and taking necessary steps to ensure that the investor's interest is protected in all circumstances.
- Not undertaking commission-driven malpractices, such as:
  - recommending inappropriate products solely because the intermediary is getting higher commissions therefrom,
  - encouraging over-transacting and churning mutual fund investments to earn higher commissions, and
  - splitting applications to earn higher transaction charges or commissions.
- Keeping investor's interest and suitability to their financial needs as paramount and ensuring that extra commission or incentive should never form the basis for recommending a scheme to the investor.
- Observing high standards of ethics, integrity, and fairness in all its dealings with all parties — investors, mutual funds and AMCs, registrars and transfer agents, and other intermediaries.[95]

Industry practitioners have indicated to CFA Institute that although requirements under the Code of Conduct were sound in intention, they may not be rigorously adhered to because AMFI is not equipped to effectively monitor compliance.

Registered investment advisers

The RIA regime was created by the SEBI (Investment Advisers) Regulations 2013[96], which came into effect on 21 April 2013. The regulations specify the conditions for registration, capital adequacy, client risk profiling and suitability, disclosures to be made to clients, code of conduct, maintenance of records, and other aspects of the profession. Only those who have registered under the regulation can use the term "investment adviser" and provide personalized advice related to investing in securities and other investment products. The term "advice" includes financial planning for individuals, but it excludes recommendations to the public through television, print, or electronic communications, such

[95] Association of Mutual Funds of India, "Revised Code of Conduct for Intermediaries of Mutual Funds," https://www.amfiindia.com/research-information/circulars-and-announcements/announcements/revised-code-conduct-of-inter-mf

[96] Securities and Exchange Board of India, "SEBI (Investment Advisers) Regulations, 2013."

as blogs. The RIA regulation replaces the earlier portfolio manager regulation, which has been in place since 1993. Portfolio managers are expected to register under the RIA regime upon expiry of their portfolio management licences.

RIA licences can be obtained by individuals, partnerships, or corporations. Corporations such as banks, for which provision of financial advice is only a part of their business, must apply for the licence through a subsidiary or a "separately identifiable department or division."

Table 1. Registered Investment Advisers in India

Type of organization	Number of organizations
Corporations	290
Limited Liability Partnerships	46
Individuals and Partnership Firms	800
Total	**1,136**

Source: SEBI, 19 March 2019.

Individuals registered as RIAs and employees of a corporation holding an RIA licence must obtain a two-level investment adviser certification and renew it every three years. The curriculum is much broader and more thorough than that for mutual fund distributors. It covers a range of investment products, such as fixed income and equities, and requires a deeper understanding of risk management, performance measurement, financial planning, investment strategies, insurance, retirement planning, taxation, and ethical issues.

RIAs are obligated to act in a fiduciary capacity toward their clients. They must disclose all conflicts of interest and must maintain an arm's length separation between advice and any other activities they conduct. They must also act with skill, care, and diligence; act in the best interest of their clients; and ensure that the financial advice they provide takes into account the client's risk profile and the product's suitability for the client. RIAs must disclose their holdings in financial products or securities on which advice is being provided.[97] Although the RIA regime is relatively new, SEBI noted an increase in the number

[97] Securities and Exchange Board of India, "FAQs on SEBI (Investment Advisers) Regulations, 2013" https://www.sebi.gov.in/sebi_data/attachdocs/1424862077270.pdf

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of complaints against RIAs during the last five years. The complaints alleged "charging of exorbitant fees, assurance of returns, and other misconduct by investment advisers."[98]

The regulation is silent on provision of discretionary portfolio management services. Most RIAs provide investment advice on a non-discretionary basis.

Fund Distribution Channels

Traditionally, the distribution of mutual funds (and insurance) in India has been in the hands of individual agents. Banks and other financial institutions, however, have been growing their distribution businesses. The market share of mutual fund distribution is 21% for banks, 18% for non-bank financial companies, 21% for individual financial advisers (including RIAs and individual distributors), and 40% for direct sales by asset management companies, the channel of choice for institutional investors.[99] The landscape is fragmented, with the top 20 distributors accounting for only 23% of the industry's assets, and the top 979 accounting for 41%.[100] The largest distributor, HDFC Bank, has a 2.8% market share.

Distribution is still very much product driven, rather than centred around customer needs and outcomes. Institutional relationships play a big role in the decision making by frontline staff, sometimes at the cost of product suitability and customer outcomes.

The introduction of the RIA segment has not affected the distribution business in a significant way, but the ban on upfront commissions and imposition of TER caps have forced many small and individual distributors to rethink their business model. The choice is to try their skill in the RIA model or to look for other revenue sources. Market practitioners noted to CFA Institute that the evolving policy landscape, the regulatory focus on fee reduction, low penetration of mutual funds, a sales-driven culture, and investors' low financial literacy all contribute to a challenging business environment.

[98] Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations."
[99] Deloitte, "Redefining Distribution: Converge, Digitize, and Achieve."
[100] Ravi Samalad, "Top 979 Distributors Manage 41% of Industry Assets," Morningstar (29 June 2018), https://www.morningstar.in/posts/47428/47428.aspx

Banks

According to Morningstar, an estimated 58% of funds in India are sold through a distributor that offers open architecture to investors.[101] Despite this, the Ministry of Finance Committee on Incentive Structure noted in its 2015 report that major banks generated at least one-third of all commission revenue from distributing in-house fund products.[102] The percentage is as high as 80–100% for some banks. Frontline bank employees clearly prefer to market in-house products. This preference may indicate a conflict of interest stemming from vertical integration. Recent analysis suggests that the situation has remained unchanged.[103]

Although the Committee saw a high concentration of in-house sales as one of the main causes of mis-selling, it did not recommend a ban on vertical integration. It suggested, however, that regulators consider imposing additional disclosure requirements to help investors identify in-house products and make informed decisions when choosing among comparable products. This issue has yet to be addressed in regulation.

Independent financial advisers

IFAs are a class of smaller distributors in India. They are defined as advisers, distributors, or agents of asset management companies operating less than 20 locations or having less than 20 sub-brokers and exclude banks, financial institutions, national or regional distributors.[104]

The industry body for IFAs is the Foundation of Independent Financial Advisors (FIFA), which was established in 2012. According to FIFA, there are nearly 100,000 IFAs with 80% selling other financial products in addition to mutual funds.[105] FIFA estimates that IFAs service 30–35% of retail investors. They are typically remunerated through product commissions. The broader public could potentially confuse them with fee-only RIAs. Because of TER caps, IFA revenues have been adversely affected, and as a result IFA registrations have reportedly been declining.[106]

[101] Morningstar, "Global Fund Investor Experience Study" (2017), https://www.fundresearch.de/fundresearch-wAssets/sites/default/files/Nachrichten/Top-Themen/2017/GlobalFundInvestorExperienceReport2017.pdf

[102] Ministry of Finance, Government of India, "Report of the Committee to Recommend Measures."

[103] Bharadwaj Sharma and Chirag Madia, "Lenders Earning More Commission by Selling In House MF Schemes," *Financial Express* (20 July 2019), https://www.financialexpress.com/money/mutual-funds/lenders-earning-more-commission-by-selling-in-house-mf-schemes/1650415/

[104] Foundation of Independent Financial Advisors, Articles of Association, http://www.fifaindia.org/images/forms/aoa2019.pdf

[105] Foundation of Independent Financial Advisors, "Profile of IFA (Independent Financial Advisor)," http://www.fifaindia.org/images/forms/Profile_of_IFA.pdf

[106] Himadri Buch, "MFs See Dip in Independent Financial Advisers Registrations on Lower Commissions," MoneyControl (22 March 2019), https://www.moneycontrol.com/news/business/mutual-funds/mfs-sees-dip-in-independent-financial-advisers-ifa-registrations-on-lower-commissions-3683011.html

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Registered investment advisers

RIAs are essentially creating a new market for themselves, but many are struggling to generate sustainable revenue from the RIA business model alone. A significant part of the challenge is convincing clients of their value proposition and creating awareness among customers of the difference between RIAs and distributors in the services they provide and the fees they charge. The success of the RIA business model hinges on the customers' appreciation for the long-term comprehensive financial advice they receive — a concept that is still unfamiliar to many. During our interviews with market practitioners, they highlighted a number of obstacles that RIAs are facing:

- **Structural issues:** After an initial flurry of interest in the new advisory regime, further progress has been hampered by structural factors, such as a low level of financialization and low penetration of investments, as well as by the lack of policy clarity and a slow pace in removing hurdles to growth.
- **Reluctance to pay:** Investors in India, as in many other Asian markets, are reluctant to pay for financial advice services. Many still prefer to buy regular mutual funds, which carry trailer fees, even if they are more costly.
- **Fee collection:** Unlike in other markets, RIAs in India do not hold client assets on their books and cannot charge fees directly from clients' accounts. Fees are usually paid by cheque, and fee collection can be problematic. An adviser noted in an interview with CFA Institute that this adds to the cost of running a business and inhibits its growth.
- **Friction in the process:** As the clients retain direct control over their investment portfolio, they need to approve all orders recommended or entered by their advisers, giving rise to friction in the process. Orders are executed by a third party and are charged separately. Discretionary investment management is not an option for RIAs under the current regulation, although PMS can be offered to affluent investors. In recognition of this, SEBI has allowed RIAs to buy and sell mutual funds through the stock exchange platform, and trading of mutual funds on the exchanges has risen significantly.[107]
- **High platform fees:** RIAs who run a pay-for-advice business tend to use a third-party platform to execute client orders. They charge a platform fee, which is added to the advice fee. In some cases, the platform fees are so high that the total cost to the client exceeds that of regular mutual funds.

[107] Ravi Samalad, "To Scale Up, Advisers Flocking to Stock Exchange Platforms," Morningstar (12 April 2017), https://www.morningstar.in/posts/40599/to-scale-up-advisers-flock-to-stock-exchange-platforms.aspx

Dual-business model

Although the two business models of investment intermediaries, distribution and advisory, are meant to be distinct and separate, corporations such as banks are allowed to hold both types of licences, as long as there is sufficient separation between the two divisions within the organization, for example, an information barrier such as a Chinese wall. The client of the advice arm is under no obligation to use the same firm's distribution arm for execution of transactions, and if they choose to do so, any brokerage charges and commissions must be paid directly to the distribution arm. The investment adviser must maintain an arm's-length relationship with the distribution division. The adviser must also disclose to the client any remuneration received by the adviser, or the firm's other divisions and subsidiaries, for distribution services of products for which advice is provided. Similarly, when recommending a broker or a distributor, any compensation the adviser receives from them must be disclosed.

This dual arrangement is not available, however, to individuals registered as RIAs, as the regulations specifically prohibit an individual or members of the individual's family from holding two different licences.

This was meant to be a temporary arrangement. As a further step toward separation of advice from distribution, in a 2018 consultation paper,[108] SEBI proposed an end to the dual model for individuals as well as financial institutions, including banks and non-bank financial companies. This proposal meant that intermediaries had to choose to provide either distribution or advisory, but not both.

The growth of fee-based investment advice, while noticeable, has been relatively slow. During the five years since the issuance of SEBI's Investment Advice regulation, more than 1,100 (less than 1% of distributors) have chosen to register as RIAs.[109] According to Morningstar, this regulatory uncertainty has dampened the switch from distribution to advisory services: a survey conducted by the Association of Registered Investment Advisers indicated that 42% of mutual fund distributors would apply to be RIAs if they were allowed to practice both as an adviser and as a distributor.[110]

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[108] Securities and Exchange Board of India, "Consultation Paper on Amendments to the SEBI (Investment Advisers) Regulations, 2013" (2 January 2018), https://www.sebi.gov.in/reports/reports/jan-2018/consultation-paper-on-amendments-to-the-sebi-investment-advisers-regulations-2013_37247.html

[109] At 1,136 as of 19 March 2019, according to Securities and Exchange Board of India, "Consultation Paper on Self Regulatory Organizations."

[110] Ravi Samalad, "What Stops Distributors from Becoming RIAs?" Morningstar (7 January 2019), https://www.morningstar.in/posts/50346/stops-distributors-becoming-rias.aspx

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The dual-business model provides a lot of flexibility to advisors in servicing their clients, but it also contributes to the complexity and opacity of the fees the clients pay. In particular, an adviser may refer the client to its distribution arm for order execution. The client may choose between a direct plan on an execution basis, or a regular plan for which the distributor receives a trailer fee. This decision can be different for each separate transaction. Although account statements show all commissions, the total amount of revenue their adviser is making is not always clear to the client.

Transition to advice

Distributors are forced to adjust their business models as a result of the removal of upfront commissions, and many have found it difficult to maintain profitability. Despite this, there has not been a mass shift of distributors into the RIA regime. The economics of being an RIA appear to be even more challenging than being a distributor in the trail-only world. Industry practitioners reported that an adviser could earn, on average, 10–20 basis points in fees based on AUM, whereas in the distribution model, revenues were around 50 basis points.

In addition, most investors have yet to learn how to judge the quality of financial advice and frequently go with the adviser offering the cheapest service. Many RIAs are cutting fees to compete.

Some RIAs indicated that it may take anywhere from three to six years of business development before an investment advisory business becomes profitable. For a business to be successful, it takes a truly long-term view, a resolve to stay the course, financial means, and the ability to convince clients of the value proposition. As a result, few intermediaries operate solely as RIAs. Most of them have retained their fund distribution business, which subsidises the advisory services. Clients of such firms are free to switch, in whole or in part, to the advice model, and firms are usually happy to keep them as clients, even with lower revenues.

While respecting SEBI's intentions to protect investors and to improve the quality of investment advice, many felt that the transition could have been smoother with more support and incentives.

Advice gap

Newcomers to the industry today find it difficult to establish their businesses, whether they are operating as distributors or RIAs, as it takes several years to achieve profitability.

Many aim to shorten their journey by focusing on high-net-worth clients, which may contribute to a widening advice gap. Even well-established firms are often reluctant to build up their fee-based advice business, as it tends to be a loss-leader, manageable only in conjunction with a distribution arm. As a result, they "take it slow for the moment," in the words of an interviewee, as the industry adjusts.

Robo-advisory services

Low-cost online investment advice platforms — robo-advisers — are sometimes proposed as a means to mitigate the growing advice gap. Although robo-advice is not specifically addressed in regulation, India is not short on players in this space. They have not been able, however, to make significant inroads. The pool of potential users is relatively small. Robo-advisers require a level of financial literacy, and a degree of comfort to entrust investment decisions to a relatively untested online start-up. As India's young, online-and mobile-savvy professionals accumulate savings, robo-advisers who can refine their offering and prove their value stand to grow their business substantially.

Other intermediaries

Some financial professionals providing advice fall outside the RIA regime. In particular, insurance agents and brokers are regulated and licenced by the Insurance Regulatory and Development Authority of India (IRDAI). Pension advisers are regulated by the Pension Fund Regulatory and Development Authority (PFRDA) and stockbrokers by SEBI. These three classes of advisers are exempt from the RIA regime, but they are required to obtain a RIA licence if they expand their advice business to other financial products.

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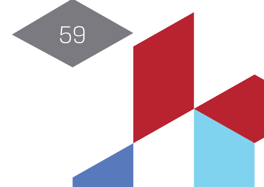

Remuneration

Mutual funds were initially distributed in India by accountants and insurance agents. As early investors switched from traditional products such as physical gold and real estate to financial products, they were offered funds that paid distributors very high upfront commissions, typically around 5%. Such high commissions incentivised portfolio churning. An interviewee estimated that a distributor would have earned in commissions as much as 10–15% of the value of a client's investments in one year by suggesting that the client move in and out of products.

These practices ended with SEBI's reforms. Today, not only are upfront commissions banned, other non-monetary inducements, such as holidays, cash vouchers, sponsorships, and expensive gifts, are also things of the past. Furthermore, in a trail-only model, distributors would be remunerated only if an investor continues to stay invested in a fund. Together these directives have a powerful effect on preventing churn.

In addition to distributors, SEBI also scrutinised the business models and practices of asset management companies. In a board memo published in October 2018, SEBI called out some of the issues, including "different practices of charging TER to the fund, and paying distributor commissions from the books of the asset management companies and charging the same to the fund, resulting in defraying the cost disproportionately on investors in direct plans."[111]

SEBI observed that the pre-tax margin for large asset management companies has remained in a tight range between 40% and 50% in the period from 2011 to 2018, when, during the same period, their AUM had tripled. This suggests that the benefits they have derived from economies of scale have not been passed onto investors.

To ensure that all investors are treated fairly and that some of the benefits from greater economies of scale are shared with investors, SEBI put a stop to the practice of paying commissions and distribution costs out of asset management companies' own profit-and-loss accounts. This has the effect of levelling the management fee in both the direct and regular plans of the same fund. SEBI also brought down the maximum caps on TERs. As can be seen in Table 2, the cap on TER for an equity fund cannot exceed 2.25% and the cap decreases as the AUM of the fund increases. There is also a cap of 1% on TERs of passive funds, such as index funds and ETFs.

[111] Securities and Exchange Board of India, "Proposal for Total Expense Ratio."

Table 2. TER for Equity and Other Schemes for Different Fund Sizes

Assets under management		TER for equity schemes	TER for other schemes[1]
(Rs crore)	(millions of USD)	(%)	(%)
Below 500	Below 71	2.25	2.00
500–750	71–106	2.00	1.75
750–2,000	106–282	1.75	1.50
2,000–5,000	282–704	1.60	1.35
5,000–10,000	704–1,408	1.50	1.25
10,000–50,000	1,408–7,042	TER reduction of 5 basis points for every increase of INR50 billion (USD704 million) AUM or part thereof	TER reduction of 5 basis points for every increase of INR50 billion (USD704 million) AUM or part thereof
Above 50,000	Above 7,042	1.05	0.80

Source: SEBI, https://www.sebi.gov.in/sebi_data/meetingfiles/oct-2018/1539576106009_1.pdf
Note: 1. Excluding index, ETFs, and fund of funds

Although the regulatory intent was laudable and improved investor outcomes, there have already been reports that instead of absorbing these costs, some asset management companies were going to pass the reduction in TER on to distributors, further squeezing them.[112] It is too soon to determine how this will play out and whether these regulatory measures will lead to consolidation in the distribution market.

[112] Aniruddha Bose, "Death Knell for Retail Distribution?", *Business World* (1 May 2019), http://www.businessworld.in/article/Death-Knell-For-Retail-Distribution-/01-05-2019-169989/

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Notwithstanding these changes, SEBI considers it important to encourage financial participation from retail investors beyond the top 30 cities in India (often referred to as B30 cities) and recognizes the critical role distributors play in this regard. Distributors selling mutual funds to retail investors in a B30 city are allowed to be paid an additional 30 basis points in the form of trailer fees.[113]

Balanced scorecard

Market participants indicated that to mitigate the risks of mis-selling and to align incentives with consumer outcomes, some firms have been turning to balanced scorecards as a tool for performance evaluation and employee compensation.

A balanced scorecard combines both sales and non-sales factors into a score that helps determine an employee's bonus. They are not mandated by the regulators but have been implemented by some financial institutions — mostly multinational banks — on their own initiative.

A common approach is to focus the score around the number of contacts with clients and cross-selling of products — an approach that is still skewed toward meeting revenue targets. Another approach we have encountered uses net sales as the main criterion, disincentivising frequent switching of products in clients' portfolios and rewarding good client relationships.

Disclosures and Conflict of Interest

Although distribution and advice are meant to be separate, the dual-business model is a grey area in which conflicts of interest are not always managed. An adviser interviewed for this report admitted that the amount of trailer fees his company's distribution arm received was a factor in his investment recommendations, although he made the point that suitability was the predominant consideration. In his view, investor outcomes would improve if such conflicts did not exist.

[113] Aditi Murkute, "SEBI's New Mutual Fund Commission & Disclosure Norms: The Impact on IFAs," PersonalFN (10 April 2019), https://www.personalfn.com/fns/sebis-new-mutual-fund-commission--disclosure-norms-the-impact-on-ifas

Asset management companies are obligated to disclose, every six months, the amount of commissions paid to distributors.[114] Disclosure requirements for distributors, however, are comparatively lax. The AMFI Code of Conduct requires distributors to disclose the different levels of commissions they would receive under different products, but it does not require distributors to disclose conflicts of interest.

In contrast, SEBI stipulated a number of disclosure requirements for RIAs, including transactional and referral remuneration, actual or potential conflicts of interest, whether an RIA has any holdings or positions in the products being recommended, and key features and risks of the recommended products.[115]

As indicated in the previous section, in the distribution of fund products, banks tend to focus on selling in-house funds. Because of the lower disclosure standards applicable to mutual fund distributors, customers do not often understand whether the products shown are in their best interest, whether any actual or potential conflict of interest exists, and how much revenue the bank is making as a result.

Also, although most institutions in the distribution business have KYC and suitability processes in place, we have heard from market practitioners that incentives for frontline employees are often skewed toward sales volume and the most profitable products, which are not always suitable to customers. Oversight and auditing can be lax, and many cases of mis-selling go unnoticed.

Alternative Products

The ban on upfront commissions, which was implemented on short notice, caught the industry off-guard. As revenues declined, many distributors tried to plug the gap by expanding into other products.

Insurance is a common alternative, with a range of unit-linked insurance plans (ULIPs) on the market available for sale to retail and mass affluent clients. ULIPs are essentially mutual funds wrapped in an insurance cover, and they fall under the regulatory domain of IRDAI. Initial commissions for such products can be as high as 10–12%.[116]

[114] Securities and Exchange Board of India, "Circular on Mutual Funds."
[115] Securities and Exchange Board of India, "Proposal for Total Expense Ratio."
[116] Sunil Dhawan, "Don't Fall for These 5 Common Ulip Sales Pitches," *Economic Times* (7 March 2018), https://economictimes.indiatimes.com/wealth/insure/beware-of-these-5-common-sales-pitch-in-ulips/articleshow/63187780.cms

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Distribution of ULIPs has been vulnerable to mis-selling practices,[117] such as frequent switching to new products to generate sales commissions. This is to the distributor's advantage because trailer fees for such products decline with time. Since ULIPs are more complex and more opaque than mutual funds, retail investors with a low level of financial knowledge are particularly vulnerable to mis-selling.

Similar to most other markets, high-net-worth investors are deemed to be more financially savvy and can access more complex financial products, such as AIFs or PMS that are not available to retail clients.

AIFs are privately pooled investment funds, structured as a trust, a company, a corporation, or a limited partnership. The category encompasses venture capital, private equity, debt, as well as hedge funds, and can be structured as either close- or open-end funds. AIFs are targeted at high-net-worth investors with a minimum investment of INR10 million (USD146,000). Assets in AIFs in India amounted to INR1.34 trillion (USD19.4 billion) as of 31 March 2019,[118] or 5.7% of mutual fund assets.

Although AIFs need to be registered with SEBI, as private funds, they are not regulated by any regulatory agency, in particular in regard to the commission fees they pay to distributors. AIF distributors earn upfront commissions of 5%, and the annual fees average 2.5%, compared with an average of 1.5% for mutual funds. Close-end products typically adopt the "2 and 20" fee model (2% flat annual rate and 20% performance fee). While fee structures are transparent, investors may not be aware of the commissions paid to the distributor by fund manufacturers. Moreover, although many AIFs do not differ much from mutual funds in their risk-return profile, they tend to be less tax-efficient and less liquid. Some AIFs replicate an existing mutual fund but charge higher fees. Frequently, AIFs are heavily marketed on the basis of their novelty and the prestige that comes with the opportunity to invest in them. Their performance, however, may not be superior to that of mutual funds and does not always justify the higher fees.[119]

[117] Sunil Dhawan, "Don't Fall for These 5 Common Ulip Sales Pitches."
[118] Securities and Exchange Board of India, "Data Relating to Activities of Alternative Investment Funds (AIFs)" (31 March 2019), https://www.sebi.gov.in/statistics/1392982252002.html
[119] Shashank Khade, "Stick Primarily to Mutual Funds," *Business Standard* (8 July 2017), https://www.business-standard.com/article/pf/stick-primarily-to-mutual-funds-117070800909_1.html

PMS are discretionary or non-discretionary investment management schemes registered with SEBI. They are also targeted at affluent clients, who can afford a minimum investment of INR2.5 million (USD36,000). The fees charged by PMS are currently not regulated; however, competition has kept them from inflating. A typical PMS charges 2.5% a year or a combination of a fixed fee of 1.5–2% and a performance fee of 10–20% on returns above 10%.[120]

Several interviewees expressed concerns that sales of alternative complex products, such as AIF and PMS, are "a mis-selling scandal waiting to happen." One practitioner noted that when investors see disappointing performance of such products a few years down the road, it will become clear that initial sales were driven more by incentives and less by customer outcomes, and the experience may sour them on the concept of financial advice and damage investors' trust in the industry. This issue has appeared on SEBI's radar as a result of complaints that distributors are aggressively pushing AIF and PMS products to clients.

In general, SEBI's regulatory reforms have tended to focus on the protection of retail investors over that of high-net-worth clients. It is broadly assumed in the industry that wealthy customers are more investment savvy and have sufficient knowledge to evaluate various investment options available to them. This assumption is not warranted in many cases, because the wealthy may not have time to devote to due diligence on investment products and are often exposed to the risk of mis-selling. This situation has created an opportunity for a "regulatory arbitrage" of sorts, whereby intermediaries shift their business to target wealthier clients who have less protection and sell them products that bring higher fees. SEBI is now addressing the issue: in August 2019, SEBI issued a consultation paper to strengthen the regulation of PMS. The consultation paper proposes a doubling of the minimum investment threshold to INR5 million (USD72,000), a ban of upfront fees, caps on operating expenses (to 50 basis points) and exit load, and higher and stricter disclosures, among others.[121] If implemented, PMS regulation will be brought closer to that of mutual funds.

[120] Yogita Khatri, "Should You Invest in a PMS or in Mutual Funds?" *Economic Times* (17 April 2017), https://economictimes.indiatimes.com/wealth/invest/should-you-invest-in-a-pms-or-in-mutual-funds/articleshow/58193843.cms?from=mdr

[121] See Joydeep Sen, "SEBI's Consultation Paper Seeks to Strengthen Portfolio Manager Regulations," MoneyControl (August 2019), https://www.moneycontrol.com/news/business/personal-finance/sebis-consultation-paper-seeks-to-strengthen-portfolio-manager-regulations-4288361.html

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Investor Education

As India's investment culture and the industry are still in a developing stage, investor education is critical if the industry is to curb mis-selling and deliver good customer outcomes. Customers need to learn not only what their investment options are, but also how the different types of services differ, what they cost, their rights as investors and the duty of care owed to them. In particular, the concepts of financial planning and investment advice need to gain better understanding, acceptance, and appreciation.

As the industry evolves rapidly, investors need to evolve with it. Investors are being exposed to a growing range of new products. The industry and the regulators need to ensure that such products are transparent and that investors are fully informed of their risks, benefits, and costs. The benefits of education and transparency go both ways, protecting investors from mis-selling and protecting intermediaries from "mis-buying" by mis-informed customers who may blame the intermediaries when results disappoint.

First-time retail investors are particularly vulnerable to mis-selling practices, and that is where SEBI has focused its efforts to curb fees and provide education. In particular, it has mandated that each mutual fund set aside 0.02% of its assets for investor education and awareness.[122]

SEBI also established the Office of Investor Assistance and Education[123] and the Investor Protection and Education Fund. The office organises investor education workshops and other programs directly, or through investor associations and financial firms.

[122] Olga Robert, "Investor Education Funds In India; Why Should You Be Aware Of Them?" Yahoo! Finance (29 December 2018), https://in.finance.yahoo.com/news/investor-education-funds-india-why-082123667.html
[123] Securities and Exchange Board of India, "Office of Investor Assistance and Education" https://investor.sebi.gov.in/ipms.html

5. Singapore

Introduction

More than 10 years have passed since the GFC. During the Lehman mini-bond crisis that arose in 2008 with the collapse of Lehman Brothers, investor protection rules were put to the test in both Singapore and Hong Kong SAR. In both markets, the collapse of widely sold Lehman mini-bonds[124] and other structured products sparked numerous complaints and street protests. They led the regulators in both jurisdictions to conduct formal investigations into allegations of misrepresentation and mis-selling of these products to retail investors. The MAS issued an investigation report in 2009 and found failure by 10 financial institutions that distributed the mini-bonds in contravention of regulations on the sale and marketing of these investment products. The breaches included financial institutions selling risky products to inexperienced retail investors, the sales team lacking knowledge and training in the product, and the misrepresentation of the risk involved in the product.[125] As a result of these failings, the MAS imposed various penalties against the financial institutions.

Since the crisis, MAS implemented various regulatory initiatives to strengthen its supervisory framework putting in place rules such as, impose management accountability in financial institutions to achieve fair dealing outcomes, enhance disclosure and transparency, improve the knowledge and skills of financial advisers, create a balanced scorecard integrating non-sales KPIs as a basis for remuneration, and assess ways to improve culture at an organization.

[124] In Singapore, about 10,000 retail investors placed about S$500 million in Lehman-related structured products, and in Hong Kong SAR, more than 40,000 investors placed USD3.7 billion in Lehman-related investment products. See CFA Institute, "Mis-selling of Financial Products: How Are Investors Protected in Today's Marketplace?" (2009), https://www.cfainstitute.org/-/media/2B4A5626E6C7489BB466B6C9BBE08A4E.ashx

[125] Monetary Authority of Singapore, "MAS Releases Investigation Findings on the Sale and Marketing of Structured Notes Linked to Lehman Brother" (7 July 2009), https://www.mas.gov.sg/news/media-releases/2009/mas-releases-investigation-findings-on-the-sale-and-marketing-of-structured-notes-linked-to-lehman-brothers

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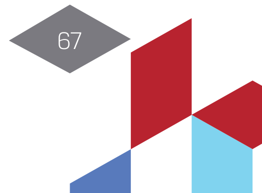

Regulatory Landscape

MAS is an integrated financial regulator with comprehensive powers over the financial services sector. It supervises financial institutions in the banking, capital markets, financial advisory, and insurance industries under the Banking Act, the Securities and Futures Act, the Financial Advisers Act, and Insurance Act, respectively. It is also the central bank of Singapore.

Financial Advisers Act

Implemented in 2002, the Financial Advisers Act (FAA) provides a set of rules and requirements for financial advisers to be properly licensed unless exempt, for their representatives to have proper professional qualifications, to be fit and proper in their roles, and to adhere to standards of conduct in the sale and marketing of investment products, among other things. The MAS continuously enhances its FAA rules, taking into consideration supervisory reviews, investigations, enforcement cases, and international regulatory developments.

Fair Dealing Guidelines

Taking into account lessons learned from the financial crisis, consumer polling,[126] consultation feedback, and monitoring international regulatory developments, the MAS issued Fair Dealing Guidelines in 2009 directed at the board and senior management of financial institutions to emphasize their responsibilities in treating customers fairly and in delivering five outcomes to customers:[127]

- Customers have confidence that they deal with financial institutions for which fair dealing is central to the corporate culture.

[126] The MAS commissioned a poll in 2007 to assess whether consumers were satisfied that financial institutions had their interests in mind when selling an investment product. The poll found that 59.5% of consumers were neutral in their satisfaction. See Monetary Authority of Singapore, "MAS Seeks Comments on Guidelines on Board and Senior Management Responsibility for Delivering Fair Dealing Outcomes to Consumers" (21 February 2008), https://www.mas.gov.sg/news/media-releases/2008/mas-seeks-comments-on-guidelines-on-board-and-senior-management-responsibility-for-delivering-fair-dealing-outcomes-to-consumers

[127] Monetary Authority of Singapore, "Guidelines on Fair Dealing — Board and Senior Management Responsibilities for Delivering Fair Dealing Outcomes to Customers," https://www.mas.gov.sg/-/media/MAS/resource/legislation_guidelines/fin_advisers/fin_advisers_act/guidelines/Guidelines-on-Fair-Dealing.pdf?la=en&hash=3A692DB36EBAA6080EFE296E23FD82398CAAB15D

- Financial institutions offer products and services that are suitable for their target customer segments.
- Financial institutions have competent representatives who provide customers with quality advice and appropriate recommendations.
- Customers receive clear, relevant, and timely information to make informed financial decisions.
- Financial institutions handle customer complaints in an independent, effective, and prompt manner.

FAIR Panel

In 2011, the MAS commissioned a mystery shopping exercise to assess how the Singapore financial services industry was complying with the Fair Dealing Guidelines issued in 2009. The mystery shopping exercise revealed that 30% of the products recommended by financial advisers to investors in Singapore were "clearly unsuitable" and representatives were not upfront in disclosing fees and charges.[128] As a result of these findings, the MAS established the FAIR panel[129] in 2012, to initiate a review into the regulatory framework for financial advisers, with the aim of raising the standards of professionalism for the financial advisory industry and to enhance market efficiency in the distribution of life insurance and investment products in Singapore.[130]

After eight months of deliberations, the FAIR panel came up with 28 recommendations that were opened for public consultation from March to June 2013. The five main focus areas of the FAIR panel recommendations were:[131]

[128] Monetary Authority of Singapore, "Report on Recommendations of the Financial Advisory Industry Review Panel" (16 January 2013), https://www.mas.gov.sg/-/media/MAS/resource/news_room/press_releases/2013/Annex-1--Report-on-recommendations-of-the-Financial-Advisory-Industry-Review-Panel.pdf

[129] The FAIR panel was chaired by the MAS and was composed of 13 representatives from industry associations, consumer and investor bodies, academia, media, and other stakeholders. See Monetary Authority of Singapore, "MAS Introduces Panel for the Financial Advisory Industry Review (FAIR)" (2 April 2012), https://www.mas.gov.sg/news/media-releases/2012/mas-introduces-panel-for-fair

[130] Monetary Authority of Singapore, "MAS Issues Response to Consultation on Recommendations of Financial Advisory Industry Review" (30 September 2013), https://www.mas.gov.sg/news/media-releases/2013/mas-issues-response-to-consultation-on-recommendations-of-financial-advisory-industry-review

[131] Monetary Authority of Singapore, Financial Advisory Industry Review, "Report on Recommendations of the Financial Advisory Industry Review Panel."

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- Raise the competence level of financial advisory representatives through minimum entry requirements and continuing professional development.
- Raise the quality of financial advisory firms through enhanced requirements on minimum base capital, continuing financial resources, professional indemnity insurance, and dedicated compliance arrangements.
- Make financial advising a dedicated service by recruiting representatives whose professional focus is primarily on their advisory role with no conflicts of interest with their business as well as better accountability and disclosure to customers.
- Lower distribution costs by harnessing competitive market forces rather than banning commissions.
- Promote a culture of fair dealing by requiring all financial advisory firms to adopt a balanced scorecard framework and ban all product-specific incentives.

Pay-for-advice model

A ban on commissions was considered by the FAIR panel but ultimately rejected. During the start of the FAIR panel review, the MAS conducted an online survey of consumers in Singapore about their receptiveness of a pay-for-advice model and the results revealed that 80% of consumers were not prepared to pay an upfront fee for advice. Concerns arose that any switch may result in segments of consumers being underserved.[132]

Fund Distribution Channels

Singapore is a well-established international asset management and fund centre. Fund distribution channels include banks, insurance companies, IFAs, and online platforms. The Singapore fund distribution market is similar to that of Hong Kong SAR in many ways, such as having a relatively simple tax system, bank-dominated fund distribution, and a preference for bundling of fees. Some key differences are notable, however. In Singapore, although banks dominate with around 75% of market share, more banks share total fund sales[133] (unlike in Hong Kong SAR where 70% of all fund sales are reportedly made by just three banks). Furthermore, fund platforms have a healthy and growing market share of 10%, and financial advisers not aligned with any banks also have a foothold in the market. Singapore has some degree of channel diversification and more competition, which in turn leads to lower distribution costs.

[132] Monetary Authority of Singapore, "Presentation of Financial Advisory Industry Review Panel Report," speech by Lee Chuan Teck.
[133] "Navigating Asia: Investment Fund Distribution: Challenges & Opportunities," Deloitte (November 2018), https://www2.deloitte.com/content/dam/Deloitte/lu/Documents/financial-services/IM/lu-asian-fund-management-report.pdf

Bank intermediaries

The distribution of investment products is mostly concentrated with banks. Many Singapore retail investors generally do their one-stop shopping for investment products at banks in which they have their bank deposit accounts. Most retail investors also trust their banks to seek financial advice from them.

Many market participants have expressed that "funds are sold, not bought," because funds typically are pushed by financial advisers. In general, banks have an advantage over other distributors. When a customer goes to the bank for service, the bank officer has access to a range of information about the customer, including for example, bank deposits, loans and mortgages, or investment holdings. This information can provide the bank with opportunities to provide financial advice or to cross-sell products to the customer. This same information is not as easily accessible to an IFA when meeting a prospective customer.

Online platforms

Notwithstanding bank-dominated fund distribution, demand is growing for online platforms and fund supermarkets for investors who prefer a more do-it-yourself approach to research and investments without a financial adviser interface. The millennial generation generally prefers to purchase and transact through online platforms. Their purchasing behaviour and technology preference is a game-changer for the fund industry. Although more convenient and easily accessible, online platforms also charge a set of fees, such as platform fees or custodian fees, and they receive trailer fees from fund managers for placing and distributing their funds on platforms.

Independent financial advisers

MAS allows financial advisers to use the word "independent" to describe themselves only if the financial adviser can show that they do not have financial or commercial links with product manufacturers that can influence their recommendations. MAS allows IFAs to receive commissions or benefits from a product manufacturer as long as they are insignificant and such commissions or benefits do not create a bias toward a particular investment, class of investment, or product manufacturer. MAS considers commissions or benefits to be significant if they are more than 20% of the financial adviser's total revenue.[134]

[134] Monetary Authority of Singapore, "Guidelines on the Use of the Term 'Independent' by Financial Advisers [FAA-G05]" (updated 1 July 2005), https://www.mas.gov.sg/regulation/guidelines/guidelines-on-the-use-of-the-term-independent-by-financial-advisers

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In general, IFAs who are "fee-based only" provide an alternative option for investors seeking financial advice. IFAs receiving commissions from product providers typically rebate those commissions to the client.

Central Provident Fund

The Central Provident Fund (CPF) is a mandatory social security system funded by contributions from employers and employees that allows working Singaporeans to set aside funds for retirement. Pension schemes offer investors a range of funds and products to invest their contributions and play an important role in retirement planning. It further encourages retail investors to learn more about portfolio diversification and to invest for the long term. The growth of pension schemes can be an important source of growth for fund products and an alternative fund distribution avenue for investors.

Remuneration and Fee Structures

During our research and interviews, CFA Institute noted a recurring theme in Singapore (and indeed in other markets) that investors do not see the value of, or want to pay upfront for, advice. Some investors mistakenly think they are receiving free advice from their advisers when, in fact, the cost of advice is embedded in the fund fees. Even those who are aware of fee bundling are not concerned as long as their investments make money for them.

Funds may charge many different types of fees. They may include one-off charges, such as initial sales charge or front-end load, redemption fees, or back-end load or switching fees. They may also have recurring fees, such as management fees, platform fees, trustee fees, custodian fees, and other administrative fees. Table 3 sets out the typical fees and charges for mutual funds in Singapore.[135]

[135] MoneySense, "Unit Trusts: Guide to Pricing and Fees" (29 October 2018), https://www.moneysense.gov.sg/articles/2018/10/unit-trusts-guide-to-pricing-and-fees

Table 3. Unit Trust Fees and Charges

Fees and Charges	
Initial sales charge or front-end load	Ranges from 1.5% to 5% of investment
Redemption fee or back-end load	Ranges from 1% to 5% of investment
Switching fee	Typically 1% of investment
Management fee	Ranges from 0.5% to 2% per year of net asset value
Platform fee	Ranges from 0% to 0.3% per year of total value of fund holdings with the platform

Source: MoneySense.

Central Provident Fund

Singapore is phasing out initial sales charges under its CPF Investment Scheme to encourage more retirement investing, reduce cost of investments, and remove sales incentives to financial advisers who sell products under the CPF Investment Scheme merely to earn more commissions.[136] From 1 October 2018, the CPF has reduced initial sales charges for retirement funds from 3% to 1.5%. This sales charge will be removed entirely from 1 October 2020.[137]

Trailer fees

Like in most Asian markets, the payment of trailer fees to the distributor of the fund is general market practice. Many investors think they are currently receiving free advice from their advisers when, in fact, the advice is not free but bundled together with other costs. Trailer fees are usually embedded in a portion of the annual management fee that the fund pays out to the fund distributors who provide advice.

[136] Lorna Tan, "Parliament: Government to Remove Sales Charge under CPF Investment Scheme," *Straits Times* (5 March 2018), https://www.straitstimes.com/business/economy/government-to-remove-sales-charge-under-cpf-investment-scheme

[137] Ministry of Manpower, "Reduction of CPF Investment Scheme Fees deferred to 1 Oct 2020" (March 2019), https://www.mom.gov.sg/newsroom/press-releases/2019/0312-reduction-of-cpf-investment-scheme-fees-deferred-to-1-oct-2020

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The annual management fee is a recurring fee that is taken out of the fund so investors are not paying for it directly. Management fees are typically somewhere between 0.5% and 2.0% of the fund's net asset value. The trailer fee can be anywhere from 20% to 60% of the fund's management fee.[138]

The management fee often accounts for a large portion of the fund's TER. Investors may not realize that high TERs generally lower the value of the fund, reducing its net asset value as well as the amount of securities the fund can invest. A fund that pays no trailer fees will effectively deliver higher returns, all else being equal.

Balanced scorecard

Recognising the impact of conflicted remuneration on investor outcomes, in 2016, a balanced scorecard framework was implemented as part of the FAIR initiatives to enhance the financial advisory industry's standards and professionalism. MAS requires financial advisers to adopt a balanced scorecard approach that integrates non-sales KPIs when assessing and determining remuneration for their sales staff as well as the supervisors and managers of those sales staff.

Under the balanced scorecard framework, non-sales KPIs are assessed based on whether the adviser (i) understood the client's needs, (ii) recommended suitable products, (iii) made adequate disclosures, and (iv) upheld standards of professionalism and ethical conduct in providing financial advisory services. These non-sales KPIs reflect the due diligence requirements captured in the various MAS conduct rules, guidelines, and notices to better align the interests of client-facing advisers and their supervisors with those of customers and to minimize conflicts of interest inherent in volume-based remuneration arrangements.

Some of the tools that financial advisory firms use to assess non-sales KPIs include compliance records, complaints, customer surveys, and diversification in product recommendations.

Many financial advisers noted that the balanced scorecard has generally been a positive influence in the way they approach clients. Some large institutions monitor sales behaviour closely (including suitability assessments and risk checks) and impose demerit points to penalise frontline advisers who do not follow policies and procedures. Some industry practitioners, however, also indicated to the CFA Institute that sales generation still is the most important component of a financial advisory business.

[138] MoneySense, "Unit Trusts: Guide to Pricing and Fees."

Moreover, not only are client-facing advisers and their supervisors graded on their balanced scorecards, these grades are also kept as part of their performance records. Such records include the employees' scorecard grades, infractions, and remuneration and are submitted by their employers on an aggregated basis to the MAS. As stipulated by the MAS, prospective employers need to conduct reference checks on potential employees' balanced scorecard grades.

Disclosures and Transparency

As long as sales incentives or inducements are built into the remuneration system, there will always be conflicts of interest. Like most markets, Singapore adopts a disclosure regime to communicate to investors the types of conflict that exist at an organization. Market participants are of the view that these disclosures are often long, displayed in fine print, and usually not read by customers.

Following are some of the regulatory disclosure requirements in place to promote transparency.

Conflict-of-interest disclosure

Under FAA conduct guidelines, financial advisers should act in the best interest of clients when providing financial advisory services to clients. Financial advisers are required to disclose in writing to clients any actual or potential conflict of interest in connection with any product provider that may compromise the objectivity or independence of the financial advice given.

Fee and remuneration disclosure

Also under FAA guidelines[139], financial advisers are required to disclose, in writing, all remuneration, including any commission, fee, and other benefits, that it has received or will receive for making any recommendation in respect of an investment product. This includes trailer fees or other soft commissions that a financial adviser receives or will receive from a product provider.

[139] Monetary Authority of Singapore, "Notice FAA-03 Information to Clients and Product Information Disclosure" (5 October 2018), https://www.mas.gov.sg/regulation/notices/notice-faa-n03

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Suitability Assessment

Suitability rules and KYC steps

The FAA's suitability rule requires financial advisers to have a reasonable basis when they recommend an investment product. A financial adviser should take all reasonable KYC steps and ensure that recommendations are suitable, taking into account the client's financial objectives, risk tolerance, financial situation, investment experience, and particular needs when making a recommendation.

Product due diligence and "know your product"

Financial advisers not only are required to "know your client" but also to "know your product" before selling an investment product to customers. MAS regulation[140] requires financial institutions to offer products and services that are suitable for their target customer segments by undertaking due diligence on any investment product that they intend to distribute, taking steps to tailor to customer profiles, investment objectives, and financial literacy of their target customer segments. In deciding whether to sell an investment product to customers, the financial adviser should consider whether the target customer is able to understand the product and determine whether the product is suitable.

The product due diligence process includes a thorough review of the product such as risk rating, complexity, and other features provided by the product manufacturer. In this regard, intermediaries often set up a new product committee that is cross-divisional and includes relevant functions of the business — including legal, compliance, risk, operations, and information technology — to review, assess, and provide a risk rating and approve the product for target customer segments.

Regulations require financial advisers to "know your product" before selling to customers, but some market participants have highlighted that advisers may not necessarily have the requisite knowledge or be properly trained about the products before they sell to customers.

Licensing and Professionalism

Licensing

Banks and merchant banks are required to obtain a banking license under the Banking Act, whereas financial advisers are required to obtain a financial adviser's license under the

[140] Monetary Authority of Singapore, "Financial Advisers Regulations 18B Product due diligence," https://sso.agc.gov.sg/SL/FAA2001-RG2

FAA. Finance companies are licensed under the Finance Companies Act. Broker/dealers, corporate finance advisers, credit rating agencies, real estate investment trust managers, and security-based crowd-funding operators are required to obtain a capital market services license (CMSL) under the Securities and Futures Act (SFA). Fund management companies can hold a CMSL or be registered with the MAS as a registered fund management company. These licenses/registrations are granted only to companies. Individuals conducting a regulated activity on behalf of such a company must be notified as an appointed representative of the company.

Although licenses may vary for financial intermediaries, uniform rules on standard of conduct apply for all industry participants. For example, licensed financial institutions such as banks, insurance companies, and holders of CMSLs are exempt from the FAA licensing requirement, but they and their representatives are subject to the same business conduct requirements set forth in the FAA.

Regulatory entrance exams

The MAS seeks to raise professional standards by enhancing regulatory entrance exams and promoting continuing professional development. Following its 2016 consultation on competency requirements, the MAS introduced ethics and skills content to its entrance examination framework for financial advisers. The MAS noted the importance of including ethics-related content to help professionals develop a greater understanding of ethical principles and a better appreciation of their obligations to go beyond following the letter of the law and focus on doing right by the customer. The skills-related content helps professionals gain a fundamental understanding of core skills and processes in the financial advisory process. The MAS works with the Institute of Banking and Finance (IBF) and the Singapore College of Insurance to implement the modules for the examinations and to develop training programs to enhance professional development.

Continuing professional development

The MAS promotes CPD to ensure that advisers are current in their knowledge of trends of new financial products as well as market and regulatory developments to be able to better serve customers. Since 1 January 2016 as part of its FAIR initiatives, the MAS require financial advisers to fulfil a minimum of 30 hours of annual CPD training of which out of 12 hours, a minimum of 4 hours are to be in ethics and 8 hours are to cover rules and regulations. In light of the industry feedback received from its 2016 consultation on competency requirements, the MAS decided to provide more flexibility to advisers and reduce the CPD requirement of 12 hours to 6 hours in which the training can be either in ethics or rules and regulations. The remaining 24 hours can include training courses relevant to the type of financial advisory services provided.

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Culture

Improving culture and conduct has been an increasingly growing topic for regulators. The culture of the organization drives behaviour and behaviour drives how employees treat customers. Employees see what is valued and rewarded at the organization and act in a similar way to succeed. The MAS has implemented the following regulatory initiatives to help promote sound culture at financial institutions.

Individual accountability

In recent years, the MAS has focused increasingly on individual accountability, identifying senior managers, allocating responsibilities and accountability to senior managers, and ensuring that senior managers are fit and proper for their roles. In 2018, the MAS issued a consultation paper proposing a set of guidelines to strengthen individual accountability of senior managers and to raise standards of conduct across the financial institutions. The Guidelines on Individual Accountability and Conduct (IAC Guidelines) promote individual accountability of senior managers, strengthen oversight of employees in material risk functions, and reinforce standards of proper conduct among all employees. MAS responded to the feedback received on the proposed IAC Guidelines in June 2019 and a second consultation paper was issued to extend the scope of the IAC guidelines to all financial institutions regulated by the MAS with flexibility for proportionate application for smaller financial institutions with less than 20 staff.

Culture and conduct steering group

In May 2019, the MAS and the Association of Banks in Singapore established a Culture and Conduct Steering Group (CCSG) to promote better culture and raise conduct standards among banks in Singapore. The CCSG is composed of MAS and members from 13 banks in Singapore who have roles in business, risk management, compliance, and human resources. The group aims to identify best practices in the area of culture and conduct and share them with banks to facilitate their adoption, monitor trends, and identify emerging conduct and culture issues within the industry and collaborate with the MAS on initiatives to promote a strong culture and conduct, such as performing industry self-assessments or updating industry codes of conduct.

Behavioural sciences unit

Behavioural insights examine how psychology, organizational, and group behaviour, as well as behavioural biases, can affect decision making. Regulators are increasingly using behavioral science to enhance their understanding of both consumer behavior

and firm behavior. By analyzing patterns of how consumers perceive, interpret and react to situations, regulators can better understand consumer behavior, biases and financial decision-making. In a similar way, by looking at how financial firms perceive and react to situations and policies, regulators can enhance financial supervision and better influence a firm's culture. The intended regulatory outcomes from the application of behavioral science are to strengthen investor protection, improve investor education and enhance policy and regulation of financial firms.

In 2019, the MAS established a behavioural sciences unit to acquire a more systematic way to understand culture and conduct issues in the institutions it supervises.[141] The unit applies behavioural insight techniques from social-psychology disciplines to gain insights on the behaviour and biases of consumers and businesses with the aim of enhancing supervision and regulation of the financial industry.

Investor Education

Many market participants noted that in Singapore, as is the case with other markets in Asia, it is difficult to change investor behaviour and biases that are generally short term in views and investments. As one adviser remarked, "When do you regulate and when do you educate?" Retail investors, many of whom are not financially sophisticated, benefit from investor education. Knowledge is the best protection against unwise investment decisions.

Established by the Singapore Government in 2003, MoneySense is the financial education program that provides resources on financial literacy and money management, and helps the public make informed financial decisions. Investor education helps to raise awareness and increase investor choice by helping individuals improve their financial planning, particularly when it comes to retirement. In Asia, retirement and pension systems are growing as governments prepare for higher life expectancies and a growing aging population. Having greater responsibility in looking after themselves, especially for retirement, may help investors learn to be more discerning on fees and products.

The recent financial troubles of Hyflux Ltd. (Hyflux), a water treatment company listed in Singapore, serves as a good reminder of the importance of investor education and inves-tor responsibility. Hyflux's restructuring has led to investor losses — not least those who invested in perpetual bonds of the company — many of whom were retail investors who subscribed to the instrument through ATMs, without the involvement of advisers or other intermediaries.

[141] Ravi Menon, "Strengthening Trust in Finance," Monetary Authority of Singapore (3 June 2019), https://www.mas.gov.sg/news/speeches/2019/strengthening-trust-in-finance

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The Hyflux case raised additional issues of product risk rating and the use of ATMs as a channel of distribution. Although ATMs increase financial participation and facilitate transactions, investors who purchase Hyflux securities via ATMs do not have the benefit of receiving advice from financial advisers or other intermediaries on the suitability of the product for the investors. At this stage, it is not clear what impact, if any, this experience will have on policies and regulations. But the point of responsibility remains — ultimately, investors are their own best protection when it comes to making investment decisions.

Accredited Investor Regime

Growth of high-net-worth clients

The number of high-net-worth individuals has been on the rise in Singapore. According to a 2018 global wealth research study,[142] the number of Singapore millionaires grew 11.2% to 183,737 individuals with more than USD1 million in net worth. Those considered to be "crazy rich" ultra-high-net-worth individuals with more than USD50 million in net worth increased 1.1% to about 1,000 individuals. The number of millionaires in Singapore is forecast to grow by 5.5% per year in the next 5 years.[143]

Accredited investors

Private banks are exempted from certain FAA requirements when serving accredited investors. Accredited investors are assumed to be more sophisticated, to be better informed, to have more resources, and accordingly require less regulatory protection relative to retail investors. Accredited investors waive the benefit of certain regulatory safeguards. For example, financial advisers are exempt from complying with the suitability requirements under the FAA when recommending investment products to accredited investors. Accordingly, accredited investors can access a broader range of investment products, including risky and complex products that would not be available to retail investors.

Wealth accumulation, however, can come in many different ways, such as property price appreciation, running a successful company, winning a lottery ticket, or selling widgets online. As a market participant noted, "Can an individual who became a self-made millionaire by manufacturing matchboxes in a third-world country really be financially savvy?" In reality, accredited investors may not be any more financially savvy compared with retail investors. Therefore,

[142] Credit Suisse, "Research Institute: Global Wealth Report 2018" (October 2018), https://www.credit-suisse.com/media/assets/private-banking/docs/uk/global-wealth-report-2018.pdf

[143] "There Are 183,737 Millionaires in Singapore, and 1,000 Who Are 'Crazy Rich': Credit Suisse," *Straits Times* (18 October 2018), https://www.straitstimes.com/business/economy/number-of-millionaires-in-singapore-up-11-to-183737-in-year-to-mid-2018-credit

the assumption that they have a bigger risk appetite or need less investor protection may not always be the case. CFA Institute's view is that the suitability requirement should apply to both accredited and retail investors to provide a level of protection for all investors.

In 2018, the MAS revised its regulatory framework for accredited investors by changing the way assets are calculated in its eligibility criteria to become an accredited investor. Table 4 summarizes the changes for individual accredited investors before and after 8 October 2018.[144]

Table 4. Criteria Changes for Eligibility for Individual Accredited Investors

	BEFORE 8 OCTOBER 2018	FROM 8 OCTOBER 2018
Personal Asset Test	Net personal assets (total assets minus liabilities) exceed SGD2 million (USD1.45 million) (Net value of primary residence contributed without a cap); or	Net personal assets (total assets minus liabilities) exceed SGD2 million (USD1.45 million) (Net value of primary residence contributed capped at SGD1 million (USD 727,800); or
Financial Asset Test	None	Net financial assets greater than SGD1 million (USD727,800) (including deposits and investment products); or
Income Test	Income in the preceding 12 months exceeds SGD300,000 (USD 218,330)	Income in the preceding 12 months exceeds SGD300,000 (USD 218,330)

Source: Allen & Overy.

[144] "The New Regime for Accredited Investors," Allen & Overy (9 November 2018), http://www.allenovery.com/publications/en-gb/Pages/The-New-Regime-for-Accredited-Investors.-.aspx

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In April 2019, the MAS made the process to become an accredited investor more strict with the introduction of an opt-in regime to give investors who qualify for accredited investor status a choice whether they are willing to waive certain regulatory safeguards in favour of access to a broader range of investment products that may include risky and complex products that otherwise would not be available to retail investors. The individual must give specific consent to opt in to be treated as an accredited investor or choose to be treated as a retail client. The MAS also requires financial advisers to inform accredited investors about the legal consequences and risks of being treated as an accredited investor. An individual who has chosen to be treated as an accredited investor may at any time withdraw his or her consent.

Private Banking Code of Conduct

To improve professional standards, strengthen transparency to clients, and improve confidence in the private banking industry, a Private Banking Code of Conduct (PB Code) was launched in 2011 with the support of the MAS and the Private Banking Advisory Group, which consists of senior industry leaders in the private banking industry.[145] The objectives of the PB Code is to provide guidance on standards of good practice to enhance competency and raise market conduct standards expected of financial institutions and their staff to provide financial services to accredited investors in the private banking industry. The PB Code covers such areas as ethics and professionalism, client relationship management, and risk management. It also requires private banking professionals to pass a competency assessment called the Client Adviser Competency Standards before providing any financial advice. Because these standards are intended to provide broad guidance for financial institutions serving accredited investors, market participants noted that private banks generally follow the PB Code.

[145] The PB Code was updated in January 2019 to reflect changes in the accredited investor regime. Association of Banks in Singapore, "Private Banking Code" (January 2019), https://abs.org.sg/industry-guidelines/private-banking

6. Conclusions and Recommendations

Subsequent to the GFC, the markets examined in this report have made material improvements in their regulatory frameworks addressing mis-selling, conflicts of interest, incentive arrangements and disclosures, and transparency. Some common trends are emerging, including:

- a move away from a purely sales-driven remuneration business model;
- increased transparency, especially around costs;
- enhanced disclosures of conflicts of interest;
- reduced or eliminated conflicts of interest;
- increased investor education;
- increased level of professionalism of intermediaries or advisers;
- senior management accountability; and
- an emphasis on culture.

Nevertheless, not all markets have taken the same approaches. CFA Institute believes that a healthy, well-functioning market should have the following attributes:

- sound investor protection;
- access to affordable, quality advice and products;
- a high degree of professionalism;
- transparency on fees;
- avoidance, mitigation, management and disclosure of conflicts of interest, as appropriate; and
- a culture of accountability.

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Such a market can support a range of different fee- and commission-based business models. Several prerequisites, however, must be met before such a market can be developed. Therefore, we recommend the following:

- **Investor protection:** Regulatory arbitrage may arise when different standards apply to different client segments. It is important for regulators to adopt a holistic approach and minimize such arbitrage. In this regard, the treatment of and protection accorded to investors with a larger amount of investable assets should not be different from that given to retail investors.
- **Holistic approach:** Similarly, consistent regulatory principles should apply to advice on all investment products, covering such aspects as incentives, licensing of firms and individuals, disclosures, product authorization, and duty of care in the selling process.
- **Duty of care:** Advisers must be upfront and clear to investors as to the duty of care the investors are owed — whether the adviser is acting as a fiduciary and in the client's best interest, or adhering to a suitability standard, or acting as a salesperson who is relatively more transactional. This enables advisers to differentiate their offerings to better service investors with diverse needs.
- **Disclosure:** Regulators should set a clear standard to ensure that pertinent information is provided and that advisers explain such information to their clients. In addition, for disclosures to be useful to investors, it is important to make them meaningful, clear, simple, complete, and user friendly. In designing disclosures and standard product factsheets, regard should be given to behavioral insights to enhance understanding and decision-making ability.
- **Investor education:** The importance of financial literacy should be emphasized. Regulators should continue to promote investor education and awareness. An educated investor has a better ability to distinguish, differentiate, and assess the different product offerings available and to select the one that is most suitable to his or her needs.
- **Remuneration:** The move in some markets toward a balanced scorecard approach in evaluating frontline performance is a welcome development. When the remuneration of both advisers and senior executives is aligned with the long-term interests of clients, the chances of achieving better investor outcomes are much higher.

Appendix A: Global Developments

This section provides a short overview of the recent developments in select markets around the world, including Canada, China, the European Union, Japan, New Zealand, the United Kingdom, and the United States.

Broadly speaking, the industry landscape for the provision of financial advisory services and the sales and distribution of financial products takes after one of the following models:

- Pay-for-advice only, with a regulatory ban on commissions (e.g., United Kingdom)
- Commission-dominated sales model (e.g., Japan)
- A combination of pay-for-advice and commission models (e.g., Canada, United States)

In several of the markets we reviewed, commissions remain the dominant and most entrenched business model. In the United Kingdom, authorities banned commissions to eliminate conflicts of interest. Several other markets have considered banning commissions but opted against it. In some countries, both models thrive, and market forces — rather than regulation — drive pricing and behaviour.

Despite the differences in levels of development as well as legal and regulatory frameworks in the markets we covered, the clear trend is toward the reduction and better management of conflicts of interest, by enhancing disclosures, raising the standards of the profession, and improving the quality of the advice provided.

Canada

Distribution of funds and securities in Canada is regulated by provincial legislation and provincial securities commissions. Securities regulators from Canada's 10 provinces and three territories have formed the Canadian Securities Administrators (CSA), an umbrella organization, which harmonizes regulations nationwide.

At the end of 2017, mutual fund assets reached CAD1.42 trillion (USD1.08 trillion). Mutual fund distribution is diversified in Canada. They can be sold across different channels such as banks, full-service brokerages, online brokerages, financial advisers and private wealth management. Banks accounted for 37% of market share in 2017, full-service

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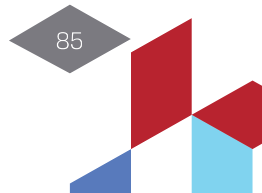

brokerage firms (investment advisers) and private wealth management for 32%, and other financial advisers for 25%. Direct distribution, robo-advisers and online brokerage made up the remaining 6%.[146]

An adviser or dealer may earn fees and commissions on a one-off basis at the time of sale, or on an ongoing basis. Commissions at the time of sale can be paid regardless of whether the fund is a front-end or back-end loaded one. In case of front-load funds, the commission is paid by the investor. In case of back-load funds, the commission is paid by the fund company to the adviser or dealer at the time of sale, even though investors do not pay an upfront commission but a deferred sales charge (DSC) at the time of redemption. The longer the holding period, the less an investor pays in DSC charges.

For on-going fees, an adviser can charge the client a fee based on AUM, usually 1–2%, or collect trailer fees from the fund management company. Typically, an independent adviser would collect 60%–80% of a fund's trailer fee, whereas a wealth manager would collect 25%–55%.[147]

All individuals engaged in advising or dealing in mutual funds must be registered with their provincial regulator directly or as representatives of a registered firm ("registrants"). All registrants are required to "deal with clients fairly, honestly and in good faith." Investment recommendations should be suitable for the client's level of knowledge, risk tolerance and goals. The regulators require registrants to fully understand any investment product they recommend and properly determine its suitability for the client.[148]

In 2017, the CSA issued a consultation paper that contemplates the banning of embedded commissions in investment fund products. CSA's concern was that sales commissions for investment products might bias behaviour and lead to advisers recommending products that pay the best commissions rather than products that are in the best interest of the investor. It identified three key investor protection and market efficiency issues stemming from the payment of embedded commissions.[149]

1. Embedded commissions raise conflicts of interest that misalign the interests of investment fund managers, dealers and representatives with those of investors.

[146] SI Research, "Canadian Investment Funds Industry: Recent Developments and Outlook," (2019), https://www.ific.ca/wp-content/uploads/2019/06/Strategic_Insight_Canadian_Investment_Funds_Industry_Recent_Developments_and_Outlook-2019.pdf/22469/

[147] PwC, "Economic Impact Assessment."

[148] PwC, "Economic Impact Assessment."

[149] Canadian Securities Regulatory System, "Consultation on the Option of Discontinuing Embedded Commissions," CSA Consultation Paper 81-408 (10 January 2017), https://www.osc.gov.on.ca/en/SecuritiesLaw_sn_20170110_81-408_consultation-discontinuing-embedded-commissions.htm

2. Embedded commissions reduce investor awareness, understanding, and control of dealer compensation costs.

3. Embedded commissions paid generally do not align with the services provided to investors.

To manage or mitigate these issues, the CSA believed that a transition to direct pay arrangements must be considered. After consultation with the industry and investors, however, the CSA decided not to proceed with an outright ban on commissions. The reason for not banning all forms of commissions was that it might lead to adverse consequences for market participants and investors. These were thought to include favouring large and vertically integrated financial institutions, and significantly disadvantaging smaller and independent firms. A ban on commissions could also lead to greater concentration and less competition in the market, which ultimately may lead to fewer product offerings, less choice for investors, potentially higher prices over time, and less market innovation.[150] The CSA did, however, implement enhanced conflict of interest mitigation rules and guidance for dealers and representatives "requiring that all existing and reasonably foreseeable conflicts of interest, including conflicts arising from the payment of embedded commissions, either be addressed in the best interests of clients or avoided".[151]

At the same time, the CSA announced proposals to ban trailer fees in cases in which advice is not given (and hence a suitability assessment is not required) as well as a ban on deferred sales charges.[152] The CSA followed up with official consultations on these two proposals but its decision not to ban embedded commissions was seen by many as a victory of commercial interests over investor protection. The CSA also issued a consultation paper on a best interest duty, which would require all registered dealers to take into account clients' best interests, a fundamental change to the client-adviser relationship. This was deemed controversial and was reportedly dropped after failing to garner unanimous support from market regulators across the country[153].

Notwithstanding these factors, fee-based accounts have been gaining popularity in Canada over the past decade, especially after the market correction in 2008 and 2009. At

[150] PwC, "Economic Impact Assessment."

[151] Canadian Securities Regulatory System, "Status Report on Consultation on Embedded Commissions and Next Steps," CSA Staff Notice 81-330 (21 June 2018), https://www.osc.gov.on.ca/documents/en/Securities-Category8/csa_20180621_81-330-status-report.pdf

[152] Canadian Securities Regulatory System, "Status Report on Consultation on Embedded Commissions."

[153] Barbara Schecter, "OSC Drops Push for 'Best Interest' Standards as Regulators Propose Narrower Reforms," *Financial Post* (21 June 2018), https://business.financialpost.com/news/fp-street/osc-drops-push-for-best-interest-standard-as-regulators-propose-narrower-reforms

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the end of 2017, CAD281 billion (USD214 billion), or 23% of assets at wealth management firms were held in non-discretionary fee-based accounts. They are expected to reach a 44% share of advised assets (full-service brokerage and financial adviser channels) by 2026, becoming effectively a "new normal" for the industry.[154]

The growing popularity of fee-based advice is driven by various factors, such as strategic shift by the industry, evolving business models, and advances in technology. Dealers and advisers have been moving toward more transparent and flexible fee models, which allow for better alignment of their interests with those of their clients.[155] Regulatory changes focusing on investor protection through enhanced point-of-sales transparency and investor education have also fanned this growth. The new transparency regulation, Client Relationship Model–2 (CRM2), first introduced in 2013, mandated changes to client reporting, fee disclosures, adviser compensation and fund performance and was implemented over a three year timeline.[156]

The shift has also seen an increase in the use of ETFs in client portfolios, as well as in fund-based asset-allocation solutions, such as wrap accounts. Wrap accounts, or fund-wrap programs, allow advisers to outsource asset allocation, investment selection and rebalancing to the wrap provider, and to focus on client relationships and financial planning. Wraps and discretionary fee-based accounts currently account for an estimated 37% of assets in mutual funds.[157]

China

The asset management industry in China has grown significantly in the past decade, and was estimated to be CNY48 trillion (USD7.4 trillion) in 2017, according to a study by Oliver Wyman.[158] The industry is distinct in many ways and, despite its size, remains in a nascent stage. Following are some key trends and characteristics of the market in China:

- China has a closed capital account, and most ordinary investors can buy and sell only onshore mutual fund products.

[154] SI Research, "Canadian Investment Fund Industry: Recent Developments and Outlook" (2019), https://www.ific.ca/wp-content/uploads/2019/06/Strategic_Insight_Canadian_Investment_Funds_Industry_Recent_Developments_and_Outlook-2019.pdf/22469/
[155] SI Research, Canadian Investment Fund Industry.
[156] PwC, "Economic Impact Assessment."
[157] PwC, "Economic Impact Assessment."
[158] Oliver Wyman, "Global Asset Managers in China" (2018), https://www.oliverwyman.com/content/dam/oliver-wyman/v2/publications/2018/march/Global_Asset_Managers_In_China_Riding_The_Waves_Of_Reform.pdf

- As a result of foreign ownership restrictions, few foreign asset managers have set up shop in China. Those who have a presence typically operate through a minority joint venture. This practice is changing as authorities have signalled a relaxation in foreign ownership limits.
- Money market funds represent the largest fund class with an estimated share of 60%.[159] This is a result of a combination of factors, including a lack of product diversity, a savings-oriented mind-set, and domination of online payment and savings platforms. This is set to change as regulators are taking steps to reduce the concentration risk posed by large money market funds.
- Banks dominate the distribution of financial products, but in recent years, Chinese investors have embraced online fund transactions. According to the *Financial Times*, a survey conducted by the Asset Management Association of China suggested that more than two-thirds of investors buy funds using mobile phone apps.[160]

Investors in China are segmented into three categories: ordinary, qualified, and professional. To be considered a qualified investor, an individual or an organization must meet requirements of investment experience and minimum assets. The professional investor category includes individuals or organizations that meet investment experience and higher minimum asset requirements, senior executives of the institutions who are professional investors, and accountants and lawyers who conduct financial business.

To provide investment advice, institutions and individuals must apply to the China Securities Regulatory Commission (CSRC) for a securities and futures investment license. It is not possible to engage in investment advice without such license. To obtain a licence, institutions must meet minimum requirements, including a number of employees who have acquired the right licenses, registered capital, a business address and company charter, and a "sound internal management mechanism."

To practice as advisers, individuals must obtain relevant licenses and join an investment advisory institution. The requirements include: Chinese citizenship; good conduct, integrity, honesty, and a professional work ethic; no criminal record or major violations related to security business; a bachelor's degree; two years' experience in the advisory industry; and passing the licensing examinations organized by CSRC.

[159] Siobhan Riding, "China's 'funds by phone' culture leads the world", *Financial Times* (13 April 2019), https://www.ft.com/content/7f9deba0-51e1-3c8e-9f1c-1d71a384028d

[160] Siobhan Riding, "China's 'funds by phone' culture leads the world", *Financial Times*.

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The conduct of investment advisers is regulated by *The Guiding Opinions on Regulating the Asset Management Business of Financial Institutions*,[161] issued in 2018. The rules stipulate, among other things, that no guarantee of return must be given to investors, that all relevant disclosures be made, that deceiving or misleading investors into buying a product that does not meet their risk tolerance is forbidden, and that such products cannot be split up for sale to investors who cannot assess risks.

The *Interim Procedures on Administration of Securities and Futures Investment Consultancy*[162] state that investment consultants must abide by principles of prudence, honesty, and diligence in such matters as the use of information and disclosure of industry affiliations and investment risks. They are forbidden from using insider information, making pledges on returns, agreeing to share profits or losses, buying stocks or securities for themselves, and manipulating the market.

Investment advisers must adhere to the suitability standard when making product recommendations. Meeting the suitability criteria include collecting information on the client's financial situation, investment experience, risk appetite, risk tolerance, investment objectives, investment horizon, credit record, and identity of the de facto beneficiary. In addition, advisers must conduct due diligence on products and have a reasonable basis for recommending them. Financial institutions should have in place internal suitability management frameworks. Products and services must be thoroughly analysed and classified according to risks and features before being recommended to customers. Financial institutions are expected to step up efforts to educate their clients and raise their awareness of risks.

Advisers must make necessary disclosures regarding possible loss of principal and other risks before the sale, in clear language. The disclosures must be made and acknowledged by the investor in writing. Although no country-wide disclosure requirements address remuneration, advisers operating in Shanghai and regulated by the Shanghai Securities Association must disclose the range of commissions they charge.

China allows a degree of flexibility in the business models of investment advisers. An adviser can negotiate and charge clients a fee for advice or fees can be charged based on the amount of AUM and period of service, as well as in other forms.

[161] Conventus Law, "China: Guiding Opinions on Asset Management Business—Key Provisions and Observations" (11 May 2018), http://www.conventuslaw.com/report/china-guiding-opinions-on-asset-management/
[162] Chinalawinfo, Peking University Center for Legal Information, "Interim Procedures on Administration of Securities and Futures Investment Consultancy," (25 December 1997), http://en.pkulaw.cn/display.aspx?cgid=2436fee9365ac6a5bdfb&lib=law

The *Code of Practice for Security Investment Consulting Institutions* (for trial implementation)[163] states that institutions providing investment advice should establish Chinese walls to prevent conflicts of interest and insider trading.

European Union

Markets in Financial Instruments Directive II (MiFID II) went into effect in January 2018. One of the objectives of MiFID II was to establish common minimal standards for fund distribution across the European Union, leaving to national regulators whether to align with the rules of MiFID II or create their own domestic framework, as was the case in the United Kingdom and the Netherlands. During the review of MiFID II, the EU considered a complete ban on commissions, but as a result of strong opposition by the financial sector, only a partial ban was implemented. The only countries within the EU to ban outright embedded commissions are the United Kingdom and the Netherlands. In both countries, clients are now required to pay advisers directly for advice. Most other countries stated that they will not exceed the MiFID II regulations. Some countries, such as Germany, introduced enhanced disclosure requirements and a separate category for fee-based advisers (although it is a small segment of the market).

In contrast to the United Kingdom and the Netherlands, which implemented a complete ban on commissions for all advisers, bans on commissions under MiFID II apply only to IFAs. They have to consider a sufficient range of products to meet the needs of clients before they make recommendations. In addition, they will not be allowed to receive product commissions from a third party with the exception of minor non-monetary benefits. To qualify as a minor non-monetary benefit, the following conditions must be satisfied:

- They must be able to enhance the quality of service provided to the client.
- They must be low in value to ensure the adviser acts in the best interest of the client.
- They must be clearly disclosed to the client.

In general, any commissions given by third party providers are transferred or rebated to the client. IFAs are required to adopt a pay-for-advice model with transparent fee structures. In contrast, an adviser providing advice on a non-independent basis can continue to

[163] Securities Association of China, "Notice on Issuing the 'Code of Practice for Security Investment Consulting Institutions (for trial implementation)", No. 147 (2019), https://www.sac.net.cn/tzgg/201906/t20190603_138902.html (link in Chinese)

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accept commissions, such as trailer fees or any other kind of monetary or non-monetary benefits, from third parties. Nonetheless, this payment has to comply with the inducement rules and no payment can be made if a value-added service is not provided. As such, distribution on its own is not sufficient, and an adviser needs to provide on-going services to justify the receipt of an on-going fee, such as a trailer fee. These services may include reporting, suitability assessment, and advice.

Notwithstanding the partial ban on commissions, MiFID II introduced extensive new obligations for both product manufacturers and distributors of investment products to make the financial markets more efficient and transparent and to improve investor protection. These obligations include creation of a product governance and approval process, stronger rules on the prevention and management of conflicts of interest, enhanced client disclosure rules, and suitability requirements.

The product governance rules under MiFID II created a fundamental change to the European distribution market for investment products. Product manufacturers are required to put in place strong product governance and product approval processes, and to perform an on-going review of those investment products to ensure that each investment product's target market and end clients are properly identified. Moreover, manufacturers are required to oversee distributors to ensure that they have access to the necessary information on those investment products. This oversight might include training so that distributors properly understand the products and ensure that they are suitable and reach the intended target market and clients. Distributors also have the responsibility to regularly review product governance requirements to ensure that their distribution of the product is consistent with the target market. Information on sales is to be shared with the manufacturer so that the manufacturer can determine whether the product is being sold to the appropriate target market. These requirements create a shared responsibility between the manufacturer and distributor to regularly monitor and review product governance.

Japan

According to data from the Japan Investment Trust Association (JITA), Japan is the seventh-largest mutual fund market globally, with JPY195 trillion (USD1.77 trillion) in assets at the end of 2018.[164]

[164] Investment Company Institute, "Table 65. Worldwide Regulated Open-End Funds: Total Net Assets," *2019 Investment Company Fact Book*, https://www.icifactbook.org/deployedfiles/FactBook/Site%20Properties/pdf/2019/19_fb_table65.pdf

Despite its size, the investment trust or mutual fund industry in Japan have been described as "stagnant" and in need of revitalization to meet the investment needs of the country's aging population.[165] As of late 2015, the share of household financial assets in investment trusts was significantly lower in Japan than it was in the United States or Europe.[166]

One reason for this lower level of investment is an arcane sales and distribution model that is neither compelling nor appealing to investors. In particular, multiple layers between investors and fund managers lengthen the distribution chain, leading to a high cost of distribution and high fees for investors.[167]

The Financial Services Agency (FSA), Japan's financial regulator, recognizes the industry's problems. In 2017, its commissioner Nobuchika Mori blamed business practices entrenched in the development and sales of investment trust products in Japan for the sluggish growth of the industry. In particular, he referred to "investment products that do not seem to put customers first" being developed and sold for many years.[168]

Vertical integration is a major issue. As much as 82% of all investment funds, measured by AUM, are sold by firms affiliated with the funds' manufacturers. According to Mori, fund manufacturers "are creating products which are convenient for sellers to rake in commissions." They are complex, theme-based funds, unsuitable for long-term holding, but conducive to churning or a "fast cycle of sales and purchases."[169]

With high average fees of 3.1% (for the top 10 funds in February 2017) and average annual trust fees of 1.5%, it is difficult for funds to deliver satisfactory net returns after deducting such costs.[170]

To steer the industry toward improved consumer outcomes, the FSA published *The Principles for Customer-Oriented Business Conduct* for financial institutions in Japan in 2017. The FSA recognized that the former rules-based approach to supervision and compliance

[165] Weizhen Tan, "Cash Hoarders Aren't the Only Problem for Japan's Struggling Fund Industry", CNBC (24 June 2018), https://www.cnbc.com/2018/06/22/japan-wants-to-revive-its-mutual-funds-industry.html
[166] Naoyuki Yoshino and Naoko Aoyama, "Reforming the Fee Structure of Investment Trusts to Increase Demand," Working Paper No. 658, Asian Development Bank Institute (February 2017), https://www.adb.org/publications/reforming-fee-structure-investment-trusts-increase-demand
[167] Tan, "Cash Hoarders Aren't the Only Problem."
[168] Nobuchika Mori, Commissioner, Financial Services Agency, "The Next Evolution in Asset Management in Japan," speech at the 8th International Seminar of the Securities Analysts Association of Japan, Tokyo (7 April 2017), https://www.fsa.go.jp/common/conference/danwa/20170407/02.pdf
[169] Mori, "The Next Evolution in Asset Management in Japan."
[170] Mori, "The Next Evolution in Asset Management in Japan."

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encouraged firms to see the rules as a minimum standard and "superficially follow regulatory formalities."[171] It proposed a principle-based approach centred around seven principles:

- Establishing a policy for implementation of client-oriented business conduct, and publishing the status of activities;
- Promoting expertise, professional ethics, honesty, fairness, and best interest of clients as part of corporate culture;
- Anticipating, monitoring, and managing conflicts of interest;
- Providing clear disclosures of commissions and fees paid by clients, and services obtained in return;
- Providing clear disclosures related to sales and recommendations of products and services;
- Providing services and recommendations that are suitable to clients, considering their assets, experience, knowledge, needs, and purpose; and
- Aligning employees' incentives with clients' interests through performance evaluation, remuneration structure, training and governance.

The FSA acknowledged that increasing transparency of investment costs may dampen appetite and threaten the business models of many fund manufacturers and distributors. The FSA, however, also recognized that the prevailing state of regulation encourages the sale of unsuitable, risky, and costly products to vulnerable investors, undermining long-term trust in the industry and depressing its growth potential. Japanese investors traditionally tend to stay away from risky investments and prefer to keep their savings in low-yield bank deposits. The practices of the asset management industry do not make investment trusts an attractive alternative.

The issue with portfolio churning is slowly being addressed by the growing popularity of wrap accounts, as noted in a 2017 report by the Asian Development Bank Institute.[172] Wrap accounts, or "separately managed accounts," are discretionary investment services that charge only on-going fees — typically 1.5%[173] — but no sales commissions. In

[171] Christopher P. Wells and Tomoko Fuminaga, "Japan Releases Draft 'Principles for Customer-Oriented Business Conduct'," Morgan Lewis (17 February 2017), https://www.morganlewis.com/pubs/japan-releases-draft-principles-for-customer-oriented-business-conduct

[172] Yoshino and Aoyama, "Reforming the Fee Structure of Investment Trusts to Increase Demand."

[173] Yuko Inoue and Emi Emoto, "Daiwa Sees Big Potential in Mutural Fund Wraps," Reuters (10 October 2007), https://www.reuters.com/article/us-wealth-summit-daiwa/daiwa-sees-big-potential-in-mutual-fund-wraps-idUST25029120071010

March 2019, the AUM in wrap accounts accounted for an estimated 2.6% of assets of all member firms of Japan Investment Adviser Association.[174]

Japanese financial institutions have been improving their sales and disclosure practices, although the FSA sees them as "nothing more than cosmetic changes." There needs to be a fundamental shift in the value proposition offered by the industry to ensure better investor outcomes.

New Zealand

The regulatory landscape for financial advice in New Zealand is shaped by the Financial Advisers Act of 2008. It has defined three types of financial advisers: Qualifying Financial Entities (QFEs), Registered Financial Advisers (RFAs), and Authorised Financial Advisers (AFAs).

QFEs are institutions that employ advisers, who can provide advice only on the institution's products. RFAs are registered with Financial Market Authority (FMA), the industry regulator, and provide advice on simpler and less risky category 2 products such as term deposits, mortgages, loans, or insurance. AFAs provide comprehensive financial planning and advice relating to category 1 products, including most investments.

The main issues with this arrangement is the bifurcation of standards: not all advisers are required to put clients' interest first and make the same disclosures as regards to potential conflicts of interest. Some are actively regulated by the FMA and are subject to disciplinary committee proceedings, whereas others are not. Also, personal advice can be provided only by a "natural person," which prevents financial innovation, such as robo-advisory services.

To overcome these issues, the Ministry of Business, Innovation and Employment (MBIE) conducted a review of financial advice in 2016 with the objectives of improving advice quality and ensuring access to advice and redress.

Some of the key changes arising out of the review include replacing the three adviser designations so that anyone providing financial advice will now be known as either a "financial adviser" or an "agent" and will be individually accountable for complying with

[174] Japan Investment Adviser Association, "Statistical Data" (March 2019), http://www.jiaa.or.jp/toukei_e/pdf/st201903.pdf

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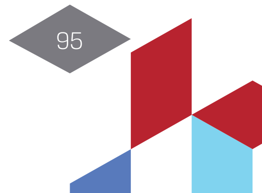

legislative and other obligations.[175] Notably, advisers will be able to provide robo-advice under the new framework.

In the same review, MBIE considered imposing a ban or placing restrictions on commissions in financial products. It decided against making this move because of concerns over a potential advice gap and the perceived ineffectiveness of a commission ban on improving conduct or reducing conflict of interest. It noted that meaningful disclosure requirements are needed to improve transparency and understanding.

These key changes were encapsulated in the Financial Services Legislation Amendment Act,[176] which was approved by the government in April 2019, replacing the Financial Advisers Act 2008 and the Financial Markets Conduct Act 2013. Furthermore, the *Summary of Disclosure Requirements in the New Financial Advice Regime*,[177] issued by MBIE in March 2019, added new rules on disclosures of commissions, other incentives, and conflicts of interest.

This new regime has a two-year transition period. During this period, a safe harbour provision applies to previously licensed advisers, who can hold a transitional licence or apply for a new full licence. The detailed rules around licensing and registration are still being prepared.

The new legislation introduces a code of conduct for financial advice[178] that will come into force in mid-2020. This code requires advisers to adhere to the following:

- treat clients fairly;
- act with integrity;
- give suitable advice;
- ensure that the client understands the advice;
- protect client information;

[175] Ministry of Business, Innovation, and Employment, “Facesheet: Review of the Financial Advisers and Financial Services Providers Act” (July 2016), https://www.mbie.govt.nz/assets/15445dd48e/factsheet-review-of-the-financial-advisers-and-financial-service-providers-acts.pdf

[176] *Financial Services Legislation Amendment Bill*, Parliamentary Counsel Office, New Zealand Legislation (2019), http://www.legislation.govt.nz/bill/government/2017/0291/latest/DLM7386310.html

[177] Ministry of Business, Innovation, and Employment, “Summary of Disclosure Requirements in the New Financial Advice Regime” (March 2019), https://www.mbie.govt.nz/dmsdocument/4762-summary-of-disclosure-requirements-new-financial-advice-regime

[178] Financial Markets Authority, “Code of Professional Conduct for Financial Advice Services” https://www.fma.govt.nz/assets/assets/code-of-professional-conduct-for-financial-advice-services.pdf

- have general competence, knowledge, and skill, demonstrated by earning the New Zealand Certificate in Financial Services (Level 5) or through equivalent professional experience;
- have particular competence, knowledge, and skill for designing an investment plan, acquired by completing the investment strand of the Certificate in Financial Services (a higher qualification requirement is being considered);
- have particular competence, knowledge, and skill for product advice; and
- keep competence, knowledge, and skill up to date (no set requirements for continuing professional development, but rather a requirement to "plan and progressively complete" learning to stay up to date).

The new legislation also contains disclosure requirements on the following:

- the licence held by the financial adviser;
- complaint procedure for clients;
- services offered, products, and providers and any limitations;
- fees and costs;
- conflicts of interests, including information on commissions and incentives that might materially affect the advice given; and
- disciplinary history or any convictions of the adviser.

Advisers in New Zealand can be paid a fixed fee for service, an hourly rate, or an ongoing management fee. They can receive commissions and other incentives from the product provider.[179] The pay-for-advice model is quite common. A 2016 study *Consumers of Financial Advice in New Zealand*[180] noted that 46% of customers who used RFAs or AFAs did so on a pay-for-advice basis, and 43% paid a combination of fees and commissions. Only 8% paid solely commissions.

[179] Financial Market Authority, "Paying for Advice" (27 May 2019), https://www.fma.govt.nz/investors/getting-financial-advice/paying-for-advice/

[180] Janine K. Scott, "Consumers of Financial Advice in New Zealand," *Financial Planning Research Journal* (15 June 2017), https://www.griffith.edu.au/__data/assets/pdf_file/0025/206449/FPRJ-V3-ISS2-pp68-86-consumers-of-financial-advice-in-new-zealand.pdf

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United Kingdom

The United Kingdom had seen several mis-selling scandals before the GFC that resulted in major financial institutions heavily fined and forced to offer compensation to customers. Prompted by the scandals, the Financial Conduct Authority (FCA, formerly the Financial Services Authority), undertook a detailed review of the advice and sale of retail investment products, known as the Retail Distribution Review (RDR), to improve public trust and confidence in the market and to avoid occurrences of mis-selling scandals that were caused by unscrupulous or incompetent advisers.[181] Implementation of the rules and regulation under RDR fundamentally changed the way the financial advisory industry operates in the United Kingdom.

The United Kingdom became the first jurisdiction to ban commissions for advice. Advisers in the United Kingdom can no longer receive commissions from fund companies for selling or recommending their products. Advisers are permitted to be remunerated only by direct charges to the client. In compliance with RDR rules, asset managers have created new share classes in funds called "clean" share classes. These clean share classes bear a lower annual management fee because sales commissions for advisory fees are taken out.

On professionalism and consumer trust, the FCA found that the level of training and standard of professionalism among financial advisers were relatively low compared with other professions and such poor qualifications of advisers in turn can generate negative consumer outcomes.[182] Accordingly, the RDR introduced a higher minimum level of education and qualification for advisers, along with minimum annual requirement of continuing professional development.

The United Kingdom distinguishes between IFAs and restricted financial advisers; their status affects the advice they can give. An IFA must consider all types of retail investment products before giving a recommendation to clients, whereas a restricted adviser can only recommend certain products or product providers to clients.

The FCA acknowledged that the RDR can create an "advice gap," a concern raised by many when considering banning commissions. To address the advice gap, in 2015 the HM Treasury and the FCA established a Financial Advice Market Review (FAMR) to explore ways in which the government, industry, and regulators can take measures to

[181] See Financial Conduct Authority, "A Review of Retail Distribution Discussion Paper" (June 2007), https://www.fca.org.uk/publication/discussion/fsa-dp07-01.pdf

[182] See Financial Conduct Authority, "A Review of Retail Distribution."

ensure that affordable advice and guidance is available to everyone.[183] The FCA is currently conducting a post-implementation study on the financial advice market reviewing the RDR and the FAMR, which is expected to be published in late 2020.

United States

In the United States, investment distribution generally occurs through broker/dealers or RIAs. These two groups are subject to different standards of care, which often creates confusion in investors' minds about their roles and obligations of each.

Under the Investment Advisers Act of 1940 (Advisers Act), RIAs with more than USD100 million in AUM are regulated by the Securities and Exchange Commission (SEC)[184] and must adhere to regulations designed for investor protection. Court interpretations of the Advisers Act have held that RIAs are subject to a fiduciary standard in their dealings with clients and have the duty to provide advice that is in their clients' best interests.

Broker/dealers, by contrast, conduct transactions on behalf of clients and generally earn commission or mark-ups on trades. The Securities Exchange Act of 1934 requires such firms to register and become members of the Financial Industry Regulatory Authority (FINRA), a self-regulatory organisation (SRO) established to help the SEC regulate broker/dealer activities. They are exempt from registration with the SEC as investment advisers so long as they refrain from certain activities stipulated in the Advisers Act, including providing advice that is not "solely incidental" to their business of executing securities transactions.[185] Until full implementation of Regulation Best Interest (Reg BI),[186] broker/dealers will be subject to a suitability standard that imposes an obligation to recommend investments that are suitable on an "adequate and reasonable basis." Hence, broker/dealers are subject to a relatively loose set of regulations compared with RIAs.

[183] See Financial Conduct Authority, "Financial Advice Market Review (FAMR)" (21 December 2015), https://www.fca.org.uk/firms/financial-advice-market-review-famr

[184] Investment advisers managing less than $100 million are subject to regulation of the state where they are organized.

[185] Regulation Best Interest, adopted on 5 June 2019, reinterpreted what the SEC considers solely incidental. On the basis of that interpretation, advice, regardless of consequence or frequency of the advice, is considered incidental as long as it is done in connection with the broker/dealer's primary business of "effecting securities transactions."

[186] Securities and Exchange Commission, "Regulation Best Interest: The Broker-Dealer Standard of Conduct" (2019), https://www.sec.gov/rules/final/2019/34-86031.pdf

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Those who are not subject to the fiduciary standard create confusion among investors, not least by calling themselves "advisers" even when not registered as RIAs. Self-interested actions by those not subject to the fiduciary standard undermine the goodwill and trust associated with other prudent and client-oriented advisers.

In June 2019, the SEC approved Reg BI, an advice reform package that is promoted as improving investor protections, but which CFA Institute and other investor advocates have criticized as something that would weaken investor protection and perpetuate confusion regarding titles and duties of care. Under Reg BI, broker/dealers and advisers would continue to be regulated separately. Although labelled "best interest," this rule does not define what constitutes best interest and requires only that broker/dealers not put their own interests ahead of the interests of their clients.[187]

[187] CFA Institute has long called on the SEC to adopt a fiduciary duty standard for all who provide personalized investment advice to retail investors, making it clear to investors what standard of care is owed by those servicing them. Clarification of the use of titles would substantially mitigate investor confusion related to the standard of care under which their service providers operate. Those who refer to themselves as "financial advisers" and provide personalized investment advice, in the view of the CFA Institute, should have to register with the SEC as an RIA and be held to a fiduciary duty standard.

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