

For discussion
on 22 March 2016

Legislative Council Panel on Financial Affairs

Exchange Distribution Platform for Funds

PURPOSE

This paper sets out background information on the subject of exchange distribution platform for funds, and provides an analysis of the potential benefits and challenges of establishing an exchange distribution platform in Hong Kong.

BACKGROUND

2. Hong Kong has a rather concentrated fund distribution market as compared to other markets worldwide, with banks having an estimated market share of 78%. In comparison, the market share of banks distributing funds in Mainland China and in Japan were estimated to be 42% and 33% respectively. Brokers in Hong Kong only account for about 3% of fund distribution, which contrasts with about 13% in the Mainland and over 60% in Korea and Japan.¹

OPERATING MODEL IN OTHER MARKETS

3. Exchange-based distribution platforms allow unlisted fund products to be transacted and/or settled via stock exchanges and their associated clearing and settlement systems. Under this model, exchanges are able to bring fund providers and investors together through brokers as intermediary and often provide order routing, settlement and custody services.

¹ Cited in *Risk-focused Industry Meeting Series: Asset Management: Looking Forward*, January 2015, published by the Securities and Futures Commission (“SFC”).

4. Financial market infrastructure operators in some other markets, such as Australia, Europe, Korea, the Mainland and Taiwan, have established centralised platforms for fund distribution. The exact operating models of these platforms vary from market to market. Some platforms are exchange-based while some are Internet-based, but could cover the following elements -

- (a) Asset managers first register their funds with the platform.
- (b) Investors can then subscribe to or redeem units of platform-registered funds based on the net asset values of the relevant funds by submitting their orders through brokers or directly to the platform.
- (c) The platform would also handle subsequent cash settlement and act as the nominee holder of the fund units.
- (d) Most of these platforms allow primary subscriptions and redemptions only. They typically do not allow secondary trading.

POTENTIAL BENEFITS OF ESTABLISHING AN EXCHANGE DISTRIBUTION PLATFORM IN HONG KONG

5. The potential benefits of establishing an exchange distribution platform in Hong Kong are set out below.

(a) Opening up a new fund distribution channel

6. Establishing an exchange distribution platform would open up a new fund distribution channel in Hong Kong by facilitating asset managers' use of brokers to distribute their funds. An exchange distribution platform would provide cost and administrative efficiency by centralising and aggregating all order routing and cash transfers between fund managers and brokers.

(b) Broadening investors' choices and reducing investment costs

7. An exchange distribution platform would be an additional channel for investors to access fund products and would introduce more competition in the fund distribution market. It could broaden product selection available to investors and drive down investment costs.

(c) Expanding the distribution channel for the Hong Kong asset management industry

8. The establishment of an exchange distribution platform could expand the distribution channel for the Hong Kong asset management industry, and provide asset managers with more “shelf space” to distribute their products. It could give them a wider reach to investors with different backgrounds and investment needs.

(d) Diversification of brokers’ business

9. Fund distribution through an exchange distribution platform could present a good opportunity for brokers to diversify their business models from traditional stock-trading.

CHALLENGES OF ESTABLISHING AN EXCHANGE DISTRIBUTION PLATFORM IN HONG KONG

10. A number of challenges have been identified regarding the establishment of an exchange distribution platform in Hong Kong.

(a) Establishment costs

11. Establishing an exchange distribution platform would inevitably incur costs in building a centralised order-routing and cash settlement platform to connect brokers with fund managers. This challenge, however, could be better managed if the project is taken up by an existing infrastructure operator, which could leverage its systems, processes and connections with market participants. With an existing operator, factors such as the volume of funds that could be sold through the platform would form part of the cost-benefit analysis.

(b) Changing the traditional model of fund distribution

12. Traditionally, investors in Hong Kong have been accustomed to buying funds through banks. The success of an alternative distribution channel, such as an exchange distribution platform, would require a change in investor behaviour.

(c) *Brokers' capacity to generate fund sales*

13. Currently, most of the brokers in Hong Kong focus on traditional stock-trading business. If brokers wish to distribute funds, they would have to build the relevant business handling capacity, and would need to bear the possible costs involved in diversifying into this new business. The costs include understanding and equipping for the product/fund manager due diligence and suitability requirements surrounding fund distribution.

(d) *Providing guidance on suitability requirement*

14. The Financial Services Development Council ("FSDC") published a paper entitled *Strengthening Hong Kong as a Retail Fund Distribution Centre* in December 2015. While expressing its support for the diversification of fund distribution channels in Hong Kong, the FSDC recommends that the SFC should consider publishing clear guidance for the industry relating to the suitability requirements.

WAY FORWARD

15. We note the potential benefits that could be brought by an exchange distribution platform for funds and support initiatives to diversify the fund distribution channels in Hong Kong in the further development of Hong Kong as a premier asset management centre. We have been in discussion with the Hong Kong Exchanges and Clearing Limited about the possibility of establishing an exchange-based platform which allows fund distribution through exchange participants. The Hong Kong Exchanges and Clearing Limited will commence a phased replacement of its system for securities clearing and settlement, and plans to include within the blueprint for its new post-trade processing system capabilities that would support Participants of the Hong Kong Securities Clearing Company Limited, its securities clearing house, in mutual fund-related trade and position handling.

16. On the regulatory side, the SFC has taken note of the industry's request that more clarity should be provided on the suitability requirement as applicable in the context of an exchange platform. An internal working group has been set up in the SFC to, among other things, examine the need for clarifying the SFC's expectations of how the suitability requirements should be implemented, including in the context of exchange

and online fund distribution platforms, and formulate appropriate guidance for intermediaries as necessary. The SFC will engage the industry during the process.

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