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The Securities and Futures Commission
35/F, Cheung Kong Center
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Ladies and Gentlemen:

Morningstar Investment Management Asia Limited ("MIM Asia") appreciates the opportunity to comment on the Securities and Futures Commission Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms ("Consultation Paper").

About MIM Asia and Morningstar, Inc. ("Morningstar")

MIM Asia is a subsidiary of Morningstar, a leading provider of independent investment research in North America, Europe, Australia, and Asia. The Morningstar group of companies offer an extensive line of products and services for individual investors, financial advisors, asset managers, retirement plan providers and sponsors, and institutional investors in the private capital markets. Morningstar and its affiliates provide data and research insights on a wide range of investment offerings, including managed investment products, publicly listed companies, private capital markets, and real-time global market data. Morningstar also offer investment management services through its investment advisory subsidiaries, with more than USD$200 billion in assets under advisement and management as of 30 June 2017. In Hong Kong, these services are provided by MIM Asia, which is licensed by the Securities and Futures Commission to provide investment advice (type 4) to professional investors only. The company has operations in 27 countries.

MIM Asia has a number of investment advisory services and tools that financial intermediaries may use as an input into their robo-advice services. Morningstar has also been involved in the "robo-advice" business since the late 1990s—before the term became common. We therefore have a unique perspective on the questions the Commission asked about robo-advice distribution, as well as the questions on the application and discharge of suitability requirements in the robo-advice context. Our feedback is set out below.

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

In general, we agree with the factors identified. However, we think the Proposed Guidelines should more explicitly cover 1) the extent to which robo-advice platforms allow individuals to aggregate their financial data across multiple accounts and 2) disclosure on how robo-advisors charge for their services.

Aggregation technology provides a low-cost way to collect investors' account data to analyze their investments holistically themselves or with the help of an advisor—whether that advisor is human, powered by an algorithm, or a service offering a mix of both. In the long term, Morningstar believes the SFC (and Hong Kong Monetary Authority) should look for ways to make these aggregation services available to investors who use online platforms by promulgating guidelines that make it clear investors have the right to share it electronically with third parties using automated solutions. This kind of aggregation allows users to unleash the full power of robo-advisors and receive truly holistic, personalized financial advice. Further, because ongoing monitoring of outside investments is dramatically less expensive when it is automated, the SFC should consider promulgating guidance to allow robo-advisors to scrape this outside data.

Additionally, we believe the SFC should explicitly require a discussion of fees and fee structures for robo-advice disclosures. In other markets, robo-advisors almost always operate as "level-fee fiduciaries"—that is, they do not generate revenue from third-parties but charge clients a fee directly, usually as a percentage of assets under management, although sometimes as a flat annual fee. Requiring more specific disclosures in the context of Hong Kong's market could help educate consumers who are used to a commission-based model about alternative forms of paying, explicitly, for advice, without relying on embedded commissions that are common in Hong Kong. Similarly, we support up-front disclosure of the types of products the robo-advisors use: exchange-traded funds, mutual funds, or insurance as contemplated by provision 2.3(v) of the draft Guidelines on Online Distribution and Advisory Platform.

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

Robo-advice is in some ways a misnomer: Almost all portfolio allocation advice is generated by software. The movement toward more "robo-advice" through the years is really about the extent to which there is less human-advisor intermediation of these recommendations. Morningstar is one of the oldest providers of robo-advice in the world (we have provided automated managed-account solutions since the late 1990s in the U.S. retirement marketplace) and one of largest providers of software for advisors, we believe there is a place for varying levels of intermediation depending on the needs and wants of a client.

The main problem with "robo-advice" is that it is only as good as the information the computer uses to inform its models. A human advisor can prod clients for more information and read emotional cues. A human advisor can follow up and ask whether a client's circumstances have changed. The problem is that human advisors will always be expensive because of the cost of labor.

Luckily, robo-advice solutions allow for rapid testing, which robo-advice providers use to learn about their users and overcome these problems. The SFC should promote these adjustments and behavioral research in their algorithm guidance. For example, at Morningstar, we can run experiments to see which approaches to presenting information with our robo-advisors resonate with investors and which ones do not. Behavioral researchers have found that there is a tremendous difference between the decision or intention to act, and people following through on their intentions. Our behavioral researchers have repeatedly found that seemingly minor details in the decision-making environment can halve or double actual follow-through rates. For example, we tested several calls to action to encourage our users to look at their retirement plan, and found that a simple “Are you saving enough for retirement?” encouraged the most people to click on retirement guidance and adjust their contribution elections.

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

Looking at an investor’s robo-advice (or other online platform) balance in isolation will likely result in a false assessment of an investor’s financial situation and the suitability of any one investment. In particular, the risk of a single investment may well be balanced or hedged with another, so assessing risk tolerance in the context of a single investment may not be helpful. Further, risk tolerance is quite different from risk capacity. Some investors may not wish to take on much risk but could do so given their goals and income streams, whereas others may be risk-loving but have little capacity. A full accounting of outside assets and income allows robo-advisors to provide higher-quality guidance.

Although the Suitability Requirements account for such asset allocation and refer to clients' risk profiles, we believe that the SFC could explicitly encourage robo-advisors that attempt to establish risk capacity as well as risk tolerance and attempt to use asset aggregation to ascertain the best securities given a holistic view of an investor's financial life. Although such aggregation may not be widely available yet in Hong Kong, establishing guidelines that clearly delineate between the different levels of advice can help unlock the potential of robo-advisors to democratize access to sophisticated asset-allocation algorithms that were previously only available with human-advisor intermediaries.

Question 7: Do you have any comments on how the design and overall impression created by an online platform’s content could trigger the Suitability Requirement?

We believe the guidelines should delineate advice into segments, and the robo-advisors should disclose which segments they serve and how they serve them. For example, do they account for risk capacity or just risk tolerance? As we have noted, consumers often do not know what robo-advisors do—and do not do—to generate their recommendations.

We would support an explicit exemption from the Suitability Requirements for general education that does not recommend a specific security but does take a “know-your-client” approach to generate an asset-allocation recommendation. One advantage of robo-advice is that it offers immediate feedback to investors, and often robo-advisors provide free modelling services to engage prospective clients. As this modeling is quite valuable to investors, even if they ultimately decline to pay for investing services, we believe promoting this model is valuable.

For example, with our United States-based robo-advice solutions, as workers adjust their retirement contributions on robo-advice solutions, they can immediately see on their screen how these adjustments translate into an increase (or decrease) in future retirement income. Similarly, they can see how delaying their retirement age is another option to help them sustain a higher standard of living in retirement. Similarly, software can help people visualize the trade-offs inherent in different asset-allocation strategies by showing them how taking additional risk can help them achieve a higher projected income in retirement but with the trade-off of having a higher probability of running out of money. The SFC could add in its information for clients that robo-advisors should help them explore multiple scenarios and provide education, without triggering the Suitability Requirements.

Please don't hesitate to contact Nick Cheung at nick.cheung@morningstar.com if you have any questions or require further information about our response.

Sincerely,

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