

CASH COMMISSION REBATES AND "SOFT DOLLAR" BENEFITS RECEIVED BY PORTFOLIO MANAGERS FROM BROKERS

Consultation Conclusions

Securities and Futures Commission December 1994 Hong Kong

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1. The SFC's Consultation Paper on Cash Commission Rebates and "Soft Dollar" Benefits received by Portfolio Managers from Brokers" was issued on 29 June 1994. It contained proposals for the regulation of cash commission rebate and soft dollar practices in the context of investment advisers and dealers licensed in Hong Kong and of unit trusts and mutual funds authorised in Hong Kong. These were, in summary :

1. **with respect to authorised unit trusts and mutual funds** , that the Code on Unit Trusts and Mutual Funds be amended to require that cash rebates be credited to the fund on behalf of investors [i.e. to prohibit the retention of cash rebates by management companies and investment advisers of authorised funds] and to regulate soft dollar practices;
2. **with respect to other discretionary accounts managed by registered persons** , that retention of cash commission rebates by fund managers initially be permitted subject to increased disclosure standards, eventually to be credited to investors [i.e. to prohibit retention by managers]; and
3. **with respect to soft dollars** , to permit these subject to limitations

broadly in line with international standards in this area.

Comments were invited on these proposals.

2. The purpose of this document is to provide interested persons with an analysis of the main areas of comment which were raised during the course of the consultation exercise and to explain the views the SFC has reached, and the changes it has made, in the light of the comment received.

Consultation

3. The consultation period, initially scheduled to last until 1 August 1994, was extended until 15 August 1994 at the request of a number of market participants. A total of 31 written submissions were received. These included a submission from the Hong Kong Investment Funds Association (HKIFA), consisting of a survey of its 42 members on the proposals, as well as submissions from a wide range of professional bodies and market practitioners.

4. As was to be expected in a consultation exercise of this type, comments varied considerably in range and depth, with some focussing on the broad principles behind the proposals and others on details. In addition to the formal submissions, the release of the Consultation Paper generated a significant level of informed public debate in the local media, which added to our understanding of market and public views.

5. Following the close of the consultation period, further discussions were held on specific issues with several commentators. As further analysis of the issues was made in light of the comments, there was consultation with the Commission's Advisory Committee and recommendations were made to the Commission by the Committee on Unit Trusts. Each of these Committees represents a wide and valuable range of market practitioner and public interest opinion. The final proposals adopted by the Commission reflect its analysis of the submissions received and its further discussions with commentators and its consultative committees. The proposals have the full support of the Commission's Advisory Committee and follow the recommendations of the Committee on Unit Trusts as well as the majority view of the HKIFA.

Summary of Comments

***Authorised funds : cash commission rebates to be credited to the fund
[prohibition of retention by the fund manager]***

6. A majority of commentators addressing this issue supported the proposal, although a significant minority opposed it. The HKIFA survey of its members revealed a 65% support level and 21% opposition.

7. Those supporting the proposal indicated that existing practice makes it difficult for clients to identify the true fee structure of a fund manager and creates a conflict of interest between the manager and clients. A number of commentators believed the proposal was particularly appropriate for authorised unit trusts as these are approved to be marketed to retail investors who may be

relatively unsophisticated. Other commentators noted that the direction of cash rebates to managers rather than clients conflicts with the principle of best execution of portfolio transactions and with the fiduciary duties owed by portfolio managers to their clients. Several commentators noted that a prohibition of the retention of rebates by the manager is appropriate to remove incentives for managers to "churn" portfolios to generate additional profits for themselves.

8. Opponents of the proposal principally argued that retention of rebates by managers is prevalent in Asian and offshore markets, therefore the proposal will adversely affect Hong Kong's competitive position, and that any problems with cash rebates could be resolved by disclosure. Some commentators also argued that small investors are only interested in performance, and that they would not be prejudiced by the rebate prohibition as rebates are bulk discounts which they could not get on their own.

Discretionary accounts : initial disclosure and eventual crediting of cash commission rebates to the account

9. The comments received by the SFC clearly supported the proposed disclosure requirements, but were mixed as to the proposed long-term approach for discretionary accounts. The HKIFA survey indicated that over 70% supported the initial disclosure requirements while 50% supported the proposed longer term approach.

10. The commentators in support of the longer term approach cited most of the same reasons as those given in support of the proposal for authorised funds. These included lack of transparency, conflicts of interest, and conflicts with best execution and fiduciary duties. A number of these commentators also argued that there are fundamental differences between cash rebates and soft dollars to support prohibition of retention for one but disclosure for the other: the differences being that soft dollar benefits must be of benefit to the clients and are subject to certain limitations.

11. Commentators opposed to the proposal were generally opposed to the eventual crediting of cash rebates to client accounts rather than the initial disclosure requirements, and for the most part supported these disclosure requirements. Reasons for objecting to the crediting of cash rebates to client accounts were similar to those raised for authorised funds, although arguments were also made that discretionary agreements are negotiated on an arm's length basis with clients who have consented to this arrangement. The comment was also made that requiring renegotiation of existing contracts is unprecedented, unreasonable and an interference with business practices. Several commentators stated that management fees for discretionary accounts are often set at a low level in exchange for permission for the manager to retain rebates.

Soft dollar arrangements

12. Most commentators supported the thrust of the proposals in relation to soft dollars. Similar support for the proposals was reflected in the HKIFA survey,

which indicated that 91% of responding fund management firms supported the soft dollar proposals. The vast majority of the commentators agreed in principle but queried some aspects of implementation.

13. These included the comment that soft dollar benefits should be of demonstrable benefit to the manager's clients (or unitholders) generally and on a world-wide basis rather than to a specific client (or unit trust). Some commentators suggested additions to the proposed list of acceptable soft dollar goods and services. Commentators also noted that commission rates payable under soft dollar arrangements should be approximately equal to (or below) the customary institutional (full service) brokerage rates.

14. Opposition to the soft dollar proposals was generally premised on the argument that soft dollars are just as open to abuse as cash rebates, if not more so, as fund managers might have to guarantee a level of business to the soft dollar broker. These commentators felt there was a stronger argument for prohibiting soft dollars than for requiring cash rebates to be credited to the fund on behalf of investors. Other comments also suggested a negative impact on the broker community in general, or particular segments thereof, as a result of the potential proliferation of soft dollar brokers.

Other matters

15. In addition to comments on the three main proposals, commentators also raised other issues such as minimum commission structure, the Prevention of Bribery Ordinance (PBO), and applicability of requirements to banks and insurance companies. The minimum commission issue has not been considered in the course of this review, as it raises issues beyond our present concerns and in any event would not solve them as many portfolio transactions are executed on overseas markets that maintain fixed commission rates. The PBO implications have however been considered and discussed with the ICAC, which has confirmed that the proposals (as revised) are consistent with the obligations imposed by the PBO.

16. Some commentators expressed concern that the consultation period was insufficient and that the proposed implementation date was too soon. As a result, the formal consultation period was extended by two weeks and the Commission considered representations made by all commentators, even though some submissions were made after the consultation period was closed. Taking these comments into account, the Commission has also delayed the implementation date by six months, to 1 July 1995.

The Issues

17. The range of comments received on the proposals and the disparity of views expressed essentially rested on the similarities and differences between, first, authorised funds and other forms of discretionary account, and second, cash rebates and soft commissions. An analysis of the issues also required a consideration of the principle of fiduciary duty and the wider context of Hong

Kong's role as an international fund management centre.

The Principle of Fiduciary Duty

18. It is generally recognised in Hong Kong and other common law jurisdictions that a portfolio manager owes fiduciary duties to his clients. A number of commentators on the Consultation Paper drew attention to the applicability of fiduciary duties and suggested that retention of cash rebates by managers conflicts with such duties. The principle of fiduciary duty must be kept in mind in the present context and is described below.

Fiduciary relationship means a relationship a person undertakes to act on behalf of or for the benefit of another, often as an intermediary with a discretion or power which affects the interests of the other who depends on the fiduciary for information and advice.

Fiduciary duty specifies that

1. the fiduciary should not place himself in a position where his own interests conflict with those of his customer, the beneficiary (the "no conflict" rule);
2. the fiduciary must not profit from his position at the expense of his customer (the "no profit" rule);
3. the fiduciary owes undivided loyalty to his customer and therefore must not place himself in a position where his duty to one customer conflicts with his duty to another (the "undivided loyalty" rule). A consequence of this duty is that a fiduciary must make available to a customer all the information that is relevant to the customer's affairs; and
4. the fiduciary must use information obtained in confidence from one customer for the benefit only of that customer and must not use it for his own advantage or for the benefit of any other person (the duty of confidentiality).

Fiduciary duties apply to all of a manager's actions in relation to clients and are relied upon by regulatory authorities in Hong Kong and elsewhere to help guide managers' conduct and protect clients. The Commission's views have therefore been formulated with these fiduciary duties in mind.

Soft dollars vs. cash rebates

19. Some commentators have argued strongly that the regulatory approach should be the same for both cash rebates and soft dollars (either to support disclosure for both or prohibition for both). Others have strongly disputed this argument on the basis that while there are some similarities between cash rebates and soft dollars there are also fundamental differences. One difference is that soft dollar goods and services must benefit the investor while there is no such limitation on cash rebates. The other is that there are natural limits on the amount of soft dollar benefits a manager can generate, therefore the conflict of interest risks inherent in both are significantly reduced in relation to soft dollars.

20. Staff salaries (including bonuses) cannot be softened, and these are traditionally the largest fund manager expense. A review of certain managers' accounts reveals that staff salaries may amount to roughly 60% of fund managers' total expenses. In addition, rent and general office equipment and administrative expenses, which also cannot be softened, may amount to an additional 15% or more of total expenses. Accordingly, the bulk of fund managers' expenses cannot be recovered through soft dollar practices, which helps to explain why soft dollar arrangements do not usually amount to more than 20% of brokerage commission payments. In contrast, there is no limit on the amount of commission payments involving cash rebates. We have observed that some managers receive rebates on nearly all portfolio transactions.

21. The natural limit on the soft dollar benefits a manager can profitably receive also lessens the potential for abuse in the form of overtrading or churning as compared to cash rebates. Where cash rebates are involved, high portfolio turnover or deliberate churning of an account could result in significant increased earnings for the manager to the detriment of clients, which would be less likely if only soft dollars were involved.

22. It is also difficult conceptually to separate soft dollar benefits from traditional research benefits, as both can be provided within a framework in which transaction execution and research services are "bundled". An additional consideration is that where the services provided are paid for directly by the broker, the fund manager has every incentive to ensure that they are provided at the lowest possible cost. Cash rebates, on the other hand, are received directly by the fund management company, as several fund managers put it, as an incentive to do business.

23. Having considered the issues, we are convinced that the natural limits applicable to soft dollars and the requirement that they be of demonstrable benefit to clients represent material differences from cash rebates.

The difference between authorised funds and other discretionary accounts

24. Some commentators have argued that the regulatory approach should be the same for both authorised funds and discretionary accounts (again, either to support prohibition of retention of rebates by fund managers for both or disclosure for both).

25. Discretionary accounts are used in a variety of situations, from sophisticated investors to less sophisticated high net worth individuals, and it is difficult for the regulatory framework to distinguish between these situations. In the case of sophisticated investors, however, or the trustees of pension funds, the contract is more likely to be an arrangement between two parties of equivalent negotiating power.

26. Importantly, however, the regulatory system in Hong Kong and the systems in most other jurisdictions have historically made major distinctions between funds which are authorised to be marketed to the investing public and other discretionary accounts, which are, in the main, provided to clients on a private

basis. Virtually all regulatory systems in the world have established comprehensive investor protection requirements for funds offered to the public, which are more rigorous than those applicable to "other discretionary accounts".

27. In Hong Kong, the Code on Unit Trusts and Mutual Funds provides relatively comprehensive requirements for the structure, operations, investment and marketing of unit trusts, which do not apply to pension and other discretionary accounts. These investor protection requirements are justified on the basis that the funds are approved to be marketed to retail investors. It would therefore be a logical extension of the existing framework to have a more stringent set of requirements for cash rebates in relation to authorised funds than for discretionary accounts.

Hong Kong's role as a fund management centre

28. A number of commentators have argued that any proposal to require fund managers in Hong Kong to credit cash rebates to client accounts would adversely affect Hong Kong's competitive position, and this issue has therefore been carefully considered.

29. In the context of authorised funds, a proposal to require fund managers to credit cash rebates to the fund would become a requirement of the Code on Unit Trusts and Mutual Funds, which applies to **all funds** that wish to market to the public in Hong Kong, **regardless of domicile**. To this extent there is a level playing field for all fund managers and there is no incentive to relocate if the fund manager wishes to market to the public in Hong Kong.

30. To the extent that Hong Kong fund managers manage **non-Hong Kong-sourced funds**, the issue needs to be examined carefully. A few commentators argued that a requirement to credit cash rebates to the fund would disadvantage their competitive position and encourage them to move elsewhere. On the other hand, some others argued that the opposite would occur, that is, a prohibition on retention of rebates by managers would provide competitive advantages in that Hong Kong would be viewed as a "clean" jurisdiction, and thereby attract overseas institutional investment.

31. In the context of authorised funds which have a significant element of non-Hong Kong-sourced funds from which the fund manager currently obtains rebate revenue, the proposal may cause the manager to review the position, and perhaps restructure the fund. But even in a "worst case" scenario the manager is more likely to just "deauthorise" the fund and make it a discretionary account (and thereby escape the "prohibition") than go through the expensive exercise of relocation from Hong Kong. In the context of discretionary accounts, there is little risk that non-Hong Kong-sourced business would move elsewhere if retention of rebates by managers was permitted subject to a disclosure regime.

32. Overall, the risks to Hong Kong's position as a fund management centre, especially under the revised proposals, are small. Even under the original proposals, the HKIFA survey showed that only 8.8% of respondents "would **consider deauthorising** some or all" of their funds if the proposals were

implemented, notwithstanding that a majority of respondents also sourced a significant proportion of their investor base outside Hong Kong.

Policy Alternatives

33. An analysis of the policy alternatives involved considerations of prohibition, disclosure, and a combination of the two, in relation to the various issues discussed above.

Prohibition of cash rebates and soft dollars

34. If one accepts the arguments first, that in this area there is no material distinction between authorised funds and other forms of discretionary account; second, that there is no overriding distinction between cash rebates and soft commissions; and third, that both involve an inherent conflict of interest and lack of transparency that could not meaningfully be cured by disclosure, then the logical policy alternative is a complete prohibition of both practices.

35. Such a policy would, however, have significant implications for the fund management industry in Hong Kong and would place us clearly at the forefront of international regulatory intervention. No major jurisdiction has yet seen fit to prohibit soft commissions, despite numerous studies, policy reviews and acknowledgements of the conflict of interest concerns. Nevertheless, our policies on soft commissions and those of other major international fund management centres will be kept under close review.

36. One overriding reason for not imposing a ban on soft dollars is due to the impact it would have on the relationship between fund managers and on brokers. Brokers in all markets have traditionally provided research services as part of their brokerage services. Such research is technically a "soft" benefit, but is not separately priced by brokers. It would be unrealistic to expect that Hong Kong fund managers could require all the brokers they use for portfolio transactions in international markets to separately price transaction execution and other benefits such as research.

37. In relation to cash rebates, many commentators noted that it would be important to consider the effects of any policy involving prohibition, given that managers are likely to seek to make up the lost income by other means. This might be achieved through an increase in management fees, imposition of transaction fees, or use of connected persons.

38. *Increase in management fees.* For fund managers generally this should be the simplest method of compensating for lost rebate revenue. Most funds disclose both a current and a maximum management fee, and the Code provides that three months' notice be given to unitholders of any increase up to the maximum permitted level. An increase in the maximum permitted level requires a meeting of unitholders. While the net effect to investors in terms of fees may be similar, this method provides maximum transparency, enables direct fee comparisons between funds and addresses the conflict of interest risk.

39. *Transaction fees*. A number of commentators have suggested that fund managers will replace rebate revenues through the introduction of transaction fees. To the extent this occurs, the end result could be said to be similar to disclosure of rebates. As such, the problem of conflicts of interest and churning would remain, and could theoretically be worse as transaction fees would not be capped at full service brokerage rate levels. For these reasons, the Consultation Paper indicated that "due to the potential conflicts of interest inherent in most transaction based charges, the SFC would not look favourably on such arrangements". It remains our view that transaction fees payable to managers or their connected persons pose conflicts with the manager's fiduciary duties and should therefore not be permitted, except on a case-by-case basis where it can be demonstrated that such a fee would not raise concerns such as conflicts of interest (e.g. due to a low flat rate or special circumstances involving the particular fund).

40. *Connected persons* . A prohibition on the retention of cash rebates by the manager of an authorised unit trust could potentially be circumvented by use of connected persons, either by arranging for a connected person to retain the rebate or to pay inflated fees to a connected person in consideration of providing services to the fund. Thus it is necessary to prohibit retention of rebates by all persons connected with the scheme.

41. *Arm's length transactions* . It is not uncommon, however, for a fund manager to direct portfolio transactions to a connected broker at arm's length terms. In this regard, the Code limits such transactions to 50% unless specifically permitted by the Commission (section 6.24), on the basis that connected brokers can have advantages, for example, where they provide superior transaction execution or particular expertise. However, the use of a connected broker even at arm's length terms can be abused if done solely for the purpose of generating income within the group of connected companies. Due to the potential advantages a connected broker can provide it is not proposed to alter the existing Code provisions, but Commission staff will monitor the use of connected brokers and the Commission would consider a reduction in the current 50% limitation if abuse was evident.

Disclosure of both cash rebates and soft dollars

42. Following the comments of some market participants, the "disclosure alternative" was examined in detail. Proponents of this alternative argue that disclosure should be tried as the initial step followed by an assessment of its operation, on the basis that it would provide for gradual, evolutionary change rather than revolutionary and disruptive change.

43. In the case of **discretionary accounts** , this would mean that the client agreement should provide for the client's specific consent to the retention of cash rebates and/or goods and services through soft dollar arrangements, including prior disclosure through a description of the practices in relevant documentation. This would be followed by periodic disclosure of the cash or goods and services received. This is essentially the same as the proposal in the Consultation Paper in relation to discretionary accounts, excepting that the proposal included

prohibition of retention of cash rebates by managers at some future time.

44. Disclosure and informed consent in relation to **authorised funds** would need to be prominent, prospective and retrospective, as the investor does not sign a client agreement. The offering document would have to disclose an estimated "fee" based on prospective portfolio turnover accompanied by a financial report disclosing the amount in actual and percentage terms for the previous financial year. It would also be necessary to ensure that this information is clearly provided alongside the advertised management fee in all documentation or marketing material. Finally, to be consistent with soft dollar proposals, the actual brokerage rates to be paid could be no more than customary full service brokerage rates.

45. Acceptance of the "disclosure" alternative would resolve much, although not all, of the criticisms of cash rebates relating to transparency. However, the use of estimates and historical data would mean that direct comparisons between rebate-retaining and non-rebate retaining funds would still not be possible. In addition, the disclosure alternative does not address the conflicts of interest inherent in cash rebate practices. For example, it would not resolve the potential for abuse in the form of a manager churning a portfolio to generate rebate revenue, which is also particularly difficult to prove in an enforcement action. Opponents of cash rebates would also argue that the practice conflicts with the principle of fiduciary duty as described above, and is inconsistent with the view that there is a fundamental difference of approach for authorised funds and discretionary accounts.

Conclusion

46. The range of views, differences among portfolio managers and clients, and differences of interpretation presented a formidable regulatory challenge to the Commission. Each of the assumptions on which the various policy alternatives are based is arguable to some degree.

47. In relation to the cash rebates/soft dollars debate, it is clear that there are both similarities and differences between cash rebates, soft commissions and full-service brokerage. It is also strongly arguable that all involve an inherent conflict of interest and potential for abuse, and there is some merit to all of the various (and contradictory) analogies being drawn. At the end of the day, we believe that despite the arguments that can be mounted for a prohibition on both cash rebates and soft commissions, soft dollar practices are different from cash rebates and are too firmly entrenched in international markets to be prohibited in Hong Kong. However, implementation of standards to require consent, disclosure and limitation of **soft dollar** practices will bring Hong Kong up to international standards. It should be noted that 91% of respondents to the HKIFA survey supported this approach.

48. In the case of **authorised funds** which are approved to be marketed to the investing public in Hong Kong, and in the light of the existing comprehensive regulatory system designed for the retail investor, we believe it is logical and appropriate to require **cash rebates** to be credited to the fund to remove the

conflicts of interest and increase transparency in a way that is simple both to understand and enforce. In forming this view we considered it significant that the majority of respondents to the Consultation Paper (including a majority of fund managers responding to the HKIFA survey), the Committee on Unit Trusts, and the Commission's Advisory Committee support this policy.

49. It is important to note that this is **not** a "ban on rebates". Rebates can still be received in the many fixed commission markets in which they are standard practice : however, they must be **credited to the account of the fund** rather than retained by the manager.

50. In relation to **cash rebates and discretionary accounts** , given the nature of the clients and the different regulatory system which applies to such accounts, we believe that the arguments for "prohibition" are not as strong and believe that a suitable disclosure regime should address many, if not all, of the concerns arising from the practice of rebates. In particular, we are reluctant in this first regulatory initiative on cash rebates and soft dollar practices to interfere with commercial arrangements that in many instances have been negotiated between parties of roughly equal bargaining powers. Disclosure would also create significantly less disruption to existing practices than would a requirement to direct cash rebates to client discretionary accounts and could therefore be implemented at an earlier time. In view of the comments we have received, we believe it is now more appropriate to review the operation of the disclosure regime rather than to declare a policy of eventually prohibiting retention of rebates by the manager. We believe that the operation of the disclosure regime should be examined after two years of operation to assess its operation in practice.

The New Code Provisions

51. The Code on Unit Trusts and Mutual Funds has been amended to :

1. prohibit the retention of cash rebates by fund managers and their connected persons (for authorised funds);
2. regulate soft dollar arrangements;
3. clarify policy in relation to connected brokers and transaction fees.

52. The Code of Conduct for Persons Registered with the SFC has been amended to :

1. require prior consent for retention of rebates and periodic disclosure of their value for discretionary accounts;
2. regulate soft dollar arrangements.

53. These amendments are set out in Appendices I and II. The differences from the proposals in the Consultation Paper are summarised in Appendix III.

Timetable and Transitional Arrangements

54. In the case of authorised funds, the Code amendments will become effective

on 1 July 1995. However, fund managers will have until 31 December 1995 to ensure that their documentation is in compliance with the new requirements.

55. For registered persons, compliance is expected by 1 July 1995. Where it is intended that cash rebates be retained, initial disclosure statements should be provided to clients by 31 December 1995.

Appendix I

AMENDMENTS TO THE CODE ON UNIT TRUSTS AND MUTUAL FUNDS

1. S. 6.24 : replace with

6.24 Neither the management company nor any of its connected persons may retain cash or other rebates from a broker or dealer in consideration of directing transactions in scheme property to the broker or dealer save that goods and services (soft dollars) may be retained if:

- (a) the goods or services are of demonstrable benefit to the holders;
- (b) transaction execution is consistent with best execution standards and brokerage rates are not in excess of customary institutional full-service brokerage rates;
- (c) adequate prior disclosure is made in the scheme's offering document the terms of which the holder has consented to (see Appendix C15); and
- (d) periodic disclosure is made in the scheme's annual report in the form of a statement describing the manager's soft dollar practices, including a description of the goods and services received by the manager.

Note: Goods and services falling within (a) above may include : research and advisory services; economic and political analysis; portfolio analysis, including valuation and performance measurement; market analysis, data and quotation services; computer hardware and software incidental to the above goods and services; clearing and custodian services and investment-related publications. Such goods and services may not include travel, accommodation, entertainment, general administrative goods or services, general office equipment or premises, membership fees, employee salaries, or direct money payments.

[New provision prohibiting retention of cash rebates, with soft dollars provisions substantially based on new C13 for Code of Conduct for Registered Persons]

2. 6.24A Brokers or dealers connected to the management company, investment adviser, directors of the scheme or any of their connected persons may not in aggregate account for more than 50 per cent of the scheme's transactions in value in any one financial year of the scheme. The Commission may consider each case on its merits and may permit the 50 per cent to be exceeded if the connected

broker or dealer offers advantages to the scheme not available elsewhere.

[Existing provision 6.24 amended slightly for clarity]

3. Appendix C15 : replace with

C15 Where a connected person receives goods or services from a broker or dealer (see 6.24 of the Code), a summary of the terms under which such goods or services are received.

4. Appendix E : Notes to the Accounts : add

6. Details of any soft commission arrangements relating to dealings in the property of the scheme.

5. Appendix D12 : add

D12 (d) all transactions carried out by or on behalf of the scheme must be at arm's length and executed on the best available terms. Transactions with persons connected to the management company, investment adviser or directors of the scheme may not account for more than 50 per cent of the scheme's transactions in value in any one financial year of the scheme.

6. 6.33 : Add

Note : Percentage-based transaction fees payable to the management company or any of its connected persons may be disallowed as inconsistent with the management company's fiduciary responsibility.

Appendix II

**AMENDMENTS TO THE
CODE OF CONDUCT
FOR PERSONS REGISTERED WITH THE SFC**

C13. Rebates, Soft Dollars, and Connected Transactions

13.1 A registered person who acts for a client in the exercise of investment discretion may receive goods or services (i.e. soft dollars) from a broker in consideration of directing transaction business on behalf of such client to the broker only if :

(a) the goods or services are of demonstrable benefit to the registered person's clients;

(b) transaction execution is consistent with best execution standards and brokerage rates are not in excess of customary full-service brokerage rates;

(c) the client has consented in writing to the receipt of such goods and services;

and

(d) disclosure is made of the registered person's practices for receiving such goods and services, including a description of the goods and services received.

Notes

Goods and services may include : research and advisory services; economic and political analysis; portfolio analysis, including valuation and performance measurement; market analysis, data and quotation services; computer hardware and software incidental to the above goods and services; clearing and custodian services and investment-related publications. Such goods and services may not include travel, accommodation, entertainment, general administrative goods or services, general office equipment or premises, membership fees, employee salaries, or direct money payments. This note is not exhaustive and may be amended from time to time.

Disclosure and consent may be made or given in the Client Agreement or other investment management agreement (or an addendum thereto). Whichever form of document is used, it must include a specific statement describing the registered person's soft dollar practices. In addition, at least annually the client must be given a statement describing the registered person's soft dollar practices, including a description of the goods and services received by the manager.

13.2 A registered person described in 13.1 who intends to receive and retain cash or money rebates in relation to client transactions may retain such rebates only if :

(a) the client has consented in writing to such retention of rebates;

*(b) brokerage rates are not in excess of customary full-service brokerage rates;
and*

(c) disclosure of such rebates and their approximate value is made to the client.

Note

Disclosure and consent may be made or given in the Client Agreement or other investment management agreement (or an addendum thereto). Whichever form of document is used it must include a specific statement that the manager may receive and retain brokerage commission rebates and describe the registered person's practices in regard to such rebates. In addition, at least twice annually the client must be provided with a quantification of the value of rebates received in relation to the client's account. Alternatively, this may be done in each contract note provided to the client. Quantification of rebates may involve estimates taken from aggregate commission and rebate data provided such estimates are reasonably accurate in relation to the client's account.

13.3 A registered person described in 13.1 shall ensure and be able to

demonstrate that any transactions undertaken or services acquired in relation to a client's account that involve payments from client assets directly or indirectly to a person connected with the registered person are undertaken at arm's length terms and in the best interests of the client. Essentially, this requires that such terms not be less favourable than those generally available in the market.

13.4 A registered dealer who provides a portfolio manager with goods, services, or cash rebates has a responsibility to satisfy himself that the manager is mindful of the requirements of this section (for example, by providing him with a copy of these Code provisions). This is in addition to any legal duties that the dealer and the manager may have, including those imposed by the Prevention of Bribery Ordinance.

Effective Date

Compliance is expected by 1 July 1995, with initial disclosure statements under 13.1 or 13.2 being required for clients by 31 December 1995.

Appendix III

SUMMARY OF MODIFICATIONS TO THE PROPOSED CODE PROVISIONS IN THE CONSULTATION PAPER

A. Code of Conduct for Persons Registered with the SFC

In response to the suggestions of commentators, **13.1(a)** has been modified to provide that soft dollar goods and services must be of demonstrable benefit to the registered person's clients generally, rather than a specific client.

13.1(b) has been changed to reword the best execution requirement and to specify that brokerage rates in relation to soft dollar arrangements must not exceed customary full-service rates.

13.1(c) has been added to clarify that the client's consent is required, which is necessary to comply with the Prevention of Bribery Ordinance.

13.1(d) has been expanded to clarify that disclosure must include a description of the registered person's soft dollar practices and of the goods and services received.

The **Notes** applicable to 13.1 have been amended to expand on acceptable soft dollar good and services and to reword the disclosure requirements. The Notes also specify that the document used to obtain consent must include a description of soft dollar goods and services received, and modify the periodic disclosure to require annual rather than semi-annual disclosure. The reference to "prominent print" has been removed for the reasons that soft dollar practices are not considered to be of such overriding importance as to deserve prominent print to the exclusion of other important matters contained in an investment management agreement, such as management fees, investment policy and restrictions, use of

leverage, etc.

13.2 has been changed to provide that brokerage payments involving cash rebates must not exceed customary full-service brokerage rates. This is to ensure that unusually high brokerage rates cannot be paid to generate rebate revenue and to be consistent with the soft dollar requirements.

The **Note** for 13.2 has been modified to reflect the comment above concerning 13.2. It has also been amended to require disclosure of rebates practices on a semi-annual rather than quarterly basis to match the semi-annual reporting required of authorised funds. The reference to "prominent print" has been removed for the same reasons given above in relation to soft dollars.

13.4 has been changed based on legal advice as to the obligations imposed under the Prevention of Bribery Ordinance, and the advice of the SFC Advisory Committee.

Note 3. The language has been simplified and the effective date moved back to 1 July 1995.

B. Code on Unit Trusts and Mutual Funds

The relatively brief provisions contained in the Consultation Paper have been expanded to parallel the Code of Conduct provisions for soft dollars, including conforming changes to those mentioned above in relation to consent, soft dollars benefitting holders generally, expansion of acceptable soft dollar goods and services, best execution, and brokerage rates not exceeding customary full-service rates.

Section 6.24 of the Code has been amended to prohibit retention of cash rebates by all persons connected with a scheme.

New provision **6.24A** replaces the provision **6.24** .

A **Note** concerning transaction fees has been added.

The effective date has been moved back to 1 July 1995.