



**SECURITIES AND FUTURES COMMISSION**  
證券及期貨事務監察委員會

## **Consultation Paper on Proposals to Enhance Protection for the Investing Public**

September 2009



# Table of contents

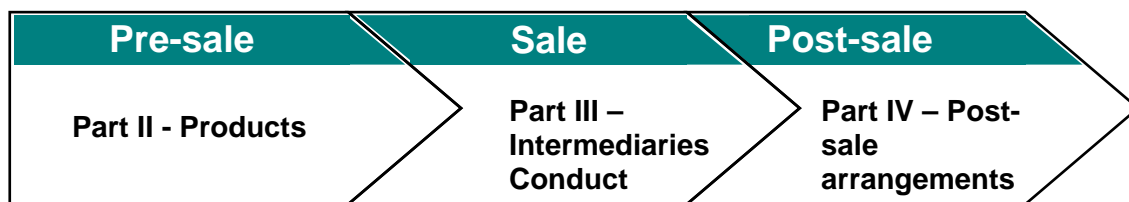
|   |           |
|---|-----------|
| Foreword.....   | 1         |
| Personal information collection statement.....  | 2         |
| <b>Part I Introduction.....</b>   | <b>4</b>  |
| Executive Summary.....  | 4         |
| Impact of financial crisis.....   | 4         |
| Background work.....  | 5         |
| The need for change to be recognized.....   | 5         |
| How to read this consultation paper.....  | 6         |
| Summary of underlying rationale for proposals   | 8         |
| Documentation.....  | 8         |
| Disclosure.....   | 9         |
| Sales Process.....  | 10        |
| Post-sale arrangements – cooling-off period.....  | 12        |
| Education.....  | 13        |
| Resolution.....   | 13        |
| Invitation for comments.....  | 14        |
| <b>Part II - Products.....</b>  | <b>15</b> |
| Consultation on the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products..... | 15        |
| Section 1 - Key proposals in the Code on Unlisted Structured Products.....  | 24        |
| Section 2 - Key proposals in the revised Code on Unit Trusts and Mutual Funds.....  | 41        |
| Section 3 - Key proposals in the revised Code on Investment-Linked Assurance Schemes.....   | 56        |
| Section 4 - List of consultation questions in Part II.....  | 61        |

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|  |    |
|--|----|
| <b>Part III - Intermediaries conduct</b> .....   | 64 |
| Consultation on the regulation of intermediary conduct and selling practices .....   | 64 |
| Summary of matters for consultation .....  | 67 |
| List of consultation questions in Part III .....   | 87 |
| <b>Part IV - Post-sale arrangements – cooling-off period</b> .....   | 89 |
| Cooling-off period .....   | 89 |
| List of consultation questions in Part IV .....  | 93 |
| <br>   |    |
| Appendix A: Proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment Linked Assurance Schemes and Unlisted Structured Products |    |
| Appendix B: Proposed illustrative templates for Product Key Facts Statements   |    |
| Appendix C: Proposed amendments to Code of Conduct and Professional Investor Rules   |    |
| Appendix D: International practices comparison for Part III  |    |

## Quick guide to this consultation paper







## Personal information collection statement

1. This Personal Information Collection Statement (PICS) is made in accordance with the guidelines issued by the Privacy Commissioner for Personal Data. The PICS sets out the purposes for which your Personal Data<sup>1</sup> will be used following collection, what you are agreeing to with respect to the Commission's use of your Personal Data and your rights under the Personal Data (Privacy) Ordinance (Cap. 486) (the PDPO).

### Purpose of collection

2. The Personal Data provided in your submission to the Commission in response to this consultation paper may be used by the Commission for one or more of the following purposes:
  - (a) to administer the relevant provisions<sup>2</sup> and codes and guidelines published pursuant to the powers vested in the Commission;
  - (b) in performing the Commission's statutory functions under the relevant provisions;
  - (c) for research and statistical purposes; or
  - (d) for other purposes permitted by law.

### Transfer of personal data

3. Personal Data may be disclosed by the Commission to members of the public in Hong Kong and elsewhere as part of the public consultation on this consultation paper. The names of persons who submit comments on this consultation paper, together with the whole or any part of their submissions, may be disclosed to members of the public. This will be done by publishing this information on the Commission website and in documents to be published by the Commission during the consultation period or at its conclusion.

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4. You have the right to request access to and correction of your Personal Data in accordance with the provisions of the PDPO. Your right of access includes the right to obtain a copy of your Personal Data provided in your submission on this consultation paper. The Commission has the right to charge a reasonable fee for processing any data access request.

### Retention

5. Personal Data provided to the Commission in response to this consultation paper will be retained for such period as may be necessary for the proper discharge of the Commission's functions.

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<sup>1</sup> Personal Data means personal data as defined in the Personal Data (Privacy) Ordinance (Cap. 486).

<sup>2</sup> Defined in Schedule 1 of the Securities and Futures Ordinance (Cap. 571) (SFO) to mean provisions of the SFO and subsidiary legislation made under it; and provisions of Parts II and XII of the Companies Ordinance (Cap. 32) so far as those Parts relate directly or indirectly, to the performance of functions relating to prospectuses; the purchase by a corporation of its own shares; a corporation giving financial assistance for the acquisition of its own shares etc.



## Enquiries

6. Any enquiries regarding the Personal Data provided in your submission on this consultation paper, or requests for access to Personal Data or correction of Personal Data, should be addressed in writing to:

The Data Privacy Officer  
The Securities and Futures Commission  
8/F Chater House  
8 Connaught Road Central  
Hong Kong

A copy of the Privacy Policy Statement adopted by the Commission is available upon request.



# Consultation paper on proposals to enhance protection for the investing public

## Part I Introduction

### Executive Summary

#### Impact of financial crisis

1. In the past twelve months following the collapse of Lehman Brothers Holdings Inc. (Lehmans), the global financial system has experienced its worst crisis since the Great Depression of the 1930s. The interconnectedness of financial centers and the increasingly connected global economy, has meant that few countries have escaped unscathed. However, it has been the financial infrastructure of the developed economies that have been hardest hit. Many developed economies have seen the collapse of financial institutions and the need for government intervention on a massive scale to prevent the collapse of their financial systems.
2. Hong Kong has not come through this period unscathed and the entire economy is suffering from the economic downturn that has followed. However, our financial sector has proved to be resilient in the face of the systemic pressures it has faced and we have not seen the major institutional failings that have been experienced in other international markets. We have also largely avoided the direct impact of the collapse of securitized mortgage products, which have been such a feature of the larger financial centers.
3. Nevertheless, the stress put on our financial infrastructure and in particular the direct impact of the collapse of Lehmans, one of the world's largest investment banks, has served to highlight significant concerns about how certain investment products have been sold to members of the public in Hong Kong.
4. The collapse of Lehmans resulted in the early termination of a number of products it had arranged and which had been sold to the Hong Kong public, resulting in significant losses for investors. Over 20,000 complaints were received from investors in Lehman products nearly all of which contained allegations of mis-selling.
5. It is important to distinguish between the debate now taking place – globally, regionally and nationally – about what structural changes to regulation may be required to prevent a future financial crisis and the actions we need to take to strengthen the regulatory regime for retail products, which the current financial crisis has merely served to highlight. These are very different issues, requiring different considerations.
6. This paper proposes enhancements to the regulation of the sale of retail products in response to issues highlighted by the early termination of Lehman products. The paper does not attempt to address any of the broader questions that have been raised about how our regulatory regime should be structured and what steps need to be taken, locally or as part of global initiatives, to address systemic weaknesses that may precipitate a future financial crisis.



## Background work

7. In view of the global financial crisis since September 2008 and its impact on unlisted structured products offered to the public, the Commission submitted a report<sup>3</sup> to the Financial Secretary in December 2008 (FS Report). This report recommended a number of measures to restore investor confidence in the financial market and to address areas relating to selling practices and complex products. The Financial Services and the Treasury Bureau has undertaken a review to consider what could be done to improve Hong Kong's regulatory framework and enhance investor protection and education. An Action Plan<sup>4</sup> was formulated after consulting the Commission and HKMA to take forward various recommendations. In the long term, the Administration will review the structure of the regulatory framework and related arrangements that are to be implemented through primary legislation.
8. Subsequently the Commission has conducted a large number of investigations into the sale of minibonds (and other unlisted structured products) by intermediaries. The Commission has concluded the majority of these investigations by entering into an agreement with 16 banks and two securities intermediaries which provide for significant levels of payment for the vast majority of investors and also require various actions to be taken by the financial institutions involved.
9. Our review of the issues relating to the sale of unlisted structured products highlighted by the collapse of Lehmans together with work performed by the HKMA, has identified areas where our regulatory regime surrounding the sale of investment products could be enhanced.
10. Our focus in preparing this consultation paper is to put forward measures to strengthen our existing regulatory regime. Whether this can be achieved is always dependent on the individual action of all participants in the process, but we believe that our recommendations are aimed to define a regulatory infrastructure that better protects the interests of investors.

## The need for change to be recognized

11. While the resilience that our financial infrastructure has shown during the financial crisis has attracted positive comments, the Minibonds incident has exposed issues in connection with the sale of investment products and has negatively impacted on the reputation of our market both locally and internationally. In order to restore the trust and confidence in our market we believe that the Government, the regulators and the industry need to collectively demonstrate that the lessons of this incident have been learned and that appropriate action has been taken. This consultation paper offers a number of suggestions as to what this action should be.
12. In determining what action should be considered we have been conscious of the need to formulate balanced proposals. The Commission has a long tradition of consulting on changes and we believe that this allows us to move forward in a pragmatic but nevertheless effective manner as we develop our regulatory regime.

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<sup>3</sup> "Issues raised by the Lehmans Minibonds crisis – Confidential Report to the Financial Secretary" issued by the SFC in December 2008

<sup>4</sup> Action Plan on Recommendations in the Reports Prepared by the Hong Kong Monetary Authority and the Securities and Futures Commission on the Lehman Brothers Minibonds Incident prepared by the Financial Services Branch of the Financial Services and the Treasury Bureau and submitted to the Legislative Council in February 2009.



13. In developing the proposals in this paper we have already conducted extensive soft consultation. We have also looked closely at developed overseas jurisdictions with comparable regulations in place. Whilst mindful of the potential impact on the financial markets, we have first and foremost had in mind the need for additional investor protection in the light of the issues arising from the sale of unlisted structured products in our market.
14. Given the seriousness of the Minibond event, it is not possible to consider returning to business as usual and intermediaries must recognize the need for enhancement of the regulatory environment in which they sell investments to the public. While we wish to consult on these proposals we urge respondents to focus on what is the right answer in the context of recent events and then to consider how to implement the necessary changes.

### **How to read this consultation paper**

15. The proposals in our paper flow directly from the recommendations made in our FS Report and a parallel report prepared by the HKMA. We have also taken the opportunity to codify some existing practice and to propose a few new matters, which can be conveniently considered at the same time.
16. This consultation paper contains a number of proposals and many of these are interconnected. These proposals should be considered as a set of integrated actions, which, together with some additional measures to be consulted on later this year, are collectively designed to enhance protection for the investing public. They should not be viewed individually.
17. However, while it is necessary to include this detail to assist the industry consider the implications for their business it is also possible to view our proposals in simpler terms. We suggest that the reader first considers an overview of all the proposals being put forward to provide context for any detailed consideration of individual proposals they may wish to undertake.
18. For the convenience of the reader, we have also grouped our proposals in this consultation in separate sections as noted below. This will allow those with an interest only in the matters which directly impact them to readily identify and consider those issues.

Part I – Introduction

Part II – Products

Part III – Intermediaries conduct

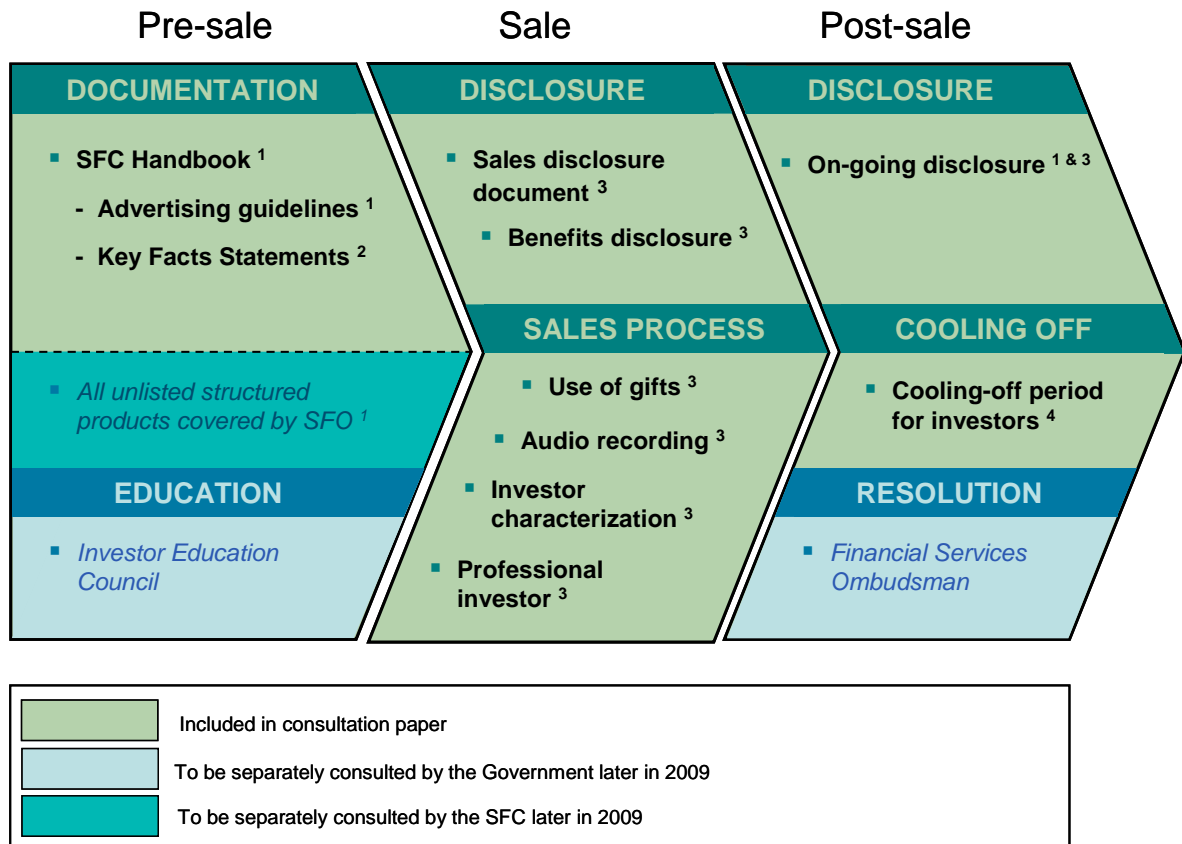
Part IV – Post-sale arrangements

Each section of our consultation paper is marked to indicate which of the above headings it falls under.

19. We would also add that the proposals set out in Part II of this consultation paper will apply only where the relevant types of investment products are offered to the public in Hong Kong, whilst the proposals set out in Part III of this consultation paper will apply to licensed or registered persons in Hong Kong in their sale of investment products, whether to the public or not.



20. How our recommendations relate to the three key stages of an investment life-cycle: Pre-sale, Sale and Post-sale, can also be visually illustrated as follows.



<sup>1</sup> As detailed in the part headed "Products" in Part II and in Appendix A to this consultation paper.  
<sup>2</sup> As detailed in the part headed "Products" in Part II and in Appendices A and B to this consultation paper.  
<sup>3</sup> As detailed in the part headed "Intermediaries conduct" in Part III of this consultation paper.  
<sup>4</sup> As detailed in the part headed "Post-sale arrangements - Cooling-off period" in Part IV of this consultation paper.

21. Starting with this overview will assist readers in putting each individual proposal in context and show how they contribute to an overall effort to improve the regulatory regime surrounding the sale of investment products to the Hong Kong public.



## Summary of underlying rationale for proposals

22. As noted above, this paper proposes additional measures to provide protection for investors for consultation. The paper does not attempt to address any of the broader questions that have been raised about how our regulatory regime should be structured. Accordingly, this consultation is premised on Hong Kong continuing to adopt a largely “disclosure-based approach”<sup>5</sup> coupled with conduct regulation on intermediaries who sell products. Disclosure-based regulation is adopted in other major financial centers e.g. the US, the UK, Singapore and Australia and is in any event the approach which we believe continues to be appropriate for our market.
23. Each proposal set out in this paper contains the necessary information to consider that individual issue. This section attempts to provide the reader with a concise summary of the rationale and regulatory philosophy underlying our proposals. This is necessarily high level and reference should be made to the detailed sections for the complete background to each proposal. However, it is hoped that this summary will allow a reader to gain an overview of the consultation so that when considering a particular proposal it can be understood in context.

## Documentation

24. While there is a responsibility for the selling intermediary to ensure that investors have an understanding of the key features of the product, as part of ensuring suitability, the effectiveness of documentation in communicating key features and risks of the investment product to investors can be enhanced.
25. In order to improve the effectiveness of documentation in communicating key issues to investors we have set out three key proposals:

### Standardisation

- (a) The criteria that the Commission will normally consider in authorising offering documentation and advertisements (see Part II of this consultation paper), will be consolidated into a single SFC handbook as set out in Appendix A covering Unit Trusts and Mutual Funds (UT), Investment-Linked Assurance Schemes (ILAS) and Unlisted Structured Products (issued under the SFO). This will include a new Code on Unlisted Structured Products (the SP Code) as well as some updating of the existing Code on Unit Trusts and Mutual Funds (UT Code) and Code on Investment-Linked Assurance Schemes (the ILAS Code) and codify existing practice. This will clarify documentation standards and also allow common principles to be applied to all of these products.
- (b) At present there are two separate regimes under which the Commission authorizes the documents of products sold to the Hong Kong public i.e. the Companies Ordinance (Cap. 32) (CO) prospectus regime and the Offers of Investments regime in Part IV of the Securities and Futures Ordinance (Cap. 571) (SFO). The Commission is working with Government to bring forward legislative amendments to transfer the authorisation of offering documentation in relation to

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<sup>5</sup> Under the “disclosure based approach”, a regulator relies on the information provided by the issuer in authorising the offering documents and marketing materials. It does not verify the accuracy of the information so provided but relies on the issuers. This approach is different from the “merit based approach” under which a regulator assesses the suitability of products for consumers at the point of vetting of offering documents or marketing materials.



structured products out of the CO prospectus regime. Public offers of unlisted structured products will then be regulated under Part IV SFO Offers of Investments regime. For practical reasons, this proposal will be consulted on separately. This proposal will allow the Commission greater scope and flexibility in defining the appropriate documentation standards through the use of powers to publish codes and guidelines under the SFO.

### **Simplification**

- (a) In order to improve the communication of key issues to investors we have proposed that all offer documents should include concise and easily-understood summaries, or product Key Facts Statements (Product KFS). These should be user friendly, standardized to the extent possible (to facilitate comparison between products), and be kept concise. While they cannot be a substitute for the full information contained in an offer document, we believe that these Product KFS will prove to be effective in ensuring that a product's key features and risks are communicated to investors.
- (b) Reference can be made to the section headed "Product key facts statements" in Part II - Products and to Appendix B to this consultation paper.

### **Disclosure**

26. There are two areas where the current regime could be enhanced:
- (a) Investors were not aware of the commercial interest of intermediaries selling the investment product to them i.e. the commission or benefits earned on the sale.
  - (b) There may have been occasions when little information was readily available to investors in the period between the completion of the sale and the maturity of the investment product.

We have included three items in our consultation proposals to deal with these issues.

### **Monetary and non-monetary benefits**

27. In reviewing the selling practice it is apparent that the level of commission (or benefits) earned is an important factor that should be disclosed by the intermediaries to investors. Concerns have been expressed about the possibility that the level of commissions may have been a factor which encouraged institutions to develop business strategies that inappropriately incentivised their sales staff to sell investment products. This in turn may have created potential conflicts of interest.
28. Requirements already exist in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) to "make adequate disclosure of relevant material information<sup>6</sup>" and "to avoid conflicts of interest and ... ensure that ... clients are fairly treated."<sup>7</sup> In order to further mitigate against conflicts of interest and to enhance transparency, we propose to require disclosure to

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<sup>6</sup> General Principle 5

<sup>7</sup> General Principle 6



clients at the pre-sale stage of commissions, fees and other benefits receivable from product issuers for the sale of the products.

29. We noted that overseas jurisdictions already require varying degrees of disclosure. While we consider that additional disclosure will benefit investors we also recognize that there are different ways in which this can be achieved. We also accept that there are some circumstances in which establishing the level of commission or benefit is complex.
30. Reference can be made to the section headed “Pre-sale disclosure of monetary and non-monetary benefits” in Part III - Intermediaries conduct of this consultation paper.

### **Ongoing disclosure requirements**

31. We believe that it would be helpful to make material information available to investors on an ongoing basis to enable them to better monitor their investments in a volatile market. The single SFC handbook as set out in Appendix A requires ongoing disclosure to investors of material information in relation to unlisted structured products in addition to the existing on-going disclosure requirements already imposed on unit trusts and mutual funds and ILAS products.
32. Distributors of these products are also reminded of their obligations to pass on to ultimate investors the information that they receive from the issuers. Reference can be made to Paragraph 11 of Part III - Intermediaries conduct of this consultation paper.

### **Sales disclosure document**

33. In their report to the Financial Secretary the HKMA recommended that consideration be given to providing a uniform statement of key facts to investors at the point of sale. This would include, inter alia, information about the capacity in which the intermediary was acting e.g. agent or principal and also any commission earned (see the part headed “Monetary and non-monetary benefits” above). We propose to specify the minimum content to be provided in a sales disclosure document.
34. Reference can be made to the section headed “Sales disclosure document” in Part III - Intermediaries conduct of this consultation paper.

### **Sales Process**

35. The sale of investment products is covered by requirements set out in the Code of Conduct. Having reviewed these requirements and with the benefit of the information provided by the many complaints received regarding the sale of Minibonds, we believe that these requirements are still appropriate. However, concerns exist about the extent to which some intermediaries complied with these requirements in the sale of investment products to the public.
36. Based on our review we do not propose any substantive changes to the Code of Conduct and its core requirement in paragraph 5.2 “to ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.” However, we have proposed changes in the following areas.



## **Gifts**

37. The HKMA noted that gifts were offered to investors in the marketing of some Lehman retail products and suggested that consideration be given to restricting the use of gifts as a marketing tool to promote a specific investment product. Accordingly we seek views as to whether an intermediary should not act in a way that should distract the client's attention from the features of the products by offering certain types of gifts as a marketing tool.
38. Reference can be made to the section headed "Use of gifts by distributors in promoting a specific investment product" in Part III – Intermediaries conduct of this consultation paper.

## **Audio recording of sales process**

39. The SFC Internal Control Guidelines and FAQs (Internal Control Guidelines) contain requirements that intermediaries "document and record contemporaneously the information given to each client and the rationale for recommendations given to the client ...." The HKMA has imposed an audio recording requirement on banks selling investments to the public to ensure that full and complete records of the sales process are kept.
40. We understand the rationale for the HKMA's requirement but are equally aware of the concerns expressed by some intermediaries regarding both the practicality of making audio recordings in all circumstances and the difficulty that some smaller intermediaries may experience in establishing the appropriate infrastructure.
41. Given that several months experience has now been gained by banks operating this system we wish to consult on whether or not this audio recording requirement should be extended to cover all intermediaries selling investments to the public or if alternative methods of compliance with the Internal Control Guidelines remain acceptable.
42. Reference can be made to the section headed "Audio recording" in Part III - Intermediaries conduct of this consultation paper.

## **Investor characterization**

43. A general concern has been expressed about the difficulty experienced by average investors in understanding the complex nature and features of some unlisted structured products, which generally have embedded derivative elements. Having reviewed overseas regulations and having regard to the structure of such products, we consider investors' knowledge of derivatives to be a crucial factor.
44. We therefore propose that it be explicitly required that intermediaries should seek, as part of the "know your client" process, client information including knowledge of derivatives. Intermediaries should then characterize those clients (other than professional investors) who have derivative knowledge as "clients with derivative knowledge". If a client is not characterized as a "client with derivative knowledge", the intermediary should not promote any unlisted derivative products to such a client in all circumstances. An intermediary can promote unlisted derivative products to a "client with derivative knowledge" provided that it complies with paragraphs 5.2 (reasonable advice) and 5.3 (derivative products) of the Code of Conduct and that the recommendation is suitable for the client.



45. References can be made to the section headed “Investor characterization” in Part III - Intermediaries conduct of this consultation paper.

### **Professional investors**

46. We have previously committed<sup>8</sup> to review the definition of “professional investor” in response to concerns expressed regarding the purchase of “accumulators” by individuals who had been classified as such. This was also included as a recommendation in our subsequent FS Report.
47. In the public debate on this issue there has been considerable focus on the minimum portfolio requirement (asset test), set out in subsidiary legislation, which requires that an investor has a minimum portfolio of HK\$8 million. There is a general market misconception that investors with a portfolio of this size will automatically be treated as professional investors under the Code of Conduct. In fact, the intermediary must establish that the investor has sufficient knowledge and experience in the relevant products and markets<sup>9</sup>. Even then an investor cannot be treated as a professional investor unless he formally agrees, in writing, that he wishes to be classified as such.
48. We believe that this test, as set out in paragraph 15.3 of the Code of Conduct, is the key test of whether or not an investor can be considered to be a “professional investor” and that this is where we need to take the most care to ensure that our criteria remain appropriate.
49. In considering the questions posed regarding the appropriate definition of professional investor it will be tempting to focus on the simple asset test and to suggest that the current hurdle is too low. However, consideration should also be given to legitimate concerns that if the asset hurdle is set too high this may adversely affect private placement activities in Hong Kong.
50. References can be made to the section headed “Professional investors” in Part III - Intermediaries conduct of this consultation paper.

### **Post-sale arrangements – cooling-off period**

51. Our examination of Minibonds highlighted that a number of investment products have the effect of locking investors in for a considerable period of time. This is not only because of the maturity period of the investment but also because of the absence of a liquid secondary market in which they can sell their investment.
52. Overseas markets we have examined have various forms of “cooling off” periods where an investor can exit a transaction within a limited period after initially committing to it. In Hong Kong such a cooling off period already exists for ILAS products.
53. In considering the possibility of cooling off periods for other investment products we have considered carefully where a cooling off period could be said to be really needed and have also been conscious of the need to avoid the impression that, where investors do not need to take any responsibility for their decisions.

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<sup>8</sup> This commitment was made at the Financial Affairs Panel meeting on 7 July 2008.

<sup>9</sup> Please refer to paragraph 15 of the Code of Conduct for full details of the criteria required and the procedures which need to be followed.



54. Our proposal is that a cooling off period should only be considered for products where the investment is long-term, and where there is no ready (and realistic) secondary market. If an investor buys a product which has a liquid secondary market e.g. most mutual funds, then if they decide that this was not an appropriate investment decision they can immediately exit by selling the product. In these circumstances a cooling off period may not be appropriate.
55. However, where there is no ready secondary market for a long-term investment, we believe that it would be reasonable to allow an investor to change their mind, within a short period after the initial investment decision, rather than lock them into a long-term investment which, they have determined is not appropriate. In these circumstances we believe that the appropriate response would be to refund their investment capital and the corresponding sales commission less a reasonable administration charge and less any legitimate market value adjustment.
56. We believe that cooling off periods determined in this way would be a win-win arrangement for both the investor and the intermediary who would not want to have a disgruntled customer for the entire period of the investment. Equally, under our proposals, we do not believe that an investor would change their mind lightly since they would be required to settle the legitimate costs of their decision.
57. Reference can be made to Part IV - Post-sale arrangements of this consultation paper.

## **Education**

58. Greater awareness of risks, an increased understanding of the different investment products available and the availability of appropriate reference material, will all help to improve the quality of the investment decisions made by the public. While regulation surrounding the sale of investments is needed to protect the investing public this needs to be complemented by efforts to help individual investors make appropriate investment decisions. We have proposed a significant increase in the amount and scope of investor education made available to the Hong Kong public as part of a continuous programme that enables individual investors to address their investment needs in an informed manner. The Government will consult the public later this year on a proposal to establish an Investor Education Council.

## **Resolution**

59. The recent Minibonds issue has highlighted the lack of an effective dispute resolution procedure for individual complaints against regulated entities. Regulatory matters will always require the involvement of the regulator. However, it is important that individuals should have a means of seeking redress in respect of their commercial disputes with financial service providers outside the regulatory regime. The Government will consult the public on the proposal to establish a Financial Services Ombudsman and will consult the public on this later this year.



## Invitation for comments

60. In this consultation, we have posed 32 questions to interested parties to consider and provide comments on. These questions are categorized as follows for ease of reference:

| Questions | Subject   | Where to find the details in this paper? |
|-----------|---|--|
| 1 to 17   | The offer of investment products to the public in Hong Kong.  | Part II                                  |
| 18 to 28  | Intermediaries conduct in the sale of investment products in Hong Kong, whether to the public or not. | Part III                                 |
| 29 to 32  | The feasibility of a cooling-off period for sales of investment products to the public in Hong Kong.  | Part IV                                  |

61. We would like to seek comments on the proposals set out in this consultation paper. In determining our regulatory approach in the areas that we consult on, it is important that we take into account the views of those who will be affected by the implementation of these proposals, including market participants and investors. We have set up various ways for interested parties to provide comments. Please see the "Foreword" section at the beginning of this consultation paper. In view of the complexity of the proposals, we consider a three-month consultation period to be appropriate. We look forward to hearing from you by 31 December 2009. After the end of the consultation period, we will analyse the comments carefully and aim to adopt a balanced and pragmatic approach for the purposes of enhancing investor protection in Hong Kong.



## Part II Products

### Consultation on the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products

#### Introduction

1. This Part II of the consultation paper sets out the framework and objectives for, and introduces key proposals in, the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products (the Handbook). The Handbook will apply where the relevant types of investment products are offered to the public in Hong Kong. The Handbook is attached as Appendix A to this consultation paper. Further details of the proposals relating to specific types of products are set out in Sections 1 to 3 of this Part II – Products.

#### Objectives of the Handbook

2. The new Handbook has been developed to address the specific products-related matters identified in the FS Report and the Action Plan as well as certain broad underlying objectives:
  - (a) to enhance product disclosure;
  - (b) to increase transparency with respect to investment products that are offered to the public in Hong Kong; and
  - (c) to update the regulatory framework for retail funds, reflecting market developments and regulatory developments in other leading funds jurisdictions. This will allow fund managers in Hong Kong to expand into a wider variety of fund classes and investment strategies, and strengthen Hong Kong's position as an international center for asset management.
3. The three broad objectives are reflected in a number of the proposals in the Handbook. Disclosure enhancement is addressed at both the general principles level, where the Handbook sets an overall standard for product disclosure and requires preparation of summary information for all products, and also in product-specific requirements. The Handbook also contains guidelines and requirements aimed at greater transparency. In the case of unlisted structured products, the Handbook includes a new code. The Commission has also revisited parts of the UT Code to align certain requirements with those in other leading funds centers, which will provide opportunities for further development of the asset management industry in Hong Kong.
4. This Part II of the consultation paper does not cover the intermediaries conduct initiatives in the Action Plan. These are addressed in Part III of this consultation paper.

#### The Handbook – framework

5. The new Handbook consists of four sections:



- (a) a general section setting out guiding principles appearing in Section I of the Handbook;
  - (b) a revised Code on Unit Trusts and Mutual Funds (the revised UT Code) appearing in Section II of the Handbook;
  - (c) a revised Code on Investment-Linked Assurance Schemes (the revised ILAS Code) appearing in Section III of the Handbook; and
  - (d) a new Code on Unlisted Structured Products appearing in Section IV of the Handbook.
6. The new Handbook will apply to most investment products that are offered to the public in Hong Kong, such as unit trusts and mutual funds, investment-linked assurance schemes and unlisted structured products, and relevant offering documents and advertisements. The new Handbook will not apply to the following types of products for the reasons stated below:
- (a) real estate investment trusts (REITs), being listed property trusts, are a different category of collective investment scheme. REITs are already regulated under a separate product code;
  - (b) listed structured products are subject to a well-established regulatory framework under the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (the Listing Rules) and the oversight of The Stock Exchange of Hong Kong Limited;
  - (c) mandatory provident fund schemes and pooled retirement fund schemes are different from other SFC-authorized schemes as they are primarily regulated by the Mandatory Provident Fund Authority (MPFA). MPFA is responsible for the overall administration of the mandatory provident fund system established under the Mandatory Provident Fund Schemes Ordinance and its subsidiary legislation. These schemes are also required to comply with the general disclosure requirements set out in separate product codes issued by the Commission, in addition to the codes and guidelines issued by the MPFA which lay down the operational requirements and specific disclosure contents; and
  - (d) immigration-linked investment schemes are a unique type of scheme subject to a separate product code. Since no such schemes have been authorized, or have remained authorized, since March 2001, the Commission may consider repealing this product code in the future if this type of scheme proves to be obsolete.

The Handbook will apply to all new products and documents within its scope on and from the date the Handbook comes into effect. Thus, where an application is made on or after the effective date for the authorization of a relevant product or the issue of a relevant document, we will expect such product or document to comply with Handbook requirements. Where products or documents have been authorized prior to this date, we will provide for their transition into the new regime over a reasonable period of time. In this regard, please refer to the proposals relating to implementation of Handbook requirements and transition periods for the various types of investment products at the end of Sections 1, 2 and 3 of this Part II respectively.



## Key proposals in the Handbook

### Principles applicable to all products covered by the Handbook

7. Section I of the Handbook sets out seven overarching principles which apply to all products within the scope of the Handbook. These principles provide guidance on certain matters described below and also provide a framework for interpretation of requirements in the specific product codes. These principles allow scope for the market to develop without forsaking appropriate investor protections.
8. Section I of the Handbook outlines general standards expected of key parties such as product providers, including guidance on matters such as selection of counterparties and other parties playing key roles in respect of investment products and dealing with conflicts of interest, to ensure greater product transparency. To enhance disclosure requirements, it also sets a cross-product disclosure standard and requirements for presentation of information about products. These general standards apply in addition to the more specific requirements for particular types of products under the three product codes.
9. Section I of the Handbook also includes further guidance on marketing materials, or advertisements, for investment products, as contemplated in the FS Report<sup>10</sup>. In the case of collective investment schemes, the principles set out in Section I of the Handbook augment existing requirements. In the case of unlisted structured products, the general principles operate in tandem with the product-specific advertising guidelines included in the SP Code and discussed below. These general principles and the guidelines specific to unlisted structured products are derived from the Commission's existing practice, and reflect our regulatory intent in setting standards for authorization of the issue of these documents.
10. As indicated in the FS Report<sup>11</sup>, we do not support the most drastic solution of banning all but the most anodyne advertisements, which announce a product but give no details as to its nature. We believe that advertisements play a role in promoting interest and encouraging competition among product issuers. However, it is essential that advertisements should not be biased, false or misleading and that they present a balanced overall picture.
11. We take this opportunity to remind senior personnel of issuers of advertisements that it is their responsibility to ensure that the contents of their advertisements comply with applicable requirements and are not misleading. The new Handbook requires issuers of advertisements to ensure that each advertisement is reviewed by a person who is designated by senior management and who is authorized to issue the advertisement on behalf of such issuer.

#### Question (1)

Do you have any comments on the Overarching Principles Section of the Handbook generally or any particular provisions in the Section? Please explain your views.

<sup>10</sup> Paragraph 28.7 of the FS Report

<sup>11</sup> Paragraph 28.5 of the FS Report



## Product key facts statements

12. Further to our recommendation to the Administration in the FS Report<sup>12</sup>, we will require offering documents for products covered by the Handbook to include user-friendly summaries setting out key information about the products.
13. These summaries, or Product KFS, will be standardized to the extent possible to enable investors to compare products more easily. The Handbook also sets out specific requirements for presentation of information aimed at making them easy to read.
14. Product KFS should be kept concise if they are to serve their purpose. An absolute page limit may not be appropriate, however, as it may encourage more densely-packed layout and discourage the use of illustrations and examples. The Handbook will therefore set out applicable principles, along with guidance for issuers that Product KFS should generally be no more than four pages in length, although it would be acceptable for them to be longer than this if necessary to accommodate graphics, charts and diagrams which are useful for investors.
15. We attach (as Appendix B to this consultation paper) proposed Product KFS templates for commonly-available retail investment products, namely a general fund, a guaranteed fund or fund with structured pay-outs, an index fund, an exchange-traded fund, an ILAS and an unlisted structured product. Upon the implementation of the finalised Handbook, illustrative templates for Product KFS will be made available on the Commission's website for reference.

## A new code on unlisted structured products

16. The SP Code will set out the criteria that the Commission would normally consider before exercising its power to authorize the issue of offering documents or advertisements for unlisted structured products. The main proposals in the SP Code broadly address the product transparency and enhanced disclosure objectives set out above, and include:
  - (a) eligibility requirements: the SP Code formalizes and augments the Commission's practice in requiring issuers and guarantors of unlisted retail structured products to meet certain eligibility requirements;
  - (b) appointment of a Hong Kong product arranger: the SP Code will require the formal appointment of a Hong Kong-licensed product arranger in respect of unlisted structured products issued by certain types of issuer. We also propose, for consideration, the requirement that a product arranger be appointed where an issuer (and a guarantor, where applicable) is not a licensed corporation or registered institution in Hong Kong. A product arranger will be required to be licensed or registered to conduct Type 1 and Type 4 regulated activities under the SFO. The SP Code sets out obligations and responsibilities for product arrangers;
  - (c) eligibility requirements for collateral in the case of collateralised structured products;

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<sup>12</sup> Paragraph 26.6 of the FS Report



- (d) the requirement that product issuers provide daily indicative valuations of their products throughout their respective terms;
  - (e) the requirement for regular liquidity provision;
  - (f) offering document disclosure requirements, including provisions concerning Product KFS and risk disclosure with respect to any collateral;
  - (g) detailed guidance on advertisements; and
  - (h) ongoing disclosure obligations: in accordance with our recommendation to the Administration<sup>13</sup>, the SP Code imposes obligations on issuers to provide notification in a timely manner of certain material adverse changes, and to facilitate dissemination of this information.
17. A separate public consultation is planned with respect to certain legislative reforms which will have implications for the regulation of structured products offered to the public in Hong Kong. This is discussed in paragraphs 33 to 36 below.
18. Further details of the proposals in the SP Code are set out in Section 1 of this Part II.

#### **New advertising guidelines for unlisted structured products**

19. The SP Code includes new advertising guidelines for unlisted structured products. As noted above, these guidelines largely reflect the Commission's existing approach in authorizing the issue of these documents.

#### **Updating the regime applicable to retail funds and ILAS to strengthen our position as an asset management center**

20. Some parts of the UT Code have been revised. The changes are largely confined to Chapters 7 and 8 of that code.
21. The main proposals in the revised UT Code are:
- (a) to provide increased investment scope for non-UCITS schemes<sup>14</sup>, bringing applicable requirements broadly into line with those applicable to UCITS III schemes with expanded powers, thus creating the opportunity for non-UCITS funds to grow and develop;
  - (b) to codify regulatory principles for structured funds;
  - (c) to provide increased flexibility for retail funds to invest in collective investment schemes and other financial instruments concurrently; and
  - (d) to require annual reports to be published in both English and Chinese.

<sup>13</sup> Paragraph 27.3 of the FS Report

<sup>14</sup> "UCITS schemes" mean collective investment schemes already authorized under the relevant national legislation of a member state of the European Union implementing the "Council Directive 85/611/EC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)" (as amended)



22. Please refer to Section 2 of this Part II for details of the proposals in the revised UT Code.
23. The revised ILAS Code imposes enhanced disclosure requirements for the offering documents for ILAS, in addition to codifying certain existing practices in relation to ILAS. Please refer to Section 3 of this Part II for details of the proposals in the revised ILAS Code.

## Regulatory approach

24. We believe that Hong Kong should maintain its disclosure-based approach in tandem with conduct regulation of intermediaries who sell products and supported by other regulatory pillars, in order to provide an appropriate level of protection for investors' interests in acquiring investment products. This is also the approach taken in other major financial centers like the U.S., the U.K. and other countries within the E.U., Australia and Singapore.
25. In the Handbook, we propose certain structural requirements for specific products to complement product disclosure requirements and to increase product transparency. This is already the case with retail funds authorized in Hong Kong, where certain eligibility criteria are imposed on parties such as fund managers and trustees/custodians. The structural requirements in the Handbook serve as basic standards for those parties who play key roles in respect of an investment product.
26. Additional structural requirements cannot, however, be regarded as failure-proof measures for investment products. Disclosure and conduct regulation still play an indispensable role. It is important to make sure that, before an investor makes his/her investment decision, he/she will be provided with all relevant information, particularly with respect to the risks involved in the investment. It is also important that intermediaries or distributors fulfil applicable requirements when selling or recommending investment products to their clients, particularly with respect to suitability considerations. These measures are supported by investor education initiatives and strong and effective enforcement actions against those who fail to meet prescribed standards.
27. This enhanced approach is not "product" or "merit" regulation, where the regulator judges the merits of an investment product before it is marketed. We do not propose that Hong Kong adopt this type of product regulation regime for the following reasons:
  - (a) a product-regulation regime is not the model adopted in leading financial jurisdictions such as the U.S., the U.K. and other countries within the E.U., Australia and Singapore;
  - (b) we do not believe that the regulator should become the final judge of the soundness or suitability of a product. In an extreme case, product regulation could be obstructive to market innovation because the regulator may substitute its own preferences for those of investors;
  - (c) we do not believe that investors should be restricted in their choice of investments. We believe that limiting approvals of products to those judged suitable for all types of investors would result in a narrower selection of products available to investors and militate against Hong Kong's reputation and status as an international financial center; and



(d) we do not believe that it is appropriate for regulators to assess products with a view to assigning a risk rating.

28. Having regard to the practical needs of the market, the need to permit investors to make their own investment choices from a broad range of investment products, and the regulatory platform established by the SFO, we believe Hong Kong's interests are best served by a disclosure-based regime enhanced by the recommendations we have made.

## General matters

### The scope of the SP code

29. The SP Code is intended to cover all unlisted structured products commonly offered to the public in Hong Kong at present, such as equity-, credit- and commodity-linked notes, equity-linked investments and equity-linked deposits.
30. In future, where issuers seek authorization in respect of types of unlisted structured products that are new to the market, the Commission will consider these on a case-by-case basis and, where appropriate, consult the Products Advisory Committee (see the discussion below). Where necessary, the Commission will engage in further public consultation and/or publish further guidance on requirements for these types of structured products.
31. Currency and interest rate products are generally regarded as banking transactions or treasury instruments of banks. There are various exemptions in Part IV of the SFO in respect of currency and interest rate products issued by authorized financial institutions. The common types of currency-linked and interest rate-linked products issued by banks will therefore fall outside the scope of the SP Code.
32. As noted above, listed structured products will continue to be subject to the Listing Rules. They are not, and will not be, required to seek the Commission's authorization.
33. Currently, investment products that take the legal form of debentures, such as equity-linked notes, fall within the prospectus regime in the CO, while other structured products are subject to the SFO's requirements for offers of investments.
34. A separate consultation is proposed on certain legislative reforms relating to the prospectus provisions in Parts II and XII of the CO (the CO Proposal). This consultation paper, including detailed provisions of the draft Bill and proposed legislative amendments to the CO and the SFO respectively, is expected to be published later this year.
35. Under the CO Proposal, the prospectus provisions in Parts II and XII of the CO would be disapplied with respect to public offers of all structured products taking the legal form of debentures. This would mean that the entire CO prospectus regime, including the safe harbours from prospectus requirements in the 17th Schedule to the CO, would no longer apply to such public offers. The aim is to transfer the regulation of the public offering of structured products in the form of debentures from the CO prospectus regime to the offers of investments regime in Part IV of the SFO, under which statute the Commission would publish codes and guidelines setting out our regulatory policy on such products.
36. Pending enactment of the proposed legislative reforms, debenture-type structured products will continue to be subject to the prospectus regime and we will authorize



prospectuses for these types of products for registration under the CO accordingly. In reviewing such applications for authorization, the Commission will have regard to the SP Code, which sets out our regulatory intent and policy in overseeing the disclosure relating to unlisted structured products that are offered to the public in Hong Kong.

### **The Products Advisory Committee**

37. With a view to rationalising the regulation of products being offered to the public and moving towards a larger level playing field, we propose to establish a new cross-products Products Advisory Committee to replace the existing Committee on Unit Trusts (the CUT) and the Committee on Investment-Linked Assurance and Pooled Retirement Funds (the ILAC).
38. The Products Advisory Committee will provide advice on policy and market trends across different product areas, including those covered in the Handbook.
39. The Commission will consult the Committee, either in a subcommittee format or at the Committee level, on products- or markets-related issues. The Committee will comprise representatives of industry participants and other stakeholders with diverse knowledge and expertise.
40. The Products Advisory Committee, as its name suggests, will be purely advisory in nature. This will bring about a more streamlined process for the exercise of the powers of authorization under the SFO.

### **Implementation and transitional arrangements for the Handbook**

41. We are mindful of the implications of these proposals for existing, publicly-offered products and the relevant offering documents and advertisements. We appreciate that both the market and investors will need time to adjust to changes.
42. We intend to conduct an extensive investor education campaign and to continue an active dialogue with other regulators and market participants once the Handbook is finalised to ensure that all concerned are familiar with its requirements.
43. There are currently more than 2,100 retail funds and 230 ILAS in Hong Kong. There are also several current offerings of unlisted structured products. In the light of past experience in dealing with licensees' transition into the new regime under the SFO, we appreciate that the industry will need sufficient time to implement the new requirements. For example, the preparation of Product KFS for all such products may take some time, particularly in the case of issuers who may need to file disclosure documents in more than one jurisdiction.
44. In our soft consultation with the market, it appeared that different product types may require different transition periods. The corresponding sections of this Part II will provide further details of the proposals for implementation of and transition to the requirements for the SP Code, the revised UT Code and the revised ILAS Code respectively.



### **Further details, draft codes and list of consultation questions**

45. The key proposals in the SP Code, the revised UT Code and the revised ILAS Code are respectively discussed in further detail in Sections 1, 2 and 3 of this Part II. Consultation drafts of the SP Code, the revised UT Code and the revised ILAS Code are attached in Appendix A.
46. A list of consultation questions pertinent to the Handbook is set out in Section 4 of this Part II.



## Section 1

### Key proposals in the Code on Unlisted Structured Products

#### Introduction

47. The Commission invites comments from the public on the proposed SP Code, which sets out guidelines for unlisted structured products to be offered to the public in Hong Kong and the criteria that the Commission would normally consider before exercising its powers to authorize the issue of the relevant offering documents and advertisements.
48. The scope of the SP Code is limited to unlisted structured products offered to the public in Hong Kong.
49. Unless otherwise defined herein, all terms used in this Section 1 have the meanings given to such terms in the SP Code.

#### Background

##### Key proposals

50. The two main proposals in the SP Code, which will be discussed in further detail below, are:

**Enhancing disclosure** - our proposal includes:

- (a) a requirement for a Product KFS;
- (b) standards for disclosure in offering documents;
- (c) standards for disclosure in advertisements; and
- (d) requirements for ongoing disclosure of material information;

and

**Increasing product transparency** – our proposal includes the following measures:

- (a) eligibility requirements for Issuers and Guarantors (including special purpose vehicle Issuers);
- (b) a requirement for the appointment of, and obligations and responsibilities imposed on, Product Arrangers, in certain cases;
- (c) criteria for eligibility of collateral;
- (d) criteria for eligibility of reference assets;
- (e) a requirement for provision of regular indicative valuations of the structured product; and
- (f) a requirement for regular liquidity provision.



## Regulation of retail structured products in other financial markets

51. Our research indicates that few financial centers have yet issued any regulatory codes or guidelines specifically targeting structured products as a class. Leading jurisdictions such as the U.S., the U.K. and other countries within the E.U. adopt a largely disclosure-based approach for most financial products, which is the approach that the Commission believes should continue to be adopted in Hong Kong. As stated in the FS Report, the Commission recommends that Hong Kong maintain the regulatory philosophy of disclosure coupled with conduct regulation of intermediaries, rather than “product” or “merit” regulation.

## The nature of structured products

52. It is important to bear in mind that structured products commonly seen in the market are usually not actively managed – they are largely products sold on a “passive” and “pre-packaged” basis.
53. The investment strategies of these structured products and, in the case of collateralised structured products, any collateral securing the issuer’s obligations to investors, are often fixed at the outset and the payouts thereunder are fixed according to a pre-determined formula. For a collateralised structured product, if the value of the collateral drops during the investment term of the structured product, there is usually no obligation imposed on any party to actively manage or substitute the collateral or otherwise replenish the loss in value. These are some of the inherent risks which must be disclosed in the offering documents for structured products.

## Soft consultation

54. We have conducted informal or “soft” consultations with financial institutions which have acted as issuers, arrangers or distributors of structured products over the past few years on a number of key issues relating to the proposed disclosure enhancements and basic structural requirements.

## General remarks

55. The SP Code is intended to provide a flexible framework within which unlisted structured products may be offered to the public in Hong Kong.
56. The Commission intends to increase its investor education efforts to assist the investing public to understand the requirements in the SP Code.

## Definition of “structured products”

57. As noted above, the consultation paper in relation to the CO Proposal, including detailed provisions of the draft Bill and proposed legislative amendments to the CO and the SFO respectively, is expected to be published later this year. The proposed legislative amendments will include a definition of “structured products”.
58. We anticipate that the present product-related consultation will be concluded and the SP Code finalised before any legislative amendments resulting from the CO Proposal consultation.



59. The definition of “structured products” to be adopted in the SP Code will need to be consistent with the definition used in the CO Proposal at that time.
60. It should be noted, however, that, to the extent that the definition ultimately adopted for purposes of the legislative amendments as a result of the CO Proposal contemplates types of structured products not yet covered by the SP Code, the definition of “structured products” in the SP Code may differ in some respects. As we note elsewhere, the SP Code is intended to cover unlisted structured products commonly available to the public in Hong Kong at present. Examples of these are equity-, credit- and commodity-linked notes, equity-linked investments and equity-linked deposits. Where a type of structured product falls outside the scope of the SP Code definition and/or is new to the Hong Kong retail market, the Commission retains the flexibility to publish further guidance, or, where necessary, conduct further public consultations and publish further product codes.
61. If necessary, the definition of “structured products” adopted in the SP Code will be amended at the conclusion of the process contemplated in the CO Proposal to take account of the final legislative amendments.

## Key proposals

### Proposal 1: Disclosure enhancements

62. The Commission’s proposed measures to enhance the disclosure regime for unlisted structured products offered to the public include the requirement for an offering document to contain a Product KFS and the provision of guidance on disclosure in offering documents and advertisements respectively.

#### (A) Product key facts statement

63. The Commission proposes that Product KFS be included as part of the offering documents for all structured products. Please refer to paragraphs 12 to 15 above for further details.
64. An illustrative template Product KFS for an unlisted structured product is attached in Appendix B to this consultation paper. Upon the implementation of the finalised Handbook, an illustrative template will be made available on the Commission’s website for reference.

#### (B) Disclosure in offering documents

### Background

65. The Commission expects that the structured products market will continue to grow and develop. In light of this, the Commission believes that it is important to codify certain existing practices relating to product disclosure and augment existing disclosure requirements for offering documents for structured products.

### Proposals

66. Instead of adopting rigid and prescriptive rules, the SP Code sets out principles providing guidance on disclosure standards that the Commission expects, together with more detailed, specific requirements for items to be included in offering documents.



67. The Commission believes that the overarching disclosure standard applicable to structured products should be that the offering document must contain the information necessary for investors to be able to make an informed judgment of the investment proposed to them.
68. The Commission notes that, where structured products are issued under a programme, it is a well-established practice that the offering document in respect of a particular structured product issue may consist of more than one document which, when read together as a whole, comprise the offering document for that issue. The Commission proposes that such multiple documents, when read together as a whole, must meet the same requirements applicable to a single offering document. The Issuer must ensure that the overall presentation in multiple documents would not confuse or mislead investors or otherwise impede an investor's understanding of the risks and nature of the structured product.
69. The specific contents requirements applicable to offering documents for structured products are set out in Appendix C to the SP Code. Key points to be addressed include the following:
- (a) information on the Issuer and the other key parties (any Product Arranger(s) appointed, any Guarantor, trustees/custodians and Key Product Counterparties (essentially, parties to agreements underpinning the structured products));
  - (b) the characteristics, nature and features of the structured product;
  - (c) details of the terms of the offer of the structured product, including fees and charges;
  - (d) payment and settlement mechanisms;
  - (e) a Product KFS (please see paragraphs 63 and 64 above);
  - (f) scenario analyses showing a balanced picture of the potential payout;
  - (g) risk disclosures;
  - (h) information on the reference assets, obligations and benchmarks;
  - (i) for guaranteed structured products, information on the guarantee;
  - (j) for collateralised structured products, information on the collateral;
  - (k) financial reports and accounts for all relevant parties; and
  - (l) the parties to whom investors have recourse, the extent of such recourse and investors' rights in the event of early termination or default (this would generally be expected to address the capacity in which each relevant party is acting).



## (C) Disclosure in advertisements

### Background

70. In the FS Report<sup>15</sup>, it was recommended that the Commission “revise its published guidance on marketing materials to establish general principles, supplemented where necessary by specific requirements, that assist the market to develop materials that are correct, properly balanced and are not misleading.”
71. In drafting the proposed advertising guidelines (SP Advertising Guidelines), set out in Appendix D to the SP Code, the Commission has drawn reference from the “Guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under the Companies Ordinance” issued by the Commission in March 2003, the “Advertising Guidelines applicable to Collective Investment Schemes authorized under the Product Codes” issued in July 2008 and Appendix 1 Part D of the Listing Rules.

### Proposals

72. The SP Advertising Guidelines set out guidance for issuers of advertisements of unlisted structured products. These guidelines largely reflect the Commission’s existing approach in authorizing the issue of these advertisements and set out the criteria that the Commission would normally consider before exercising its powers to authorize advertisements in respect of structured products.
73. The overarching principle is that advertisements must not be false, biased, misleading or deceptive. They must be clear and fair and present a balanced picture of the structured product. It is proposed that all advertisements to be issued in respect of a structured product must meet the requirements set out in the SP Advertising Guidelines.
74. The issue of advertisements relating to unlisted structured products will continue to require prior authorization and pre-vetting by the Commission. The Commission will have regard to the standards set out in the SP Advertising Guidelines and the other applicable provisions of the Handbook in reviewing these advertisements.

## (D) Ongoing disclosure of material information

### Background

75. As mentioned in the FS Report<sup>16</sup>, there is at present no statutory requirement for ongoing disclosure of information to investors in unlisted structured products after the initial investment. There is no statutory requirement for Issuers to ensure that investors are provided with information as to important events which may affect the value of their investments in these products.
76. The Commission believes that Issuers should be obliged to disclose a range of information to investors on a continuous basis to keep them informed of relevant information which may affect their investments. However, the Commission is mindful of the need to strike a balance as to the amount and nature of information to be provided

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<sup>15</sup> Para 28.7 of the FS Report.

<sup>16</sup> Para 27.1 of the FS Report.



so as to avoid overloading investors with information and causing unnecessary confusion. As a related matter, we note intermediaries' obligations to pass such information to investors (see paragraph 31 of Part I of this consultation paper).

## Proposals

77. The SP Code requires Issuers to provide the information described in 7.6 of the SP Code to investors on an ongoing basis throughout the investment term of the relevant product, including financial updates, any material adverse change affecting the Issuer, any Guarantor or any Key Product Counterparty, or any material failure of collateral to meet the eligibility requirements, if applicable. In many cases, an investor's contact point in respect of a structured product is the distributing intermediary and not the Issuer directly. The SP Code requires Issuers to facilitate timely dissemination of the information; intermediaries are subject to Code of Conduct requirements to disclose such information to their clients.

### Question (2)

What are your views on the proposed disclosure requirements in Appendix C (*Information to be Disclosed in Offering Documents for Unlisted Structured Products*) and Appendix D (*Advertising Guidelines Applicable to Unlisted Structured Products*) to the SP Code?

### Question (3)

What are your views on the requirement for Issuers to provide ongoing disclosure of the types of information set out in 7.6 of the SP Code throughout the term of a structured product? Please explain the reasons for your views. Are there any other matters which you think an Issuer should be obliged to disclose to investors on an ongoing basis?

## Proposal 2: Increasing product transparency

78. In addition to measures to enhance disclosure, the Commission considers that investors' interests would be better served if there were greater transparency in product infrastructure and maintenance, the appointment of parties playing key roles in respect of a structured product and matters such as valuation in respect of the product from manufacture through to maturity.

### (A) Eligibility requirements for Issuers and Guarantors

#### Background

79. Over the past few years, the Commission has seen three main types of issuers offering structured products to the public in Hong Kong:
- (a) direct issuers – banks or securities firms (i.e. registered institutions or licensed corporations) typically issuing structured notes and equity-linked investments as part of their own product programmes, and banks issuing equity-linked deposits;



- (b) subsidiaries of substantive corporations (usually banks or securities firms but less frequently “blue chip” corporations) typically issuing structured notes and equity-linked investments with guarantee support from substantive corporate parents; and
- (c) special purpose vehicles (SPVs) issuing collateralised structured notes.

80. The SP Code requires that Issuers/Guarantors of structured products meet certain eligibility standards as to net asset value and either credit rating or regulatory status. The proposed eligibility requirements are comparable to those applicable to issuers/guarantors of listed structured products under Chapter 15A of the Listing Rules.

### Proposals

81. The SP Code imposes eligibility requirements with respect to Issuers, and (in the case of guaranteed structured products) Guarantors, both at the time of issue of the structured product and for the period during which any of the Issuer’s obligations to investors under the terms and conditions of the structured product remain outstanding.

82. In the case of a direct Issuer or an entity with guarantee support from a substantive entity, Appendix A to the SP Code sets out core requirements which must be met by either the Issuer or (in the case of a guaranteed structured product) the Guarantor. The relevant entity must:

- (a) have a net asset value of not less than HK\$2 billion; AND
- (b) either:
  - (i) be a licensed bank regulated by the HKMA or a corporation licensed by the Commission (or an overseas banking entity subject to equivalent regulatory oversight); OR
  - (ii) have a credit rating which is one of the top three investment grades awarded by at least one rating agency of international standing and reputation acceptable to the Commission;

AND

- (c) not be subject to insolvency or other similar proceedings as more fully described in Appendix A to the SP Code.

83. In addition to satisfying the core requirements, the Issuer, or (in the case of a guaranteed structured product) the Guarantor, must also be in good standing.

An entity may offer a structured product to investors and, for purposes of meeting its obligations under the terms of the product, rely upon one or more financial transactions which the offering entity in turn has entered into with third parties. For example, a bank may offer an equity-linked deposit where the bank, to support that product, has entered into derivative transactions with one or more counterparties. Issuer requirements will apply to the offering entity notwithstanding any arrangements which it may have put in place to support the product or otherwise hedge its exposure. These requirements include due diligence in the selection of the counterparties to such underlying transactions and disclosure of information (including an explanation of counterparty risk



exposure and provision of financial statements) with respect to such counterparties where they are Key Product Counterparties.

## Use of special purpose vehicles

### Background

84. In the case of SPV Issuers which cannot meet the proposed eligibility requirements in paragraphs 82 and 83 above, investors would rely primarily (if not totally) on either collateral held as security for, or a guarantee of, the Issuer's obligations.
85. Structured products issued by SPVs are typically collateralised, and would rarely be supported by guarantees. In general, SPVs are set up to act as single-purpose investment vehicles and hence are not heavily capitalised. An SPV is usually incorporated outside Hong Kong and is designed with the aim of being insulated from liabilities of third parties or the corporate group sponsoring its establishment and protected from dissolution risk. It will normally have appropriate restrictions on its filing of a bankruptcy or winding-up petition or taking any other insolvency action. SPVs can be used as issuing vehicles for different kinds of structured products. The use of an SPV as the Issuer of structured products has its justifications.

### Proposals

86. The Commission proposes to impose the following structural and eligibility requirements in respect of SPV Issuers and collateralised structured products:
- (a) basic attributes for SPV Issuers (please refer to paragraph 88 below for further details);
  - (b) the appointment of a Hong Kong-licensed Product Arranger (please refer to paragraphs 90 to 94 below for further details);
  - (c) selection of collateral in accordance with a set of principles-based criteria; (please refer to paragraph 98 below for further details); and
  - (d) enhanced and specific risk disclosure pertaining to a collateralised SPV structure (please refer to paragraph 107 below for further details).
87. The SP Code requires that the obligations of an SPV Issuer to investors under the terms of a structured product be either (i) guaranteed by a guarantor meeting the eligibility requirements discussed above (and set out in Chapter 3 of the SP Code), or (ii) secured against collateral which meets the criteria set out in Chapter 5 of the SP Code (see paragraph 98 below).
88. An SPV Issuer must satisfy the criteria in 3.3(b)(ii) of the SP Code, which, in summary, require that it:
- (a) be established for the sole and exclusive purpose of issuing the structured products and incidental activities;
  - (b) be subject to ownership transfer restrictions;



- (c) not have any encumbrances on its share capital or ownership interests other than in favour of the investors;
- (d) not have any other borrowings or similar indebtedness;
- (e) maintain proper accounts and records;
- (f) have independent, professional directors or trustees; and
- (g) be “bankruptcy remote”.

89. SPV Issuers may hedge their obligations to investors under the terms of a structured product by entering into one or more financial transactions. The SPV may grant a security interest in the collateral held in respect of the structured product to the counterparty/ies to these transactions, and the terms of these transactions may give such counterparties a claim to the proceeds of this collateral if they are owed amounts by the SPV in the event of early termination of the transaction. The SP Code, however, stipulates as an overriding principle that Issuers and Product Arrangers should pay the highest regard to the protection of investors’ interests in designing a structured product and therefore requires that, going forward, investors’ claims to collateral proceeds should be accorded priority and should not be subordinated to claims to the proceeds of the same collateral by counterparties to such transactions. The Commission would like to invite market participants and the wider public to provide their views on the proposed requirements.

## **(B) Appointment, obligations and responsibilities of Product Arranger**

### **Background**

90. The Commission considers that there is a need for Issuers, and in particular SPV Issuers, to maintain a dialogue with investors and regulators on material issues that may arise after the sale of a structured product. Therefore, particularly in the case of SPV Issuers, it is important that an entity with a licence/registration status with the Commission or the HKMA be held answerable to the Commission for certain administrative matters and continuing regulatory compliance throughout the life of a structured product.

### **Proposals**

- 91. The SP Code requires that, for each collateralised structured product issued by an SPV, a Product Arranger be appointed for so long as any of the SPV Issuer’s obligations to investors under the terms and conditions of the relevant structured product remain outstanding. The Product Arranger must be licensed or registered in Hong Kong to conduct Type1 and Type 4 regulated activities.
- 92. The SP Code requires that a Product Arranger must be in good standing. The Commission may require the Product Arranger to confirm its own record of past disciplinary actions or proceedings and such other matters which may reasonably affect its good standing and its competence.
- 93. Without limiting the Issuer’s obligations and responsibilities at law and under the SP Code, it is proposed that, in the case of an SPV Issuer, the Product Arranger be required to assume, to the same extent as if it were the Issuer, responsibility for compliance by



the Issuer with all applicable requirements in the SP Code. The Product Arranger would not, however, by virtue of this provision of the SP Code, be responsible for the Issuer's financial obligations in connection with the structured product.

94. Structured products are also issued by substantive entities, or issued by non-substantive entities (including SPVs) but guaranteed by substantive entities, where these entities are not subject to prudential regulation by the financial regulators of Hong Kong. Therefore, the Commission would like to invite views from the public as to whether a Hong Kong-licensed Product Arranger should also be appointed for each structured product issued by an Issuer or guaranteed by a Guarantor which is not a local Regulated Entity (i.e. where the Issuer/Guarantor is neither a licensed bank regulated by the HKMA nor a corporation licensed by the Commission pursuant to section 116 of the SFO).

## **(C) Collateral**

### **(i) Eligibility criteria**

#### **Background**

95. The Commission believes that it is important to establish criteria for the eligibility of collateral in order to enhance the transparency of collateralised structured products.

#### **Proposals**

96. The SP Code sets out specific requirements for the selection of collateral in the case of collateralised structured products.
97. The overall objective of the proposed requirements is to ensure that the collateral is used primarily to secure the Issuer's obligations under the structured product to the investors. Investors should, however, understand that despite the proposed requirements it is not possible to eliminate certain risks inherent in a collateralised structure. Investors must fully understand the risks involved and make sure that they are willing to and are able to take these risks when investing in collateralised structured products.
98. Issuers and Product Arrangers must be prudent in selecting the collateral for a structured product. To this end, taking the views of the industry into account, the SP Code requires that collateral held as security for the Issuer's obligations to investors under the terms of a structured product must either be cash deposits or must satisfy the requirements set out in 5.13 of the SP Code. Key requirements are that the assets comprising the collateral must:
- (a) be liquid and tradable;
  - (b) have a credit rating which is one of the top three investment grades awarded by at least one rating agency of international standing and reputation acceptable to the Commission;
  - (c) not include structured products or securities issued by SPVs or similar entities;
  - (d) be fully-funded;



- (e) be used solely for the purpose of securing the interests of the investors, and not primarily used to enhance the return on the structured product;
- (f) be appropriately diversified;
- (g) not be issued by a party who is or is related to the Issuer, a Product Arranger, any Guarantor or any Key Product Counterparty; and
- (h) not subject investors to undue risks.

Details of the assets comprising or to comprise the collateral are required to be disclosed in the offering document. In some circumstances, however, the collateral may not have been identified or acquired as of the date of the offering document, or the Issuer may be subject to regulatory obligations preventing such detailed disclosure at that time. In such a case, the SP Code requires that the Issuer provide certain information in the offering document and, subsequently, provide investors with the remaining details required by the SP Code by the business day in Hong Kong following the acquisition of the collateral. This would in effect be within two business days in Hong Kong after the relevant trade date, since the SP Code requires that Issuer acquire all collateral and create all security interests in such collateral for the benefit of investors (see paragraphs 102 to 105 below) at the latest by the end of the first business day in Hong Kong after the trade date.

99. The SP Code requires that the collateral be marked to market daily. The Issuer must make sure that the valuation is verifiable and independently conducted, according to established valuation policies consistently applied and disclosed in the offering document.

## (ii) Basic structural requirements

### Background

100. Hong Kong adopts an open architecture for the offering of investment products and this is conducive to allowing investors a wider investment choice. It is common for investors in Hong Kong to invest in overseas stocks or securities held by overseas depositories. Risks arising from such overseas investments are similar to those arising from an investment in structured products with overseas collateral held by overseas trustees/custodians.

### Proposals

101. The Commission believes that risks relating to the use of overseas collateral should primarily be addressed by prominent disclosure of such risk factors in the offering documents to alert investors to such issues.
102. In addition to the requirements for selection of collateral, the Commission proposes a number of further requirements relating to collateral in Chapter 5 of the SP Code, including those set out below. These requirements must be met at all times so long as any of the Issuer's obligations to investors under the terms and conditions of the relevant structured product remain outstanding. The requirements, broadly stated, are that:
- (a) the collateral must be clearly identified and ring-fenced for the benefit of the investors in the relevant structured product;



- (b) upon enforcement, investors' claims to the proceeds of the collateral must have priority; and
  - (c) the Issuer should ensure that the collateral can be realised in an efficient and timely manner.
103. The Commission also generally expects that, without the investors' consent, there will be no power on the part of the trustee/custodian alone, or any other counterparty to direct the trustee/custodian to substitute collateral.
104. The SP Code requires that, details of the security arrangements, details of the duties owed by trustees and custodians of the collateral to the investors, and any restrictions and limitations to which they are subject, be disclosed in the offering documents.
105. The Commission has also proposed (in Appendix B to the SP Code) a number of eligibility requirements for trustees and custodians to be appointed in respect of structured products. As proposed, only a Hong Kong-licensed bank, a trust company which is a subsidiary of such a licensed bank, or a foreign banking institution subject to equivalent regulatory oversight acceptable to the Commission may act as a trustee or custodian in respect of a structured product. Further, such trustee or custodian must be independently audited and have minimum issued and paid-up capital and non-distributable capital reserves of HK\$10 million or its equivalent in foreign currency. A proposed trustee/custodian must not be subject to insolvency or other similar proceedings.
106. The Commission welcomes the market's feedback on the feasibility of practical steps necessary to implement the proposed measures, bearing in mind the need to give the highest regard to the protection of investors' interests in designing a structured product.

**(iii) Prominent and upfront risk disclosure applicable to collateralised structured products**

**Proposals**

107. In line with Hong Kong's disclosure-based approach, the Commission believes that prominent and upfront disclosure of risks is important. For details of measures proposed to enhance disclosure requirements, please refer to Proposal 1 of this Section 1. For example, in the case of collateralised structured products, the Commission would expect such risk disclosure to include the following:
- (a) that **the collateral is not managed on an active basis** – given the nature of structured products, there is usually no extra source of funding to top up the value of the collateral or actively manage the collateral after the issuance of the structured product; and
  - (b) that **the value of collateral may fall rapidly** – the above structural requirements serve as the guiding principles for the Issuer and the Product Arranger to select the collateral. However, it should be noted that, once collateral has been acquired, the value of the collateral may change during the term of the structured product due to many different market factors and could fall rapidly if market conditions worsen.



## (D) Reference assets - eligibility criteria

### Background

108. For the purpose of enhancing transparency, the Commission considers that it is necessary to codify the existing eligibility criteria for reference assets for structured products.
109. The Commission believes that reference assets should be carefully selected by the Issuer to avoid a false market in the reference asset or the structured product. Depending on their nature, reference assets should be of sufficient liquidity and/or their valuation must be transparent.

### Proposals

110. As a general principle, the SP Code provides that the reference assets to which a structured product is linked must be acceptable to the Commission. It is proposed that in considering whether reference assets are acceptable, the Commission will generally take into account the following factors:
  - (a) where the structured product is linked to equity securities, indices or funds, whether the proposed reference assets are also eligible from time to time as reference assets for structured products listed on The Stock Exchange of Hong Kong Limited;
  - (b) whether sufficient information about proposed reference assets is, or will be, made available to the investors in English and Chinese;
  - (c) if a proposed reference asset is an index, the name of its publisher, how it is compiled, the frequency with which the index is updated and published and the circumstances in which the index could be modified or discontinued;
  - (d) in the case of structured products linked to a basket or baskets of reference assets, the number of reference assets and their relative weightings; and
  - (e) the extent to which any reference asset, or its price, value or performance or any other relevant attribute could be controlled or influenced by one party or a group of parties.
111. The SP Code requires that reference assets for structured products meet the following criteria:
  - (a) information regarding the performance, value or any other attribute of the proposed reference assets that is relevant to determining the Issuer's obligations under the terms and conditions of the structured product must be transparent and regularly available free of charge to investors; and
  - (b) the basis upon which the value or return of the structured product is linked to each reference asset must be transparent and objective.



## (E) Indicative valuations

### Background

112. The Commission believes that it would be helpful for investors to assess the performance of a structured product if they were provided with regular information about the prevailing market value of their investments.

### Proposals

113. The SP Code requires that Issuers or their market agents make available indicative valuations of structured products on a daily basis throughout their terms. Such indicative valuations are required to be determined in good faith, on an independent basis, and must be fair and reasonable.

## (F) Liquidity provision

### Background

114. In order to provide investors with a means to exit an investment in a structured product before its scheduled maturity, particularly in the case of products with relatively long tenors, the Commission believes that Issuers should be obliged to offer liquidity by providing market-making on a frequent and regular basis.
115. Investors should, however, be aware that they may suffer a loss if they sell their investments before the scheduled maturity, as any price will take into account break funding and unwinding costs.

### Proposals

116. The Commission proposes that, except for structured products with a short tenor of one month or less (in the absence of early termination or default) as stated in the relevant offering document, an Issuer or its market agent should provide liquidity by way of making firm price quotations for the structured product available to investors at least weekly. Such quotations should be fair and reasonable. Issuers must ensure that suitable arrangements are in place with distributors to enable investors to avail themselves of this facility.
117. Investors should note there is a difference between indicative valuations (being a fair market value of the structured product) and the provision of liquidity by making a firm price quotation (being the actual bid price at which the Issuer or its market agent is willing to buy back the structured product). Issuers should ensure that the basis in which the information is provided is clearly set out.

#### Question (4)

What are your views on the eligibility requirements for Issuers and Guarantors of unlisted structured products proposed by the Commission?

#### Question (5)

(a) What are your views on the proposed requirements applicable to SPV



Issuers?

- (b) What are your views on the current proposal to mandate the appointment of a Hong Kong-licensed Product Arranger for structured products issued by an SPV and make such Product Arranger responsible for ensuring an SPV Issuer's compliance with the SP Code throughout the term of the structured product?
- (c) Do you think a Product Arranger should also be appointed for structured products issued by Issuers (whether SPVs or not) or guaranteed by Guarantors where these entities are not local Regulated Entities (i.e. where the Issuers/Guarantors are not licensed banks regulated by the HKMA or corporations licensed by the Commission pursuant to section 116 of the SFO)?
- (d) Other than what has been proposed, what other obligations or requirements (if any, both before and after an offering), do you think a Product Arranger should be made subject to? Please give a list of any such additional obligations with reasons.

Please explain your views.

**Question (6)**

- (a) What are your views on the proposed eligibility criteria for collateral in respect of structured products?
- (b) Do you think that collateral should be subject to any additional eligibility criteria? If so, what criteria?
- (c) What are your views on the requirement that investors' claims to collateral proceeds should be accorded priority and should not be subordinated to claims by counterparties to transactions with the Issuer that are related to the structured product?

**Question (7)**

Do you believe that the Commission should take into account any additional eligibility criteria for reference assets, or any other factors, when considering whether or not to accept a proposed reference asset or asset class for a structured product? If so, please list such additional criteria / factors and give an explanation for each.

**Question (8)**

- (a) Should indicative valuations of structured products be required to be provided daily? Do you think there are additional or other measures which could help investors to assess the performance of their investments? If so, please provide details.
- (b) With regard to the proposal to provide liquidity by way of making firm price quotations, do you think an exemption is justifiable for structured products



with a short scheduled tenor, e.g. of one month or less? How often do you think Issuers or their market agents should provide liquidity by way of making firm price quotations? Do you think that there are other circumstances or periods during the term of certain structured products in which liquidity provision should not be required or could not reasonably be provided? If so, why?

## Further issues for discussion

### References to annualised returns in advertisements

118. References to annualised returns are sometimes included in offering documents and/or advertisements for structured products to facilitate comparison of returns of structured products of different tenors.
119. It is worth noting that the Hong Kong Association of Banks has, in its Code of Banking Practice, provided for banks to quote annualised percentage rates for banking products.
120. The Commission believes that the use of annualised returns may be useful to investors in some circumstances. The Commission is, however, concerned that investors may be given a false impression of the return of the structured product. Investors may not necessarily understand the assumptions upon which the annualised return is based.
121. The Commission proposes that an Issuer may only present annualised rate of expected return of a structured product if all of the assumptions behind the calculation and the fact that it is not the actual return are clearly and prominently stated. The actual and annualised returns must be set out side by side to facilitate investors' understanding of the two figures.
122. The Commission would like to seek the views of the public on allowing references to be made to annualised returns in advertisements and offering documents.
123. To assist the public in better understanding the implications of the use of annualised rates in the context of different structured products, the Commission intends to increase its investor education efforts in this regard.

### Question (9)

Please give your views on the use of annualised returns in offering documents and advertisements for structured products.

### General comment

124. If you have any comments on any other parts of the SP Code which have not been highlighted in this section, please include such comments in your written submissions, indicating the relevant section(s) of the SP Code.



## Transition period

125. To facilitate compliance and a smooth transition to the new regime, the Commission proposes that, where the issue of offering documents and (if applicable) advertisements for structured products has been authorized prior to the effective date of the SP Code and:
- (a) such authorization remains in force as of the effective date; and
  - (b) structured products are being sold to the public using such offering documents,
- all necessary measures must be taken, and all revised or supplemental offering documents (including Product KFS) and (if applicable) advertisements incorporating the necessary amendments required for compliance with the SP Code must be issued, by the end of a transition period which is 6 to 9 months after the effective date of the SP Code.
126. Where offering documents and (if applicable) advertisements for structured products are submitted for authorization after the effective date of the SP Code, or have not yet been authorized as of that date, the Commission proposes that they should be required to comply in full with the SP Code.

### **Question (10)**

Please provide your views on the length of the transition period for compliance with SP Code requirements for unlisted structured products where the issue of documents has been authorized prior to the date of the SP Code's effectiveness.



## Section 2

### Key proposals in the revised Code on Unit Trusts and Mutual Funds

#### Introduction

127. The Commission proposes to revise the UT Code. The proposed amendments have been marked against the current version of the UT Code.
128. The key objectives of the proposed changes are to codify existing practices, enhance the existing regulatory requirements, introduce certain new measures to facilitate further product development, and implement the key recommendations concerning investment products made in the FS Report.
129. The Commission is grateful to the various financial institutions, industry bodies and industry professionals that have helped with our research and for their ideas and views. Our analysis and recommendations have also benefited from the discussions with other Hong Kong regulators and overseas counterparts.

#### Background

130. In mid-2008, the Commission commenced a review of the UT Code with the aim of modernising the regulatory framework for SFC-authorized schemes and broadening the scope for product development, in response to developments in the financial markets, regulatory changes in major overseas fund jurisdictions, and new product proposals presented to us by industry practitioners. The proposed revised UT Code also seeks to provide a broadly level playing field between UCITS III schemes and local schemes so that local managers will have a wider space to develop and grow.
131. The Commission wishes to take the opportunity of this UT Code review exercise to codify our existing practices. These have been developed over the years through our experience in reviewing products and documents submitted for our authorization and in our dialogues with market participants.
132. Finally, the UT Code review also incorporates recommendations submitted by the Commission to the Financial Secretary in the FS Report, to the extent that they are relevant to SFC-authorized collective investment schemes.

### Key proposals

#### Proposal 1: Structured funds

##### Background

133. As a result of the increasing use of financial derivative instruments (FDI) for investment purposes, we have seen the emergence of a new category of schemes which seek to achieve their investment objectives primarily through investing substantially all of the scheme assets in FDI, such as swaps or market access products, or repo agreements or similar arrangements.



134. We have developed a framework for authorizing these structured funds, based on the principles currently embodied in the UT Code. We have also authorized a number of these structured funds. In the revised UT Code, we codify our practice by adding this new category of structured funds as a type of 'specialized scheme', and setting out requirements in respect of these structured funds.

## Proposals

135. The revised UT Code includes structured funds as another scheme type and sets the criteria to which the Commission will normally have regard when reviewing structured funds, including the following requirements:
- (a) the management company of a structured fund and the issuer of any FDI must be independent of each other;
  - (b) the valuation of the FDI must be marked-to-market, with such valuation being conducted independently. There must be regular, reliable and verifiable valuation, through measures such as a valuation committee or engagement of third party services;
  - (c) exposure to the issuer of any FDI (including the relevant counterparty) must be limited to no more than 10% of the net asset value of the scheme. Where this threshold is exceeded, collateral must be provided to bring the net exposure to the counterparty risk of the issuer of the FDI to a level of 10% or less;
  - (d) the collateral has to satisfy the requirements set out in 8.8 of the revised UT Code, including requirements for enforceability, liquidity, valuation, issuer credit quality, diversification and independent custody.
  - (e) structured products whose payouts primarily rely on embedded derivatives or synthetic instruments, or securities issued by special purpose vehicles, special investment vehicles or similar entities, must not be held as collateral.
  - (f) the management company must put in place detailed contingency plans regarding credit events such as a significant downgrading of the credit rating of, or the collapse of, the issuer of FDI;
  - (g) the scheme's offering document must explain the structure, any potential conflicts of interests, and relevant risks; and
  - (h) where the aggregate value of all collateral held by a scheme represents 30% or more of its net asset value, the scheme must publish the nature, value and other specified information relating to the collateral as at each quarter end within one month after the relevant quarter.
136. Pursuant to the revised UT Code, the requirements for structured funds shall apply to all SFC-authorized funds (other than hedge funds) which invest, or may invest, a substantial portion of scheme assets in FDI to achieve their investment objectives. SFC-authorized hedge funds are separately regulated under 8.7 of the revised UT Code.
137. Currently, several SFC-authorized funds use FDI to achieve their investment objectives. These include index funds, exchange-traded funds and guaranteed funds. We propose that exchange-traded funds that are already SFC-authorized and are currently



complying with the applicable counterparty exposure threshold of 15% may choose to continue to comply with the 15% threshold. We would propose to grandfather existing SFC-authorized guaranteed funds that are no longer open for new subscriptions, as any change to the structure of these funds could adversely affect the availability or terms of the guarantees currently supporting these funds.

## Proposal 2: Funds that invest in FDI

### Background

138. Since the implementation of the UCITS III regime, schemes in the E.U. region have had considerable flexibility in their investment activities, including in the use of FDI. Currently, there are over 2,100 unit trusts and mutual funds authorized by the Commission, of which around 1,500 are UCITS III schemes. About 450 of these UCITS III schemes utilise expanded investment powers permitted under the UCITS III regime and invest in various types of FDI. Over the past four years, it is clear that the share of SFC-licensed fund managers is increasing as the value of SFC-authorized funds under their management or advised by them has grown by over 30% to about HK\$590 billion as at the end of 2008 according to the [Fund Management Activities Survey 2008](#). We believe that Hong Kong has the ability to develop into a key asset management hub of Asia, and a key platform for managing wealth and liquidity from the Mainland. To this end, it is important that we enhance our current fund regulatory regime so that non-UCITS funds are given the space to innovate.
139. Non-UCITS schemes (most of which are managed by locally-based fund managers) are required to comply in full with the UT Code. However, the current UT Code does not have a comprehensive framework to provide for investments in FDI in general. It does however allow non-UCITS schemes to invest in certain specific types of FDI (such as warrants, options and futures) subject to applicable limits and requirements.
140. The Commission wishes to take this opportunity to provide a broadly level playing field between UCITS III schemes and non-UCITS schemes with respect to their investments in FDI, and to provide non-UCITS schemes with investment flexibility comparable to UCITS III schemes with expanded powers.
141. A new category of schemes is therefore created under 8.9 of the revised UT Code for non-UCITS schemes that invest substantially in FDI. Such schemes may invest in FDI subject to a limit of no more than 100% of the net asset value of the scheme (the basis for this calculation is further elaborated below). FDI acquired for hedging purposes will not be counted towards the 100% limit. FDI are considered as being acquired for hedging purposes provided that they are solely intended for the purpose of limiting or offsetting the probability of loss from fluctuations in the prices of the financial asset that is hedged, and involves, without limitation, taking equal and opposite positions in respect of the hedged asset. Further, the prices of both the asset to be hedged and the FDI are expected to always move in opposite directions and demonstrate a strong and negative correlation in all market conditions.

### Proposals

142. The revised UT Code provides for non-UCITS schemes to have the flexibility to invest in FDI for investment purposes, provided that their global exposure to FDI is no more than 100% of the net asset value of a scheme. This exposure threshold is in line with the UCITS III regime.



143. Global exposure is a measure of the incremental exposure and leverage generated by a scheme through the use of FDI. In calculating the global exposure of a scheme in relation to FDI acquired for investment purposes, the revised UT Code requires schemes to use the commitment approach (as opposed to the value-at-risk approach), whereby the derivative positions of a scheme are converted into the equivalent position in the underlying assets.
144. While the UCITS III regime does not restrict the global exposure calculation methodology to the commitment approach and accepts alternative methodologies such as the value-at-risk approach, the Commission believes that, at this initial stage of implementing the new proposed FDI framework, the more conservative method of commitment approach is preferable. As and when the market becomes more familiar with this new category of schemes, we may then revisit the issue and consider additional means for calculating global exposure to FDI.
145. The revised UT Code stipulates that the risk exposure to a counterparty of a scheme in an over-the-counter derivative transaction must not exceed 10% of the scheme's net asset value. To limit the exposure to each counterparty, the scheme may receive collateral from such counterparty, provided that the collateral satisfies the requirements set out in Proposal 1 above.
146. It is important that management companies have robust risk management policies (RMP) to support responsible investment activities. In the case of non-UCITS schemes managed by local fund managers licensed by the Commission, the Commission is the primary regulator of the managers of the schemes. SFC-licensed management companies must establish and maintain effective risk management systems which are appropriate for and commensurate with the scheme's business strategies, investment activities and risk profile. In the case of non-UCITS schemes managed by overseas managers licensed by regulators based in jurisdictions with regulatory framework comparable to Hong Kong, the overseas managers are subject to the on-going supervision of the overseas regulators.
147. The revised UT Code requires that offering documents in respect of these schemes contain additional information to explain the nature and risks of FDI investments in plain language to facilitate investors' understanding of the scheme.

### **Implications of the proposals**

148. It should be noted that this is an additional category of 'specialized schemes', and does not affect the current classification of schemes such as warrant funds and futures and options funds. Therefore, schemes may continue to be authorized under 8.3 of the revised UT Code if their principal objective is to invest in warrants, or 8.4A of the revised UT Code if their principal objective is to invest in futures contracts. Hedge funds continue to be separately categorized under 8.7 of the revised UT Code.
149. Due to the broad FDI investment powers provided under this new category of schemes, the Commission believes that the category of 'leveraged funds' under 8.4 of the UT Code is no longer relevant for the following reasons. One, where a scheme intends to use leverage that does not exceed the limit provided under 8.9 of the revised UT Code, such a scheme may apply for authorization under the revised UT Code. Two, schemes that primarily use alternative investment strategies, such as extensive leverage or borrowing, to achieve their investment objectives, are able to apply for authorization as



hedge funds under 8.7 of the revised UT Code. Under the circumstances, the existing category of 'leveraged funds' and the relevant provisions will be repealed.

150. As a transitional measure, we propose that, schemes that have already been authorized as 'leveraged funds' have two choices. They may maintain the status quo and remain authorized as such in so far as they continue to comply with the provisions previously set out for 'leveraged funds'. For these funds, no action is required. Alternatively, where the management company of a leveraged fund wishes to adopt the new regime provided under 8.9 of the revised UT Code, it may conduct the relevant conversion, subject to compliance with the relevant provisions in the revised UT Code (including seeking the Commission's approval of changes to the schemes pursuant to 11.1 of the revised UT Code) and the terms set out in the constitutive documents of the relevant scheme.
151. If existing authorized non-UCITS III schemes seek to make use of the expanded investment flexibility provided under this new category of schemes, they may convert to Chapter 8.9 schemes, subject to compliance with the relevant revised UT Code provisions (including seeking Commission approval of changes to the schemes pursuant to 11.1 of the UT Code) and the provisions set out in their constitutive documents. Depending on the terms of the constitutive documents of individual non-UCITS III schemes, investors' approval may or may not be required to approve the conversion to Chapter 8.9 schemes. The Commission notes that such a conversion and expansion of investment activities would constitute a scheme change pursuant to 11.1 of the revised UT Code and at least one month's prior written notice would be required to be given to the investors in respect of the changes.
152. The provisions (other than those in relation to disclosure) in respect of this category of schemes apply only to non-UCITS schemes and will not affect UCITS schemes, which will continue to be authorized according to existing practices as set out in the Commission circular dated 31 March 2005 titled "[Interim Measures on the Disclosure and Submission Requirements for the authorization of UCITS III Funds domiciled in Luxembourg, Ireland and the United Kingdom by the SFC](#)" and the Commission circular dated 30 March 2007 titled "[Circular to Fund Management Companies of SFC-authorized Funds - Streamlined Measures for Processing UCITS III Schemes with Special Features](#)". However, the disclosure requirements set out in 8.9 of the revised UT Code are applicable to both non-UCITS schemes falling under 8.9 of the revised UT Code and UCITS schemes using financial derivative instruments for investment purposes.

### **Proposal 3: Investment in other schemes**

#### **Background**

153. Currently, 7.11 of the UT Code provides that a scheme may invest in other collective investment schemes, provided that the value of a scheme's holdings in other collective investment schemes may not in aggregate exceed 10% of its total net asset value. Separately, 8.1 of the UT Code provides for schemes that invest exclusively in other collective investment schemes. However, the UT Code currently does not provide for schemes that invest more than 10% but less than 100% of their net asset value in other collective investment schemes.
154. We believe the existing framework should be broadened to allow the adoption of a 'hybrid structure' whereby a scheme invests more than 10% of its net asset value in



other collective investment schemes, but concurrently also invests a portion of its net asset value in other financial instruments such as bonds, equities or money market instruments. The threshold applicable to investments in other collective investment schemes should also provide a sufficient level of investment flexibility.

## Proposals

155. The revised UT Code takes into account industry requests for increased investment flexibility, while maintaining an appropriate level of investor protection. The following additions have been made to provisions in relation to “Investment in Other Schemes” in Chapter 7 of the UT Code:
- (a) allowing a scheme to invest up to 10% of its net asset value in non-recognized jurisdiction schemes;
  - (b) allowing a scheme to invest in one or more SFC-authorized schemes or recognized jurisdiction schemes, provided that no more than 30% of the scheme’s total net asset value may be invested in any one of these schemes; and
  - (c) allowing a scheme to invest more than 30% of its net asset value in an SFC-authorized scheme (but not a recognized jurisdiction scheme) if the underlying scheme is specifically named in the offering document of the scheme and its key investment information is disclosed therein.

In addition, in making investments in other collective investment schemes, we require the limitation on charges as set out in Chapter 8.1 (h) and (i) be complied with. This however does not apply to investments in collective investment schemes falling within 155(a) above.

156. There is theoretically a concentration risk arising from the exposure to a particular security if a scheme is allowed to concurrently make direct investments and investments through other collective investment schemes. For example, under the proposed new regime, a scheme may invest in a security both directly and through its underlying collective investment schemes, thus creating a concentrated exposure to the security. However, it should be noted that this risk is mitigated in that both the scheme and the underlying scheme (other than one which accounts for less than 10% of the net asset value of the scheme) are SFC-authorized schemes or recognized jurisdiction schemes and thus subject to the diversification requirements.
157. Schemes that invest exclusively in other collective investment schemes will continue to be governed by the provisions in 8.1 of the revised UT Code (Unit Portfolio Management Funds or UPMF).

## Proposal 4: Bilingual annual reports

### Background

158. Currently, all SFC-authorized schemes (with the exception of a limited number due to unique circumstances) provide offering documents, notices and announcements in both English and Chinese languages, but not all of these schemes provide interim and annual



reports in both languages. About 12-15% of the SFC-authorized schemes currently produce both English and Chinese language annual reports. The remaining provides only English language annual reports. The Commission believes that given the demographics in Hong Kong, there is good reason for schemes that are marketed in Hong Kong to produce both English and Chinese language annual reports.

## Proposals

159. The Commission proposes that annual reports must be published in both English and Chinese for SFC-authorized schemes which are not recognized jurisdiction schemes and which have Hong Kong investors, starting from the financial year ending on or after 31 December 2010. The requirement is not proposed to apply to interim reports, which may be prepared in English only.
160. Some managers of foreign funds (predominantly UCITS schemes from the E.U.) have reservations regarding this proposal for bilingual annual reports. They have concerns about added costs and time involved in preparing Chinese language annual reports. Some have raised the issue of which a mandatory requirement for the preparation of bilingual annual reports would drive some foreign-based funds away from Hong Kong. There are also foreign fund managers who said that they would be willing to provide Chinese language annual reports, and in fact some are already doing this voluntarily at the moment.
161. Accordingly, the Commission proposes that for SFC-authorized schemes which are recognized jurisdiction schemes, publication of a Chinese language annual report is voluntary. Nonetheless, where such recognized jurisdiction schemes are marketed to the public in Hong Kong and do not produce bilingual annual reports, distributors of such schemes in Hong Kong should take steps to make investors aware that annual reports for the scheme will be available in English only.
162. In light of the above, the Commission believes that for SFC-authorized schemes that are not recognized jurisdiction schemes and which have Hong Kong investors, the market could consider adopting any one of the following three options:
  - (a) option 1 – the full version of the bilingual annual report must be published and distributed to investors within the same period as currently applies (i.e. within four months of the end of the scheme's financial year);
  - (b) option 2 – the full version of the English language annual report and an abridged version of the Chinese language annual report must be published and distributed to investors within the same period as currently applies (i.e. within four months of the end of the scheme's financial year);
  - (c) option 3 – (i) the full version of the English language annual report must be published and distributed to investors within four months of the end of the scheme's financial year; and (ii) the full version of the Chinese language annual report must be published and distributed to investors within two weeks thereafter.



## Proposal 5: Product key facts statement

### Background

163. In the FS Report, the Commission recommended that summaries be required to be prepared for all investment products offered to the Hong Kong public in order to provide investors with information about products which they can readily understand and compare.
164. It is noted that the Committee of European Securities Regulators has proposed a draft key information document (KID) but that proposal is still under consultation. The KID's aim is also to provide investors with key information about a product. However, it differs somewhat from the Product KFS both in subject matters and presentation. UCITS scheme managers have raised the prospect of them being allowed to use (instead of the Products KFS) the KID that they have adopted under the E.U. regime.

### Proposals

165. Since the Product KFS is intended to facilitate investors' understanding of the key features of a scheme, the Commission proposes that a Product KFS be produced for each scheme in the case of single funds or each sub-fund of an umbrella fund. In principle, all schemes should produce Product KFS in the same format, in order to ensure standardisation of presentation and to facilitate investors' understanding and comparison of vital fund information. However, the Commission notes that certain specialized schemes may have unique characteristics which need to be highlighted or explained. As well, the Commission is open minded about the possibility of UCITS schemes using the KIDs that satisfy their home E.U. regulator's requirements, provided that the KIDs in substance provide the same information, and their format and presentation also adhere to the principle of providing information in a manner which is user friendly and easy for investors to understand.
166. Other than the inclusion of certain information specific to the particular type of scheme, the content requirements of the Product KFS for the different types of schemes mentioned above is expected to be largely the same, and should include the name of the management company, the scheme's investment strategy, key risks, asset allocation, and fees and charges. In particular, if a scheme utilises FDI for investment purposes, this fact and the associated risks must be stated. Further, the key risk factors must also be included.
167. The disclosure of (i) total expense ratio (TER) and (ii) past annual performance information in the Product KFS is proposed to be optional:
- (a) in relation to (i), we understand that there is currently no universal definition for TER. Therefore, if TER is included in the Product KFS, the issuer of the Product KFS has to clearly disclose the calculation basis or formula of the TER; and
  - (b) in relation to (ii), if performance information is included, it should be presented in bar charts, calculated on a calendar year basis and should cover a minimum of five years (or the period since the launch date of the scheme if it has been launched for less than five years). Further, if a scheme measures its performance against a benchmark, then the performance of the benchmark should also be included.



168. To allow easy comparison of different types of products (one of the key objectives behind the Product KFS proposal), the general subject matter, layout and format adopted in the templates should be substantially similar in Product KFS. Specific disclosures under each of the broad subject matter headings must, of course, be tailored by product issuers properly to reflect the features of the scheme in question.
169. Product KFS are different from the fund fact sheets which are commonly used by fund houses as marketing tools. The Product KFS will form part of the offering document for a scheme.
170. The Product KFS in respect of a scheme will be required to be updated as necessary to reflect changes in the offering document. If a scheme chooses to include performance information in the Product KFS, the Product KFS should be updated at least every six months in order to comply with the applicable requirements in the [Advertising Guidelines<sup>17</sup>](#).
171. It should be noted that the Product KFS provides for the clear and prominent disclosure of the key risks of investing in a scheme, thus standardising the enhanced risk disclosure practice which many fund houses have adopted in recent months. Under the circumstances, fund houses may dispense with the use of the upfront disclosure box in their offering documents upon the adoption of the Product KFS.

## Proposal 6: Miscellaneous

### Connected party transactions

172. Currently, 10.13 of the UT Code provides that brokers or dealers connected to the management company, the investment adviser, the directors of the scheme or any of their connected persons may not in aggregate account for more than 50% of the scheme's transactions in value in any one financial year of the scheme.
173. In light of the trend to focus on conduct regulation, the Commission believes that it would be preferable to focus on substantive principles to guide conduct, such as the requirement for arm's-length terms and best execution standards, rather than imposing prescriptive limits in governing connected party transactions. The Commission therefore proposes to replace the above 50% limit with applicable general principles as follows:
  - (a) connected party transactions should be on arm's-length terms;
  - (b) the fund management company must use due care in the selection of brokers or dealers and ensure that they are suitably qualified in the circumstances;
  - (c) transaction execution must be consistent with applicable best execution standards;
  - (d) the fee or commission paid to any such broker or dealer in respect of a transaction must not be greater than the prevailing market rate for a transaction of that size and nature;

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<sup>17</sup> "Advertising Guidelines Applicable to Collective Investment Schemes Authorized under the Product Codes" issued by the Commission in July 2008.



- (e) the management company must monitor such transactions to ensure compliance with its obligations; and
- (f) all such transactions and the total commissions and other quantifiable benefits received by such broker or dealer must be disclosed in the scheme's annual report.

### **Criteria for appointment of Hong Kong representative**

- 174. Non-Hong Kong based schemes are required, under 9.1 of the current UT Code, to appoint a Hong Kong representative who satisfies the criteria set out in 9.4 of the UT Code.
- 175. To facilitate effective communication with management companies of non-Hong Kong based schemes, the Commission proposes to clarify in 9.4 of the revised UT Code that these management companies are encouraged to appoint a representative within the management group. In addition, the Commission proposes to codify in the revised UT Code that the representative must be either (i) licensed or registered under the SFO; or (ii) a trust company registered under Part VIII of the Trustee Ordinance (Chapter 29 of the laws of Hong Kong) where such company is an affiliate of an authorized financial institution defined under the SFO and is acceptable to the Commission.

### **Performance fees**

- 176. Currently, 6.17(b) of the UT Code provides that, if a management company charges a scheme a performance fee, the fee can only be payable if the net asset value per unit/share of the scheme exceeds the net asset value per unit/share on which the performance fee was last calculated and paid.
- 177. The Commission proposes to permit greater flexibility for the calculation of performance fees in light of market developments, provided that the principles of maintaining an equitable basis for such calculation and adequate disclosures to investors are not compromised. The revised UT Code provides that a performance fee may also be calculated with reference to the performance of a benchmark or an asset class. In such a case, and the performance fee is only payable upon outperformance of the net asset value per unit/share vis-à-vis that of the benchmark or asset class.

### **Maximum interval for payment of redemption amounts**

- 178. Currently, under 6.14 of the UT Code, the maximum interval between the receipt of a properly documented request for redemption of units/shares of a scheme and the payment of the redemption amount to the holder may not exceed one calendar month.
- 179. The Commission recognizes that some schemes may face difficulties in complying with this deadline where they are subject to restrictions such as market access/exit and foreign exchange controls in certain markets. The Commission proposes, therefore to provide for a carve-out from this requirement if the market(s) in which a substantial portion of a scheme's investments is made impose(s) legal or regulatory requirements (such as foreign currency controls), which render the payment of the redemption money within the aforesaid time period not practicable. In such a case, the time frame for the payment of redemption money may be extended to reflect the additional time needed in light of the specific requirements in the relevant market(s).



## Sub-managers of multimanager schemes

180. Currently, 5.5(a) of the UT Code provides that the key personnel of the management company or those of the investment adviser (where the latter has been delegated the investment management function) are expected to possess at least five years' investment experience in managing unit trusts or other public funds with reputable institutions. 5.5(b) of the UT Code further provides that such key personnel must be dedicated, full-time staff with a demonstrable track record in the management of unit trusts or mutual funds.
181. The Commission notes that some managers appointed by management companies of multimanager schemes possess extensive investment management experience in their respective strategies or asset classes, but not necessarily in the form of retail funds. For the purpose of 5.5(a) and (b) of the revised UT Code, we may consider such experience on a case-by-case basis, provided that the management company of the scheme exercises proper due diligence in the selection of the managers of the multimanager scheme, and exercises due care in managing the overall liquidity of the scheme. The offering documents for these schemes should clearly disclose the due diligence processes adopted by the management company in selecting and monitoring the sub-managers on an on-going basis.

## Distribution of financial reports

182. Currently, 11.6 of the UT Code provides that the financial reports of a scheme must be published and distributed to investors in the scheme within four months of the end of the scheme's financial year (in the case of annual reports) or within two months of the end of the scheme's financial period (in the case of interim reports).
183. As an alternative to the physical distribution of printed financial reports, the Commission proposes that investors in a scheme may be notified of where such reports, in printed and electronic forms, can be obtained within the time frame required under the UT Code.

## Proposed implementation timetable

184. Subject to the results of the consultation, the Commission proposes that different parts of the revised UT Code will enter into effect on different dates. This is to allow the industry a reasonable time to adapt to and comply with the new regime, without compromising investors' interests. For the purposes of the implementation of the revised UT Code:
- (a) "Effective Date" means the effective date of the Handbook (including the UT Code) declared by the Commission and published in the government gazette;
  - (b) "New Schemes" means collective investment schemes for which applications for authorization are submitted to the Commission on or after the Effective Date; and
  - (c) "Existing Schemes" means: (a) collective investment schemes which have been authorized by the Commission prior to the Effective Date and remain authorized on that date; and (b) collective investment schemes for which applications for authorization were submitted to the Commission before the Effective Date, but are authorized on or after the Effective Date.



### **Proposals 1, 2 and 3 (structured funds, funds that invest in FDI, and funds that invest in other schemes)**

185. All of the provisions of the revised UT Code relating to Proposals 1, 2 and 3 will apply to New Schemes on and from the Effective Date.
186. Existing Schemes will be grandfathered under the new regime relating to Proposals 1, 2 and 3 in that they may continue with their current structure. If Existing Schemes wish to convert to the new regime, they may do so on a voluntary basis. If, after the Effective Date, there is a change in the investment objectives, policies or strategies of an Existing Scheme which falls within the scope of Proposal 1, 2 or 3, such Existing Scheme will be required to comply with the relevant requirements in the revised UT Code.

### **Proposal 4 (bilingual annual reports)**

187. The provisions of the revised UT Code relating to Proposal 4 will apply to SFC-authorized schemes which are not recognized jurisdiction schemes and which have Hong Kong investors with effect from their financial year ending on or after 31 December 2010.
188. For SFC-authorized schemes which are recognized jurisdiction schemes, compliance with Proposal 4 is voluntary.

### **Proposal 5 (Product KFS) and other disclosure requirements set out in the revised UT Code**

189. The requirement for preparing a Product KFS and other disclosure requirements set out in the revised UT Code (including but not limited to the disclosure requirements in 8.8, 8.9 and Appendix C of the revised UT Code) (together, the Product KFS and Other Disclosure Requirements) will apply to New Schemes on and from the Effective Date.
190. Existing Schemes which are no longer marketed to the public in Hong Kong as of the Effective Date will not be required to comply with the Product KFS and Other Disclosure Requirements.
191. Existing Schemes which continue to be marketed to the public in Hong Kong as of the Effective Date must be in compliance with the Product KFS and Other Disclosure Requirements by the end of **9 to 12 months** from the Effective Date (the Long Stop Date). Before the Long Stop Date, management companies may choose to implement the KFS and Other Disclosure Requirements on a voluntary basis.

### **Proposal 6 and others**

192. The provisions of the revised UT Code relating to Proposal 6 and the other changes set out in the revised UT Code (which are largely codification of existing practices or facilitative in nature) will apply to all schemes on and from the Effective Date.



**Question (11):**

In relation to proposals regarding investment activities set out in Proposal 1 (structured funds), Proposal 2 (funds that invest in FDI) and Proposal 3 (investments in other schemes), other than the proposed general requirements, what other requirements do you think should be included? Please explain your views.

**Question (12):**

In relation to the disclosure and reporting requirements set out in Proposal 4 (bilingual annual reports) and Proposal 5 (Product KFS), do you agree with the proposals? Please explain your views.

**Question (13):**

Do you have any comments on the revisions to the UT Code generally? Please explain your views.

**Question (14):**

What are your views about the idea of UCITS schemes which have issued KIDs under their own E.U. regulator's regime using those KIDs in place of the Product KFS? The issue here is how we should balance the importance of developing broadly standardized Product KFS across all products sold to the Hong Kong public so that it is easy for Hong Kong investors to understand and compare different products, and the commercial needs of individual fund houses to reduce costs and lessen administrative burdens. Also, if a large number of SFC-authorized funds adopt KIDs instead of Product KFS, it may defeat the purpose of comparability under the Product KFS proposal. The SFC would like to hear your views.

**Question (15):**

Do you agree that the proposed approach to implementation of the revised UT Code is acceptable and practicable, taking into account the needs and circumstances of various stakeholders? Do you have any particular views as to exactly how long the transition period should be for Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements (paragraph 191)?



## Implementation schedule of the revised UT Code

| Proposals                                 | Provisions of the revised UT Code | Schemes that submit their applications for authorization on or after the Effective Date (i.e. New Schemes)  | Currently SFC-authorized schemes and schemes that submit their applications for authorization prior to the Effective Date and which are subsequently authorized (i.e. Existing Schemes) |
|---|-----------------------------------|---|---|
| <b>A. Investment activities</b>           |                                   |   |   |
| Proposal 1 (structured funds)             | 8.8                               | Immediate implementation  | Grandfathered (unless there is a change in investment objectives and strategies which falls within the scope of these Proposals)  |
| Proposal 2 (funds that invest in FDI)     | 8.9                               |   |   |
| Proposal 3 (investments in other schemes) | 7.11-7.13                         |   |   |
| <b>B. Disclosure and reporting</b>        |                                   |   |   |
| Proposal 4 (bilingual annual reports)     | 11.6                              | <ul style="list-style-type: none"> <li>▪ Non-recognized jurisdiction schemes that have HK investors – mandatory application starting from their financial year ending on or after 31 December 2010</li> <li>▪ Recognized jurisdiction schemes – voluntary compliance</li> </ul> |   |



| Proposals   | Provisions of the revised UT Code | Schemes that submit their applications for authorization on or after the Effective Date<br><br>(i.e. New Schemes) | Currently SFC-authorized schemes and schemes that submit their applications for authorization prior to the Effective Date and which are subsequently authorized<br><br>(i.e. Existing Schemes)   |
|---|-----------------------------------|---|--|
| Proposal 5 (Product KFS) and other disclosure requirements set out in the revised UT Code | 6.3                               | Immediate implementation  | <ul style="list-style-type: none"> <li>▪ Existing schemes no longer marketed in HK – compliance not required</li> <br/> <li>▪ Existing schemes that are still being marketed in HK- a long stop date of <b>9 to 12 months</b> from the Effective Date</li> </ul> |
| <b>C. Miscellaneous</b>   |                                   |   |  |
| Proposal 6 (connected party transactions)   | 10.13                             | Immediate implementation  |  |
| Proposal 6 (criteria for appointment of Hong Kong representative)                         | 9.4                               | Immediate implementation  |  |
| Proposal 6 (performance fees)   | 6.19                              | Immediate implementation  |  |
| Proposal 6 (maximum interval for payment of redemption amounts)                           | 6.16                              | Immediate implementation  |  |
| Proposal 6 (sub-managers of multimanager schemes)   | Note to 5.5(b)                    | Immediate implementation  |  |
| Proposal 6 (distribution of financial reports)  | 11.6                              | Immediate implementation  |  |



## Section 3

### Key proposals in the revised Code on Investment-Linked Assurance Schemes

#### Introduction

193. The Commission proposes to revise the ILAS Code. The proposed amendments have been marked against the current version of the ILAS Code.
194. The key objectives of the proposed changes are to codify existing practices, enhance disclosure in the offering documents of ILAS and implement the key recommendations on investment products made in the FS Report.
195. The Commission is grateful to the various financial institutions, industry bodies and industry professionals that have helped with our research and for their ideas and views. Our analysis and recommendations have also benefited from the discussions with other Hong Kong regulators and overseas counterparts.

#### Proposal 1: Product key facts statement

196. In the FS Report, the Commission recommended that summaries be required to be prepared for all products offered to the Hong Kong public in order to provide investors with information about products which they can readily understand and compare.

#### Proposals

197. An ILAS must issue a Product KFS. Product KFS should be kept concise if they are to serve their purpose and the Commission therefore expects that, as a matter of best practice, Product KFS should not be more than 4 pages. Product KFS should contain the key information to enable prospective scheme participants to make an informed judgment of the investment proposed to them. Product KFS shall form a part of the offering document.
198. To promote scheme participants' understanding of the nature of ILAS, the Commission proposes to require disclosure of the key features and risks of ILAS in the Product KFS. For instance, the nature of ILAS, namely that they are insurance policies issued by an insurance company with benefits linked to performance of investment options by scheme participants and scheme participants do not have any rights or ownership over the underlying assets, should be highlighted. Any early surrender/withdrawal penalties should also be stated. Illustration templates of the Product KFS will be made available on the Commission's website.
199. In fact, the Commission has been providing guidance to the industry regarding upfront risk disclosure in their ILAS offering documents and marketing materials in light of recent market events.



## Proposal 2: Enhanced disclosure requirements

200. It is the primary obligation of the ILAS insurers to ensure that their offering documents continue to be up-to-date and contain sufficient information necessary for scheme participants to make an informed decision.
201. In view of the developments in the global financial markets in the last 12 months, the Commission proposes to enhance the contents requirements in ILAS offering documents in respect of the following areas.

### Proposals

#### Disclosure regarding market value reduction for ILAS with “with-profits” features

202. For ILAS or investment options with “with-profits” features, it is provided in the insurance policies that the ILAS insurers have the absolute discretion to declare the relevant applicable investment return by reference to the performance of the underlying assets. It is also provided in the insurance policies that ILAS insurers have the absolute discretion to apply a market value reduction to the encashment/surrender value of the ILAS policy. The amount of the reduction could be up to 100% of the policy value in certain cases. This reduction could have the effect of negating any investment return upon the encashment/surrender of the ILAS policy.
203. The Commission proposes to require the ILAS insurers to disclose in the ILAS offering documents that, in respect of ILAS or investment options with “with-profits” features, the extent to which the investment can be deducted by such market value adjustment and how the prevailing rate of market value reduction is disclosed to scheme participants. An ILAS insurer must keep scheme participants informed of any exercise of the market value reduction relating to ILAS having the “with-profits” features. This reflects our existing practices adopted for disclosure of ILAS having the “with-profits” features since the outset of the financial crisis.

#### Enhanced disclosure regarding internal funds in the ILAS offering document

204. To promote transparency of the underlying investments of ILAS, the Commission proposes that, where the return of an investment option is determined with reference to one or more SFC-authorized funds, a statement as to how to make available offering documents of such SFC-authorized fund(s) shall be included. For other cases, the specific investments and associated risks are required to be disclosed, e.g. the use of financial derivative instrument, or leverage (if any).

#### Proposal 3: Deletion of chapters in the ILAS Code

205. In conducting the housekeeping exercise, the Commission notes that a few chapters of the ILAS Code may no longer be relevant under the current regulatory regime/market, and therefore proposes to remove them from the ILAS Code.



## Proposals

### Deletion of Chapter 5 regarding the appointment of Hong Kong representative

206. Under the current regulatory regime, ILAS must be issued by an insurance company authorized under the Insurance Company Ordinance to carry on the relevant class of insurance business in Hong Kong. Thus ILAS issuers do not need to appoint a Hong Kong representative pursuant to Chapter 5. The Commission proposes to remove Chapter 5 from the ILAS Code.

### Deletion of Chapter 8 regarding Broker Managed Funds (BMFs)

207. The last SFC-authorized BMF has applied to the Commission for de-authorization. Upon its de-authorization, there will no longer be any authorized BMFs. To the extent ILAS insurers wish to delegate investment authority to external managers, they may still do so within the requirements of the current regime. The industry has no objection to the Commission removing the Chapter on BMFs. The Commission therefore proposes to remove Chapter 8 from the ILAS Code.

### Deletion of Chapter 9 regarding Investment-linked Savings Plans (ISPs)

208. It is the Commission's policy that ILAS must be issued by an insurance company authorized under the Insurance Company Ordinance to carry on the relevant class of insurance business in Hong Kong. The Commission therefore proposes to remove Chapter 9 from the ILAS Code given that ISPs are obsolete.

### Proposal 4: Codification of certain existing practices

209. There have been certain existing practices adopted by the Commission in administering the ILAS Code. The Commission would like to take this opportunity to codify certain existing practices so as to enhance and promote transparency of such requirements.

## Proposals

210. The Commission proposes to codify the practice that the computation of surrender values shall not take into account any non-guaranteed returns, including without limitation, any discretionary bonus, dividend payments, reimbursements of charges. The Commission expects ILAS insurers to follow industry's best practices as well as the applicable provisions in the ILAS Code. At present, we understand that a work group has been established by the Actuarial Society of Hong Kong in formulating guidelines in this respect. The Commission will keep this in view and any further guidance when issued would be made available on the Commission's website.
211. In general, the Commission will expect that one month's prior written notice (or such longer period as required under applicable laws and regulations or the provisions as set out in the offering document or constitutive documents) should be provided to scheme participants in respect of scheme changes. However, a shorter period of notice may be permitted if the change is not significant or if it is not practicable for the applicant in doing so due to circumstances beyond its control. The above is proposed to be reflected in Chapter 7 of the revised ILAS Code.



### Question (16)

Do you have any comments on (1) the Product KFS requirements, (2) the enhanced disclosure requirements on "with-profit" features and internal funds, (3) the deletion of Chapter 5, 8 and 9 of the current ILAS Code, and (4) the codification of the existing practices regarding the computation of surrender values and the notification requirements on scheme changes?

### Proposed implementation timetable

212. The Commission has maintained a close dialogue with the industry as well as the Insurance Authority on the matters under consultation.
213. For the purpose of this section,
- (a) "Effective Date" means the effective date of the Handbook (including the ILAS Code) declared by the Commission and published in the government gazette;
  - (b) "New Schemes" means ILAS for which applications for authorization are submitted to the Commission on or after the Effective Date; and
  - (c) "Existing Schemes" means (i) ILAS which have been authorised by the Commission prior to the Effective Date and remain authorized on that date and (ii) ILAS for which applications for authorization were submitted to the Commission before the Effective Date, but are authorized on or after the Effective Date.
214. Subject to the result of this consultation:
- (a) the requirement of a Product KFS and other disclosure requirements set out in the revised ILAS Code (including but not limited to the disclosure requirements in Appendix A to the revised ILAS Code) (together, the "Product KFS and Other Disclosure Requirements") will apply to New Schemes starting from the Effective Date;
  - (b) Existing Schemes which are no longer marketed to the public in Hong Kong as of the Effective Date will not be required to comply with the Product KFS and Other Disclosure Requirements;
  - (c) Existing Schemes which continue to be marketed to the public in Hong Kong as of Effective Date must be in compliance with the Product KFS and Other Disclosure Requirements by the end of **9 to 12 months** from the Effective Date) (the "Long Stop Date"). Before the Long Stop Date, ILAS Insurers may choose to implement the Product KFS and Other Disclosure Requirements on a voluntary basis; and
  - (d) The provisions in the revised ILAS Code relating to other proposals (which are largely codification of existing practices or facilitative in nature) will apply to all schemes starting from the Effective Date.



**Question (17)**

Do you agree that the proposed approach to implementation of the revised ILAS Code as acceptable and practicable, taking into account the needs and circumstances of various stakeholders? Do you have any particular views as to exactly how long the transition period should be for Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements (paragraph 214(c))?



## Section 4

### List of consultation questions in Part II

#### Consultation questions in relation to Overarching Principles Section

**Question (1)** Do you have any comments on the Overarching Principles Section of the Handbook generally or any particular provisions in the Section? Please explain your views.

#### Consultation questions in relation to the SP Code

**Question (2)** What are your views on the proposed disclosure requirements in Appendix C (*Information to be Disclosed in Offering Documents for Unlisted Structured Products*) and Appendix D (*Advertising Guidelines Applicable to Unlisted Structured Products*) to the SP Code?

**Question (3)** What are your views on the requirement for Issuers to provide ongoing disclosure of the types of information set out in 7.6 of the SP Code throughout the term of a structured product? Please explain the reasons for your views. Are there any other matters which you think an Issuer should be obliged to disclose to investors on an ongoing basis?

**Question (4)** What are your views on the eligibility requirements for Issuers and Guarantors of unlisted structured products proposed by the Commission?

**Question (5)**

- (a) What are your views on the proposed requirements applicable to SPV Issuers?
- (b) What are your views on the current proposal to mandate the appointment of a Hong Kong-licensed Product Arranger for structured products issued by an SPV and make such Product Arranger responsible for ensuring an SPV Issuer's compliance with the SP Code throughout the term of the structured product?
- (c) Do you think a Product Arranger should also be appointed for structured products issued by Issuers (whether SPVs or not) or guaranteed by Guarantors where these entities are not local Regulated Entities (i.e. where the Issuers/Guarantors are not licensed banks regulated by the HKMA or corporations licensed by the Commission pursuant to section 116 of the SFO)?
- (d) Other than what has been proposed, what other obligations or requirements (if any, both before and after an offering), do you think a Product Arranger should be made subject to? Please give a list of any such additional obligations with reasons.

Please explain your views.

**Question (6)**

- (a) What are your views on the proposed eligibility criteria for collateral in respect of structured products?
- (b) Do you think that collateral should be subject to any additional eligibility criteria? If so, what criteria?
- (c) What are your views on the requirement that investors' claims to



collateral proceeds should be accorded priority and should not be subordinated to claims by counterparties to transactions with the Issuer that are related to the structured product?

- Question (7)** Do you believe that the Commission should take into account any additional eligibility criteria for reference assets, or any other factors, when considering whether or not to accept a proposed reference asset or asset class for a structured product? If so, please list such additional criteria / factors and give an explanation for each.
- Question (8)**
- (a) Should indicative valuations of structured products be required to be provided daily? Do you think there are additional or other measures which could help investors to assess the performance of their investments? If so, please provide details.
  - (b) With regard to the proposal to provide liquidity by way of making firm price quotations, do you think an exemption is justifiable for structured products with a short scheduled tenor, e.g. of one month or less? How often do you think Issuers or their market agents should provide liquidity by way of making firm price quotations? Do you think that there are other circumstances or periods during the term of certain structured products in which liquidity provision should not be required or could not reasonably be provided? If so, why?
- Question (9)** Please give your views on the use of annualised returns in offering documents and advertisements for structured products.
- Question (10)** Please provide your views on the length of the transition period for compliance with SP Code requirements for unlisted structured products where the issue of documents has been authorized prior to the date of the SP Code's effectiveness.

### Consultation questions in relation to the revised UT Code

- Question (11)** In relation to proposals regarding investment activities set out in Proposal 1 (structured funds), Proposal 2 (funds that invest in FDIs) and Proposal 3 (investments in other schemes), other than the proposed general requirements, what other requirements do you think should be included? Please explain your views.
- Question (12)** In relation to the disclosure and reporting requirements set out in Proposal 4 (bilingual annual reports) and Proposal 5 (Product KFS), do you agree with the proposals? Please explain your views.
- Question (13)** Do you have any comments on the revisions to the UT Code generally? Please explain your views.
- Question (14)** What are your views about the idea of UCITS schemes which have issued KIDs under their own E.U. regulator's regime using those KIDs in place of the Product KFS? The issue here is how we should balance the importance of developing broadly standardized Product KFS across all products sold to the Hong Kong public so that it is easy for Hong Kong investors to understand and compare different products, and the commercial needs of individual fund houses to reduce costs and lessen administrative burdens. Also, if a large



number of SFC-authorized funds adopt KIDs instead of Product KFS, it may defeat the purpose of comparability under the Product KFS proposal. The SFC would like to hear your views

**Question (15)** Do you agree that the proposed approach to implementation of the revised UT Code is acceptable and practicable, taking into account the needs and circumstances of various stakeholders? Do you have any particular views as to exactly how long the transition period should be for Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements (paragraph 191)?

### **Consultation questions in relation to the revised ILAS Code**

**Question (16)** Do you have any comments on (1) the Product KFS requirements, (2) the enhanced disclosure requirements on "with-profit" features and internal funds, (3) the deletion of Chapters 5, 8 and 9 of the current ILAS Code, and (4) the codification of the existing practices regarding the computation of surrender values and the notification requirements on scheme changes?

**Question (17)** Do you agree that the proposed approach to implementation of the revised ILAS Code as acceptable and practicable, taking into account the needs and circumstances of various stakeholders? Do you have any particular views as to exactly how long the transition period should be for Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements (paragraph 214(c))?



## **Part III Intermediaries conduct**

### **Consultation on the regulation of intermediary conduct and selling practices**

#### **Introduction**

1. In this Part III of the consultation paper, the Commission seeks public views on proposed measures to effectively enhance intermediary conduct and selling practices relating to the sale of investment products in Hong Kong. To this end, the Commission has issued the FS Report in December 2008. Specific proposals were also made by the HKMA in another report to the Government (HKMA Report).
2. Some of the proposals set out in this Part III will entail a revision of certain provisions in the Code of Conduct and the Securities and Futures (Professional Investor) Rules (Professional Investor Rules). The proposed amendments are marked up against the current version of the relevant requirements in Appendix C to this consultation paper.

#### **Background**

3. The regulatory structure for the sale of investment products rests on two important pillars – disclosure of product information and suitability of the product for the investor. The first pillar requires product issuers to disclose sufficient product information in the product documentation to enable a reasonable person to make an informed decision. The second pillar requires intermediaries<sup>18</sup> that recommend a product to ensure the suitability of the product for the particular investor.
4. Under the Code of Conduct, intermediaries are required to comply with a series of general principles (GPs) which are supplemented by specific requirements. The general principles are set out below:

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<sup>18</sup> For the purposes of this consultation paper, use of the word “intermediaries” refers to licensed and registered persons under the Code of Conduct.



(a) GP1. Honesty and fairness

In conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market.

(b) GP2. Diligence

In conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market.

(c) GP3. Capabilities

A licensed or registered person should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.

(d) GP4. Information about clients

A licensed or registered person should seek from its clients information about their financial situation, investment experience and investment objectives relevant to the services to be provided.

(e) GP5. Information for clients

A licensed or registered person should make adequate disclosure of relevant material information in its dealings with its clients.

(f) GP6. Conflicts of interest

A licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.

(g) GP7. Compliance

A licensed or registered person should comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market.

(h) GP8. Client assets

A licensed or registered person should ensure that client assets are promptly and properly accounted for and adequately safeguarded.

(i) GP9. Responsibility of senior management

The senior management of a licensed or registered person should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm. In determining where responsibility lies, and the degree of responsibility of a particular individual, regard shall be had to that individual's apparent or actual authority in relation to the particular business operations, and the factors referred to paragraph 1.3 of the Code of Conduct.



5. Paragraph 5.1 of the Code of Conduct requires intermediaries to take all reasonable steps to establish the true and full identity of each of its clients and their financial situation, investment experience and investment objectives.
6. Based on the information gathered in the “know your client” process conducted under paragraph 5.1, paragraph 5.2 of the Code of Conduct further sets out the key requirement for intermediaries to ensure suitability –  
  
Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the intermediary should, when making a recommendation or solicitation, ensure the *suitability* of the recommendation or solicitation for that client is reasonable in all the circumstances.
7. In addition, paragraph 5.3 of the Code of Conduct makes particular reference to derivative products –  
  
A licensed or registered person providing services to a client in *derivative products*, including futures contracts or options, or any leveraged transaction should assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.
8. In May 2007, the Commission issued some Frequently Asked Questions (Suitability FAQs) to provide further guidance on the existing requirements of the Code of Conduct and the Management, Supervision and Internal Control Guidelines (Internal Control Guidelines) by clarifying the suitability obligations of intermediaries engaged in financial planning and wealth management business activities. In particular, intermediaries must know their clients, understand the investment products they recommend to clients and provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom the product is recommended.
9. The Commission recognizes that although the current regulatory framework has served Hong Kong well and provides a sound basis for guiding intermediaries’ business conduct, issues such as those arising from the sale of structured products, especially those with embedded derivative elements, show that certain areas of intermediary regulation can be further strengthened. The Commission takes the view that new regulatory requirements could be usefully introduced and further guidance may be provided to enhance the overall regulatory framework, having taken into account international regulatory developments and market feedback.
10. Paragraph 35 of the FS Report proposed to further study and consult on establishing a new dispute resolution procedure or body. The Commission will not pursue the study of this issue given the Government’s intention to consult the market in the near future on the formation of a financial services ombudsman that will cover the dispute resolution process.
11. Paragraph 27.3 of the FS Report recommended that issuers of investment products are to provide relevant information and that intermediaries should ensure that this information is brought to the attention of investors. Under GP5 of the Code of Conduct, an intermediary should make adequate disclosure of relevant material information in its



dealings with its clients. Intermediaries are reminded that they have an on-going obligation to pass on any relevant material information provided by issuers of investment products to their clients.

## **Summary of matters for consultation**

12. In this Part III of the consultation paper, the Commission is consulting on the following proposals:

### **Investor characterization**

This section seeks public views on whether intermediaries should, as part of the “know your client” procedures, obtain clients’ information about their knowledge of derivatives and characterize those clients (other than professional investors) with such knowledge as “clients with derivative knowledge”, to assist intermediaries in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable.

### **Professional investors**

This section discusses how the “professional investors” regime could be further refined so as to enhance investor protection. The section suggests ways in which intermediaries may assess the “knowledge, expertise and investment experience” of a professional investor in a relevant market and/or product and discusses whether the minimum portfolio requirement should be adjusted from the existing level.

### **Pre-sale disclosure of monetary and non-monetary benefits**

This section analyses various disclosure options to address potential intermediary conflicts of interest issues regarding monetary and non-monetary benefits received.

### **Use of gifts by distributors in promoting a specific investment product**

This section discusses whether there should be restrictions on the use of gifts by product distributors in promoting a specific investment product to investors.

### **Sales Disclosure Document**

This section discusses the manner in which intermediaries would disclose material information regarding their relationships and dealings with clients by preparing and delivering to clients Sales Disclosure Documents prior to or at the point of sale.

### **Audio recording**

This section discusses whether audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current SFC record keeping requirements are already sufficient.

13. The above proposals will generally apply to securities and futures products (hereafter referred to as investment products). However, the Commission recognizes that some of the proposals may be more applicable to unlisted investment products because of the different operation modes, information disclosure framework etc. of such products. The



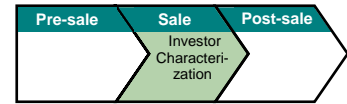
Commission thus invites market views on the scope and applicability of the proposals above.

**Question (18)**

Do you agree that some of the proposals in this part of the consultation paper should only apply to unlisted investment products? Please explain your views.

**Transitional Period**

14. The Commission will provide an appropriate transitional period for any of the proposals that are implemented under this Part III of this consultation paper.



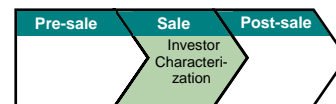
## Investor characterization

15. There is a general concern that the complex nature and features of some unlisted investment products makes it difficult for the average investor to fully appreciate the product's characteristics and the risks involved. The Lehman Minibonds is a good example. A SFC Investor Survey in December 2008 revealed that two-thirds of the investors surveyed knew very little about at least one of the products they had invested in, such as unlisted equity linked products<sup>19</sup>.
16. Paragraph 34.3 of the FS Report recommended that:

“the SFC brings forward requirements for Intermediaries to adopt suitable criteria for characterizing investors with a view to assisting in ensuring that investment advice and products offered are suitable for the investors”.
17. The Commission has also looked at how other jurisdictions address this issue. In Europe, the E.U. Markets in Financial Instruments Directive (MiFID) Article 19(5) provides that “Member States shall ensure that investment firms, when providing investment services other than investment advice or portfolio management, ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client”.
18. In the US, an investor's experience and/or knowledge are also important factors that an intermediary has to consider. The Financial Industry Regulatory Authority (FINRA) member firms are required to consider limiting purchases of structured products to those clients that have accounts approved for options trading, given the similar risk profile of many structured products and options. In approving an account for options trading, a firm has to ascertain essential information about the client, including his investment experience and knowledge in options and other financial instruments. In addition, in determining customer suitability in connection with specific structured products, FINRA member firms are required to consider, among other factors, whether the client meets the options suitability requirements by having “such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction”<sup>20</sup>.
19. In Hong Kong, the conduct of intermediaries in relation to the selling and advising of investment products is governed by the Code of Conduct and clarified by the Suitability FAQs. Intermediaries are required to conduct proper “know your client” procedures before providing services to clients. Specifically, intermediaries should seek from their clients information about their financial situation, investment experience / knowledge / objectives and risk tolerance etc. Furthermore, having regard to the information collected above, the intermediary should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.

<sup>19</sup> Key Findings of Retail Investor Survey, December 2008  
(Link: <http://www.sfc.hk/sfc/html/EN/speeches/public/surveys/surveys.html>)

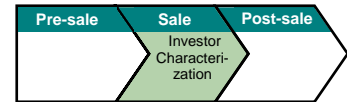
<sup>20</sup> NASD Notice to Members 05-59 and FINRA Rule 2360(b)(19)(B) (previously being NASD Rule 2860(b)(19)(B) as quoted under NASD Notice to Members 05-59).



20. As the regulation of the conduct of intermediaries in Hong Kong is principle based, intermediaries would need to tailor their own selling or advisory procedures according to the risk level of the investment products and the investors' profiles. For products having features and risks which are not difficult for an average investor to understand, the suitability requirement can be achieved under simplified procedures. It is important to note that the suitability requirement is triggered when the intermediary makes a recommendation or solicitation.

## Proposal

21. Major markets, including Hong Kong, consider investors' knowledge in investment products to be a crucial factor in determining whether an investment product is suitable for a client. The assessment of the client's investment knowledge is already part of the "know your client" procedures under the Code of Conduct. As unlisted investment products with embedded derivatives elements are generally difficult for investors to understand and are increasingly popular, the Commission sees merit in providing further guidance to intermediaries who provide services in relation to unlisted derivative products to clients.
22. Accordingly, the Commission would like to explicitly set out that before serving clients in relation to unlisted derivative products, intermediaries should seek from clients, as part of the "know your client" process, information in relation to clients' knowledge of derivatives. Intermediaries would then characterize those clients (other than professional investors) who have derivative knowledge as "clients with derivative knowledge".
23. If a client is not characterized as a "client with derivative knowledge", the intermediary should not promote any unlisted derivative products to such a client in all circumstances. An intermediary can promote unlisted derivative products to a "client with derivative knowledge" provided that it complies with paragraphs 5.2 and 5.3 of the Code of Conduct and that the recommendation is suitable for the client.
24. Where a client who does not have derivative knowledge wishes to purchase an unlisted derivative product on his own initiative, the intermediary should warn the client about the proposed transaction and provide appropriate advice to him, including assessment of suitability of the transaction. The suitability assessment should take into account, inter alia, the client's personal circumstances such as his total portfolio, asset concentration and exposure to a particular market or asset class. The warning and communications with the client should be recorded. If the product is assessed to be not suitable for the client, the intermediary should exercise caution in serving the client and should act in the best interest of the client pursuant to GP1 of the Code of Conduct.
25. Intermediaries are not required to seek information about a client's knowledge of derivatives if no services with respect to unlisted derivative products are envisaged to be provided to that client. If a client who has not been characterized as a "client with derivative knowledge" subsequently wishes to purchase unlisted derivative products, the intermediary should seek such information from the client.
26. Investors may be regarded as having knowledge of derivatives through:
- (a) Undergoing training or attending courses on derivative products;
  - (b) Prior trading experience in derivative products; or



(c) Current or previous work experience related to derivative products.

The Commission seeks views on the contents of the training or courses and the extent of previous trading experience or work experience.

27. For the avoidance of doubt, intermediaries are still required to comply with the requirements under paragraphs 5.2 and 5.3 and other parts of the Code of Conduct when providing services to clients, where applicable.
28. See the draft amendments to the Code of Conduct in Appendix C to this consultation paper.

**Question (19)**

Do you think that intermediaries should, as part of their “know your client” procedures, seek clients’ information about their knowledge of derivatives and characterize those clients (other those professional investors) with such knowledge as “clients with derivative knowledge” to assist intermediaries in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable ?

Please give your views on the contents of the proposed measures for intermediaries to assess whether investors have knowledge of derivatives.



## Professional investors

29. The examination of the existing “professional investors” regime began in mid-2008 with the Commission agreeing to review the regime at a Legislative Council Panel on Financial Affairs meeting and it was decided that the professional investors review should form part of this consultation.
30. Paragraph 29.7 of the FS Report states that:
- “We recommend that the SFC consults the market on whether it is appropriate:
- (a) to raise the minimum asset portfolio requirement under the Professional Investor Rules; and
  - (b) to clarify and tighten the assessment criteria under the Code of Conduct”
31. The concept of “professional investors” was first introduced in the Code of Conduct in 2001, followed by the Professional Investor Rules being issued in 2003. The idea was that professional investors, by virtue of their experience and financial resources, would be in a better position to make informed decisions and protect their own interests. Certain investor protection requirements imposed upon intermediaries could therefore be dispensed with when providing investment services to these professional investors. A similar concept of “professional investors” is also found in other jurisdictions, such as the UK, the US, Australia and Singapore.

## Definition of “professional investors”

32. Under the Code of Conduct, there are two types of professional investors – (i) **market professionals**<sup>21</sup> (e.g. banks and insurance companies); and (ii) **high net worth investors**<sup>22</sup>. To be treated as a professional investor, a high net worth investor must possess a minimum portfolio of HK\$ 8 million, be knowledgeable and have sufficient expertise and investment experience in the relevant products and markets, and have signed a written declaration consenting to be treated as such.
33. If an investor is classified as a “professional investor”, the legal restrictions on the issuance of advertisements in relation to investments<sup>23</sup>, the making of unsolicited calls<sup>24</sup>, and the communication of an offer in relation to securities<sup>25</sup> do not apply. Further, the offering of any shares in (or debentures of) a company to professional investors is not subject to the prospectus regime under the CO.
34. Notwithstanding the above statutory exemptions, intermediaries are still required to comply with the Code of Conduct when they serve professional investors. However, under paragraph 15.5 of the Code of Conduct, intermediaries are exempted from complying with certain requirements in the Code of Conduct such as paragraph 5.2 on suitability.

<sup>21</sup> Being persons referred to in paragraph 15.2A of the Code of Conduct

<sup>22</sup> Being persons referred to in paragraph 15.2B of the Code of Conduct

<sup>23</sup> Section 103 of the SFO. This exemption also applies to issuers of securities, regulated investment agreements or collective investment schemes.

<sup>24</sup> Section 174 of the SFO

<sup>25</sup> Section 175 of the SFO



35. In the case of high net worth investors, the intermediary has to assess the knowledge, expertise and investment experience of the high net worth investor, and should have regard to factors such as the type of product previously traded, frequency and size of trades, the person's dealing experience and the person's awareness of the risks involved in trading in the relevant markets. The assessments are hereafter collectively referred to as the **“knowledge, expertise and investment experience assessment”**.

## Proposal

36. There has been an increase in the sale of investment products whose structures and features tend to be complex and the Commission is concerned that these products may not be easily understood by high net worth investors. The Commission is therefore reviewing the “professional investors” regime with the objective of ensuring that only those investors with sufficient knowledge, expertise and investment experience in the relevant financial products and having an investment portfolio of an appropriate size would be regarded as professional investors.

## Reviewing the knowledge, expertise and investment experience assessment criteria under the Code of Conduct

37. Under the existing Code of Conduct, an intermediary could “treat” a high net worth investor as a professional investor for the purposes of the Code of Conduct (and thereby be exempted from certain conduct requirements) only if it is reasonably satisfied that the investor has sufficient knowledge, expertise and investment experience in the relevant products and markets (*emphasis added*). It has always been the intention of the Commission that, as stated in the existing Code of Conduct, intermediaries should consider the investor's knowledge, expertise and investment experience that is relevant to the product type and markets under consideration. To this end, products would be regarded as “relevant products” if they have similar nature, features and inherent risks.
38. In considering whether a high net worth investor has specific knowledge and expertise in trading in the relevant product, it is proposed that the intermediary should consider whether
- (a) the person is currently working or has previously worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or
  - (b) the person has undergone training or studied courses which are related to the relevant product.
39. An independent and separate assessment should be undertaken by the intermediary prior to treating an existing high net worth investor as a professional investor in a different type of product or market.
40. In light of rapid market development and innovation, a high net worth investor may not have a sufficient level of knowledge and expertise as expected if he has ceased trading in that market or product for some time. To address this, the Commission considers that intermediaries should re-assess the knowledge, expertise and investment experience of those high net worth investors who have ceased trading for two years or more in the relevant market or product.



41. Moreover, it is the Commission's intention that the knowledge, expertise and investment experience assessment be conducted formally and in writing so that an intermediary will be able to demonstrate its compliance with the requirement. This requirement will also be expressly set out under the Code of Conduct.
42. There are other criteria that can be adopted by intermediaries to carry out the above assessment and the Commission invites market views on the appropriate criteria.
43. See the draft amendments to the Code of Conduct in Appendix C.

#### **Question (20)**

Should a high net worth investor be considered to have specific knowledge and expertise if:

- (a) he is currently working, or has previously worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or
- (b) he has undergone training or studied courses which are related to the relevant product?

Do you have any other suggestions?

#### **Reviewing the minimum portfolio requirement under the Professional Investor Rules**

44. The minimum portfolio requirement of HK\$ 8 million for high net worth investors has remained the same since 2001. For reference, as at 2 April 2001<sup>26</sup>, the Hang Seng Index closed at 12727.30 while it closed at 19724.19 on 31 August 2009. In 2007, the average net worth of wealthy individuals in Hong Kong ("individuals with a net worth of or exceeding USD 1 million") was USD 5.4 million<sup>27</sup> (around HK\$ 42.1 million). The Per Capita Gross National Product also increased by approximately 21% from 2001 to 2007<sup>28</sup>. Therefore, a fresh review might be appropriate in light of the change in social and economic conditions.
45. Industry feedback indicates that many of Hong Kong clients treated as "professional investors" have portfolios far exceeding HK\$ 8 million. In fact, the Commission initially proposed that the threshold be set at HK\$ 16 million and finally agreed to revise the threshold downwards to HK\$ 8 million after considering market feedback in 2001. In comparison with other jurisdictions, the existing minimum portfolio requirement in Hong Kong is lower than some jurisdictions: in Singapore for example, the minimum portfolio requirement is SGD 2 million (around HK\$ 11 million) while it is AUD 2.5 million in Australia (around HK\$ 16 million). However, the minimum portfolio requirement in Hong Kong is higher than that of the United Kingdom which is EUR500,000 (around HK\$5.5 million).

<sup>26</sup> The revised Code of Conduct came into effect on 1 April 2001.

<sup>27</sup> Page 8 of the "Asia-Pacific Wealth Report 2008" published by Capgemini and Merrill Lynch.

<sup>28</sup> Figure calculated by reference to the per capita GNP figures in the "2008 Gross Domestic Product (Yearly)" and "2006 Gross Domestic Product (Yearly)" published by the Census and Statistics Department of Hong Kong.



46. While it may now be the appropriate time to re-consider the minimum HK\$ 8 million portfolio requirement for a high net worth investor to be classified as a “professional investor” under the Professional Investor Rules, some of the feedback received during the soft consultation did not support raising the existing minimum portfolio requirement. Any excessive increase in the minimum portfolio requirement may have the following unintended and adverse consequences: (i) adversely affecting the private placement activities in Hong Kong; and (ii) hindering the market practice of the direct placement of a newly listed company’s shares in an initial public offering to professional investors in Hong Kong.

**Question (21)**

What amount should the minimum portfolio requirement be set at? Please give your reasons.



## Pre-sale disclosure of monetary and non-monetary benefits

47. Product issuers of investment products remunerate distributors in a variety of ways, the common ones being initial commission rebate<sup>29</sup>, trailer fee/commission<sup>30</sup> and volume benefit<sup>31</sup>. To a lesser extent, some product issuers offer non-monetary benefits (e.g. sponsored overseas conferences) to distributors. It is noted that distributors may make trading profits from the transaction (for example by buying an investment product from a third party and re-selling it to an investor).
48. Some distributors may have incentive to promote investment products that bring higher monetary rewards or benefits to themselves and this creates potential conflicts of interest between them and their clients. In such circumstances, it would be helpful if an investor is aware of the rewards or benefits received by the distributor, among other factors, in order to make an informed investment decision.
49. Potential conflicts of interest also arise for some distributors whose related companies are product issuers, as these distributors may be inclined to promote in-house products to clients.
50. Such issues are generally addressed by existing requirements in the Code of Conduct which provide that an intermediary should
- (a) act in the best interests of its clients (GP 1);
  - (b) try to avoid conflicts of interest, and when they cannot be avoided, should ensure that clients are fairly treated (GP 6); and
  - (c) not advise or deal in relation to a transaction for which it has an actual or potential conflict of interest unless it has disclosed that material interest or conflict to the client and it has taken all reasonable steps to ensure fair treatment of the client (paragraph 10.1).

Moreover, under paragraph 2.2 of the Code of Conduct, any mark-ups or fees affecting a client should be fair and reasonable in the circumstances and be characterized by good faith.

51. In order to further mitigate the abovementioned conflict of interest issues and enhance transparency, under paragraph 31.6 of the FS Report:

“We recommended that the Commission reviews requirements for comprehensive disclosure to clients at the pre-sale stage of commissions, fees and other benefits the Intermediary receives from the sale of product that it recommends or is offering to clients.”

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<sup>29</sup> An initial commission rebate is a payment made by a product issuer to a distributor at the deal closing stage in recognition of the distributor placing an investor's investment with the product issuer.

<sup>30</sup> A trailer fee/commission is an ongoing payment made by a product issuer to a distributor as long as the client holds the investment with the product issuer.

<sup>31</sup> A volume benefit is an additional reward given by a product issuer to a distributor or the group of companies in which the distributor is a member based on the sales volume in a particular product or a range of products. Depending on the structure of the volume benefit, it may not be possible to attribute the volume benefit to any particular product.



52. Reference has been made to the disclosure of benefits requirements of the UK, the US, Australia and Singapore. Currently, all these jurisdictions have rules requiring pre-sale disclosure in varying degrees whereby regulated firms (or any of their related companies in the case of the UK and Australia) are required to disclose to investors the monetary and non-monetary benefits receivable by these firms in relation to the provision of services to investors. The extent of the required disclosure varies, as can be seen in Appendix D which sets out a broad comparison of the requirements in various jurisdictions. In this regard, the Commission notes that the UK has recently issued a consultation proposing to ban product providers from offering commission to secure sales from adviser firms<sup>32</sup>. The Commission will continue to closely monitor international developments.

### Proposal

53. The Commission has identified various business models whereby an intermediary or its associates receive or will receive benefits from providing a service. Where the monetary benefits are quantifiable (e.g. initial commission rebate) prior to or at the point of sale, there are various disclosure options which are discussed below.
54. In relation to non-monetary benefits and some monetary benefits which are not quantifiable prior to or at the point of sale, a distributor would only be required to make generic disclosure of the existence and nature of each benefit.
55. All the proposed disclosures are to be made to investors, prior to or at the point of sale, in a document called a “Sales Disclosure Document”, which is covered in the section on “Sales Disclosure Document” of this consultation paper.
56. For the avoidance of doubt, this disclosure only applies to the benefits receivable at the institutional level and therefore disclosure of the benefits receivable by the sales staff is not required. Furthermore, this disclosure would not apply to situations where the intermediaries are remunerated directly by the clients for executing trades.

### **Business model 1 – Where a distributor distributes a product and it or any of its associates explicitly receives monetary benefits from that product issuer (directly or indirectly)**

The following three disclosure options are identified:

#### **Option 1.1 – Specific disclosure of dollar amount or percentage**

57. Under this option, a distributor would disclose the monetary benefits that are receivable by it and/or any of its associates in dollar amount or a precise percentage of the investment amount.

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<sup>32</sup> FSA consultation on “Distribution of retail investments: Delivering the RDR” (June 2009)



Illustration A1 - A distributor is engaged in distributing a product which requires an investor to pay 5% in subscription fees for an investment amount of HK\$100. The product issuer splits the subscription fee 50:50 between itself and the distributor. Therefore, the commission rebate paid by the product issuer to the distributor is 2.5% (or HK\$ 2.5). Option 1.1 would require the distributor to disclose to the investor the receipt of HK\$ 2.5 or 2.5% of the investment amount.

58. During the soft consultation, some market practitioners expressed concern that this option would reveal sensitive commercial information but others were supportive on the premise that this disclosure option provides the most relevant and easily understandable information to investors.

### **Option 1.2 – Specific disclosure of percentage band or ceiling (i.e. “x% to y%” or “up to y%”)**

59. Under this option, a distributor would disclose the monetary benefits that are receivable by it and/or any of its associates in percentage band or ceiling of the investment amount. Some market practitioners consulted have specifically suggested the Commission to standardise the percentage bands.

Illustration A2 - Following on from Illustration A1, Option 1.2 requires the distributor to disclose the commission rebate in the form of (i) a percentage band (say, “2% to 3% of the investment amount”) or (ii) percentage ceiling (say, “up to 3% of the investment amount”).

60. This option should provide investors with some useful information regarding how the distributor is being rewarded without revealing the same level of sensitive commercial information as Option 1.1. However, the percentage band or percentage ceiling should not be too large or too high or otherwise the disclosure may not be meaningful.

### **Option 1.3 – Generic disclosure**

61. Under this option, a distributor would simply make a generic disclosure of the existence and nature of each of the monetary benefits and where possible, the method of calculating each benefit.

#### **Question (22)**

Where a distributor and/or any of its associates explicitly receives or will receive monetary benefits from a product issuer (directly or indirectly), which of the following three disclosure options would be more appropriate? Please explain your views.

Option 1.1 – Disclosure of dollar amount or percentage

Option 1.2 – Disclosure of percentage bands or ceiling (i.e. “x% to y%” or “up to y%”)

Option 1.3 – Generic disclosure

#### **Question (23)**

Do you have any suggestions as to how the percentage bands referred to in Question 22 should be set (e.g. up to 1%, over 1% to 2%, etc)?



## **Business model 2 – Where a distributor does not explicitly receive any monetary benefits for distributing an investment product issued by itself or any of its associates**

### **Option 2.1 – Specific disclosure**

The distributor would have to determine the distribution reward in the following manner:

#### **Determining benefits - where the distributor is able to ascertain the external distribution reward**

62. A distributor of an in-house<sup>33</sup> product would ascertain how much an external distributing firm in Hong Kong is paid for distributing the same or similar product, and whether that external distributing firm is having more or less the same set of circumstances as the distributor such that this arms-length external distribution reward is a good approximation of what the distributor would reasonably expect to receive as its own product distribution reward.
63. The arms-length product distribution reward that an external distributing intermediary receives, with any reasonable adjustment necessary to reflect the distributor's own particular circumstances, would then be disclosed by the distributor to the investor in terms of precise dollar amount, percentage, percentage band or percentage ceiling together with a description of the methodology used.

Illustration B1 – A distributor is engaged in distributing an in-house product and the investment amount is HK\$100. The product issuer pays an external distributing intermediary (in comparable circumstances as the distributor within the group) 2.5% of the investment amount for distributing the same product. Under Option 2.1, the distributor would be required to disclose (i) HK\$ 2.5 or 2.5% of the investment amount; (ii) 2% to 3% of the investment amount; or (iii) up to 3% of the investment amount.

#### **Determining benefits – where the distributor is unable to ascertain the external distribution reward**

64. Where the external distribution reward cannot be ascertained, the distributor would have to estimate how much it should charge for the service it provides with a view to recovering its costs and making a profit. This approach is based on the premise that any distributor, when negotiating with a third party product issuer about the distribution reward, would seek to recover its costs and earn a target profit.

Illustration B2 – A distributor is allocated an overhead expense of HK\$870 for the year to be recovered from its service. Its senior management has a budgeted profit margin of 15% (or HK\$130). The distributor should therefore seek a total product distribution reward of HK\$1,000 (being HK\$870 (cost) + HK\$130 (profit)). Total sales have been budgeted at HK\$30,000. For a product with an investment amount of HK\$100, the product distribution reward should be  $[\text{HK}\$100 \div \text{HK}\$30,000] \times \text{HK}\$1,000 = \text{HK}\$3.3$ .

<sup>33</sup> An in-house product is a product issued by an intermediary or its associate



Under Option 2.1, the distributor would be required to disclose (i) HK\$3.3 or 3.3% of the investment amount; (ii) 3% to 4% of the investment amount; or (iii) up to 4% of the investment amount.

65. The Commission recognizes that this approach will entail higher compliance costs and any internal allocation and budgeting is likely to be subjective. On that basis, it may be difficult for investors to compare products and distribution channels on a like-with-like basis.

### Option 2.2 – Generic disclosure

66. In circumstances where the investment product is issued by an associate of the distributor, the distributor would make a generic disclosure stating that while it does not explicitly receive any benefits in distributing the investment product, the associate will benefit from the origination and distribution of the product. This disclosure obligation would also apply when the product issuer and distributor are the same company.

#### Question (24)

Where a distributor does not explicitly receive any benefits for distributing an investment product, which of the following disclosure options would be more appropriate? Please explain your views.

Option 2.1 – Specific disclosure of distribution reward

Option 2.2 – Generic disclosure

### Business model 3 – Where a distributor makes a trading profit from a transaction

67. Where a distributor sources the product externally and re-sells the product to the investor (i.e. a back-to-back transaction) and makes a profit, the distributor should disclose to the investor the profit to be made. This trading profit, to some extent, is similar to the commission that may otherwise be generated from the same transaction and therefore should be disclosed under the same principle.
68. Although, conceptually, a distributor should also disclose the trading profit where it sources the investment product from its own inventory, there are market concerns that distributors may have acquired the investment product at a different time and price and/or have different cost allocation policies and procedures. Investors will therefore not be able to compare costs on a like-with-like basis and as such, disclosure of the trading profit should not be required in such circumstances.

The distributor should disclose to the investor the profit to be made in the back-to-back transaction using either of the disclosure options outlined below.

### Option 3.1 – Specific disclosure of trading profit

69. Under this option, a distributor would have to disclose the profit from the transaction in a dollar amount, percentage, percentage band or percentage ceiling together with a description of the methodology used.



Illustration C1 – A distributor externally sources a product for a client at a price of HK\$100 and the client agrees to purchase this at a price of HK\$105. The distributor thus makes a profit of HK\$5.

Option 3.1 requires the distributor to disclose to the investor (i) the profit of HK\$5 or 5% (ii) 4% to 5% of the investor's investment amount, or (iii) up to 5% of the investor's investment amount.

70. Many of the market practitioners consulted claim that this option would reveal sensitive commercial information such as the distributor's bargaining power for securing the product from external sources. In addition, many risk or cost factors such as counterparty credit risk, financing cost etc. have not been reflected, so that the mere disclosure of trading profit may overstate the profit made by the intermediary in a back-to-back transaction.

### Option 3.2 – Generic disclosure

71. Under this option, a distributor would disclose to a client that it is making a trading profit without disclosing further details. This option may provide a practical solution to address market concerns as explained in the above paragraph.
72. Consideration may also be given to the view that distributors should disclose trading profits only where the transaction results directly from recommendations or solicitations made to clients, as this would give rise to potential or perceived conflicts of interest.

#### Question (25)

Where a distributor makes a trading profit from a back-to-back transaction, which of the following disclosure options would be more appropriate? Please explain your views.

- Option 3.1 – Disclosure of specific trading profit  
Option 3.2 – Generic disclosure

73. The Commission aims to provide investors with additional information regarding the remuneration structure of distributors to help investors make informed investment decisions. The specific disclosure option for all three business models above would best meet this objective, although the Commission is mindful of the operational issues, costs and disclosure of sensitive commercial information that may arise with this disclosure option. The Commission, therefore, seeks market views as to how disclosure of remuneration should be made in these circumstances.
74. See the draft amendments to the Code of Conduct in Appendix C to this consultation paper.



### Use of gifts by distributors in promoting a specific investment product

75. The HKMA noted that in the marketing of some Lehman retail investment products, “gifts” having monetary value such as supermarket gift coupons, audio-visual equipment and the like were offered to investors. The HKMA pointed out that consideration should be given to restrict the use of gifts as a marketing tool to promote financial products to investors.
76. In this consultation paper, the focus is on whether distributors should be subject to similar restrictions from offering certain types of gifts when marketing investment products to investors.
77. In Singapore, while the MAS does not restrict the offering of gifts to clients for conclusion of a sale, it considers it good practice for financial institutions to have proper systems and controls to ensure that the basis for any recommendation is not compromised as a result of offering gifts.
78. Such a restriction may help prevent investors, particularly unsophisticated investors, from being distracted by the gifts without paying sufficient attention to the features of the investment product.
79. Market practitioners who were soft consulted on this issue took the view that corporate gifts with low resale values should be allowed and added that discount of fees and charges for substantial purchases/transactions should also be allowed as it will reduce investors’ initial investment outlay or offset future transaction costs or fees and thus benefit investors. Intermediaries should, however, refrain from pricing the discount of fees and charges into the products.
80. See the draft amendment to the Code of Conduct in Appendix C.

#### **Question (26)**

Do you consider it appropriate to restrict distributors from offering investors supermarket gift coupons, audio visual equipment and other kinds of gifts having monetary value (except discount of fees and charges) in promoting a specific investment product to investors?

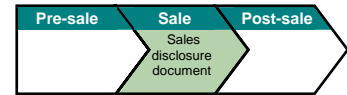


## Sales disclosure document

81. The HKMA recommended that consideration be given to require distributing institutions to produce Sales Key Facts Statements in uniform disclosure formats in respect of retail investment products. This consultation paper further discusses the pre-sale disclosure of monetary and non-monetary benefits to investors to enhance transparency.
82. Current regulations require a distributor to make adequate disclosure of relevant material information in its dealings with its clients. For example, where distributors only recommend investment products which are issued by their related companies, they should disclose this limited availability of products to each client.
83. In relation to this type of pre-sale disclosure, other jurisdictions such as the UK, the US, Australia and Singapore have rules in varying degrees requiring disclosure to investors in written form. The Commission therefore seeks views on whether a distributor distributing an investment product should disclose in writing certain information material to the sales process to an investor, in a Sales Disclosure Document, which would be delivered to the investor prior to or at the point of sale.

## Proposal

84. Although the HKMA's proposal covers all retail investment products, in practice, investors in listed products are currently being provided with information regarding the nature of the services and basis of remuneration at the account opening stage and in the client agreement and the contract note for each transaction. Hence, it appears that the Sales Disclosure Document proposal would only apply to unlisted investment products. The Commission would like to seek views on this.
85. In circumstances where delivering a Sales Disclosure Document is not possible before a transaction is concluded (e.g. telesales for a time-critical investment), the distributor should make a verbal disclosure and deliver the Sales Disclosure Document to the investor as soon as practicable after the conclusion of the transaction.
86. Regarding the information content of the Sales Disclosure Document, the following information would be included at a minimum:
  - (a) The capacity (principal or agent) in which a distributor is acting;
  - (b) Affiliation of the distributor with the product issuer;
  - (c) Disclosure of monetary and non-monetary benefits  
(For proposed disclosure options, please refer to the section on "Pre-sale disclosure of monetary and non-monetary benefits" of this consultation paper); and
  - (d) Terms and conditions in generic terms under which an investor may receive a discount of fees and charges from a distributor.
87. Some market practitioners indicated during soft consultations that if there is significant support for generic disclosure of the monetary and non-monetary benefits as set out in the relevant section in this paper, it may then be possible for the proposed disclosure in the Sales Disclosure Document to be made during the account opening stage.



Otherwise, such disclosure should be made during the selling process.

88. A Sales Disclosure Document should be in Chinese or English according to the language preference of an investor.
89. See the draft amendments to the Code of Conduct in Appendix C.

**Question (27)**

Do you have any comments on the proposed information content of the Sales Disclosure Document which includes (a) capacity (principal or agent); (b) affiliation with product issuer; (c) monetary and non-monetary benefits; and (d) discount of fees and charges available to investors?



## Audio recording

90. The HKMA Report proposed, among others, a mandatory requirement for registered institutions to audio record their customer risk profiling process and investment selling process (including where there are risk mismatches between clients' risk profiles and product risk ratings). This audio recording requirement applies to the sales of investment products, and the audio records should be kept for seven years.
91. On 25 March 2009, the HKMA issued a circular to all authorized institutions requiring them to implement the above audio recording requirements effective from July 2009. Notwithstanding this, due to the unique operating mode of private banking business, certain flexibility may be allowed on the application of this requirement for the private banking sector.
92. In overseas jurisdictions such as the UK, the US, Australia and Singapore, audio recording of the risk profiling or sales process is required under specified circumstances. For example, in Singapore, audio recording is generally not mandatory but is required in carrying out treasury activities relating to investment products, such as interest rate swaps and forward rate notes. In the US, FINRA only requires those member firms that employ 5 or more staff who have previously been subject to disciplinary actions to implement audio recording. In Australia, audio recording is regarded as an alternative to recording of advice in writing.
93. The Securities and Futures (Keeping of Records) Rules set out a broad requirement in that intermediaries would need to retain such records that are sufficient to explain and reflect the financial position and operation of their business. In addition, the Code of Conduct requires an intermediary to use a telephone recording system to record order instructions received from clients over the telephone and maintain those records for 3 months. Furthermore, under the Internal Control Guidelines and Suitability FAQs, intermediaries are requested to document and record contemporaneously the information given to each client and the rationale for recommendations given to the client, including any material queries raised by the client and the responses given by the intermediary. A copy of the basis of the investment recommendations should also be provided by the intermediary to its client.
94. On one hand, a mandatory audio recording requirement would provide a useful audit trail, particularly when a post sale dispute arises. On the other hand, such a requirement would increase compliance costs for firms. Implementation of the audio recording requirement would generally entail the installation of a specialized recording and retrieval system and additional storage space for the recorded data. There might also be a need to change the business infrastructure to enable proper recording of conversations or discussions between clients and frontline staff.
95. In addition, experienced investors who had bought similar products before might consider this arrangement to be inconvenient and time-consuming. In this regard, consideration should be given as to how the benefits of a mandatory audio recording requirement are balanced against the additional costs to firms and inconvenience to investors.
96. We understand from discussion with a fellow regulator that given the different nature of operations of different types of intermediaries, mandatory audio recording may be more preferable for intermediaries with operations in which a wide range of investment products (from relatively simple to highly complex) are offered to a large and diverse



client base (particularly with high proportion of inexperienced customers who have little knowledge in investment products), as this could offer enhanced investor protection to the customers concerned. Audio recording would be a better measure to ensure uniformity, appropriateness and due compliance with regulatory standards in this kind of operational environment.

97. In view of the HKMA's current requirements, public views are sought as to whether the audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current SFC record keeping requirements are sufficient.

**Question (28)**

Do you think audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current record keeping requirements are sufficient? If audio recording is made mandatory, how long do you think these audio records should be kept for? Please explain your views.



## List of consultation questions in Part III

**Question (18)** Do you agree that some of the proposals in this part of the consultation paper should only apply to unlisted investment products? Please explain your views.

**Question (19)** Do you think that intermediaries should, as part of their “know your client” procedures, seek clients’ information about their knowledge of derivatives and characterize those clients (other than professional investors) with such knowledge as “clients with derivative knowledge” to assist intermediaries in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable?

Please give your views on the contents of the proposed measures for intermediaries to assess whether investors have knowledge of derivatives.

**Question (20)** Should a high net worth investor be considered to have specific knowledge and expertise if:

- (a) he is currently working, or has previously worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or
- (b) he has undergone training or studied courses which are related to the relevant product?

Do you have any other suggestions?

**Question (21)** What amount should the minimum portfolio requirement be set at? Please give your reasons.

**Question (22)** Where a distributor and/or any of its associates explicitly receives or will receive monetary benefits from a product issuer (directly or indirectly), which of the following three disclosure options would be more appropriate? Please explain your views.

Option 1.1 – Disclosure of dollar amount or percentage

Option 1.2 – Disclosure of percentage bands or ceiling (i.e. “x% to y%” or “up to y%”)

Option 1.3 – Generic disclosure

**Question (23)** Do you have any suggestions as to how the percentage bands referred to in Question 22 should be set (e.g. up to 1%, over 1% to 2%, etc)?

**Question (24)** Where a distributor does not explicitly receive any monetary benefits for distributing an investment product, which of the following disclosure options would be more appropriate? Please explain your views.

Option 2.1 – Specific disclosure of distribution reward

Option 2.2 – Generic disclosure

**Question (25)** Where a distributor makes a trading profit from a back-to-back transaction, which of the following disclosure options would be more appropriate? Please explain your views.



Option 3.1 – Disclosure of specific trading profit  
Option 3.2 – Generic disclosure

- Question (26)** Do you consider it appropriate to restrict distributors from offering investors supermarket gift coupons, audio visual equipment and other kinds of gifts having monetary value (except discount of fees and charges) in promoting a specific investment product to investors?
- Question (27)** Do you have any comments on the proposed information content of the Sales Disclosure Document which includes (a) capacity (principal or agent); (b) affiliation with product issuer; (c) monetary and non-monetary benefits; and (d) discount of fees and charges available to investors?
- Question (28)** Do you think audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current record keeping requirements are sufficient? If audio recording is made mandatory, how long do you think these audio records should be kept for? Please explain your views.



## Part IV Post-sale arrangements – cooling-off period

### Introduction

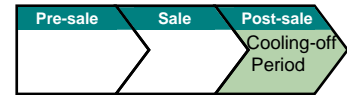
1. This Part IV discusses the request, in the Action Plan, to consider the feasibility of a cooling-off period for sales of investment products. Paragraphs 8 to 14 set out certain issues for consideration at a product-issuer level and also in terms of general implementation should responses to this consultation indicate support for its adoption. Since a cooling-off period would have implications not just for product issuers but for distributors as well, the feasibility of a cooling-off period must also be considered at the distributor level. Paragraphs 15 to 17 address these issues.

### Cooling-off period

2. Following the FS Report, the Commission was asked, in the Action Plan, to consider the feasibility of a cooling-off period for the sale of investment products. It should be noted that the term “cooling-off” is a short-hand description for rights that investors may exercise to cancel an investment in a product or to sell a product back to the issuer or its agent.
3. Typically, a cooling-off period would be a period of days after an investor places an order or acquires an investment product during which the investor could cancel the order or exit the investment<sup>34</sup>.
4. This requires consideration on several levels. We focus in paragraphs 8 to 12 below on issues arising at the product-issuer level. Introduction at the product-issuer level would, however, be dependent upon effective introduction at the distributor level, since the entitlement to a refund of at least part of the sales commissions paid by investors would be an integral part of any cooling-off rights. Without this, the focus at the product-issuer level would become more one of liquidity provision. In the case of a number of widely-available retail products, there is already a requirement in the Handbook for dealing or redemption to be available on a regular basis. In the case of unlisted structured products, requirements in this regard are proposed elsewhere in this paper.
5. It is important to note at the outset that a cooling-off period would not come without a cost to investors.
6. If an investor were to exercise his or her right to cancel an order or exit an investment during a cooling-off period, he or she would not generally be entitled to receive a full refund of the principal invested or, in some cases, of all of the sales commission he or she paid.
7. It is also important to bear in mind that there would in many cases be an increased administrative burden on product issuers and distributors in accommodating cooling-off periods and processing investor requests. Product issuers and distributors may seek to pass on certain of these administrative costs to investors in the price of the product itself and/or the commissions or sales fees charged, if they are not able to deduct these from amounts due to investors.

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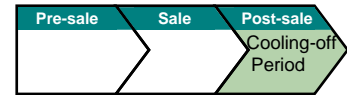
<sup>34</sup> Our review of several major jurisdictions indicates that, where cooling-off periods apply to sales of investment products, the length of time allowed may range from as little as two days to as long as 14-21 days (or even longer, in the case of certain long-term plans).



8. In some situations, it may be comparatively easy for product issuers to accommodate order cancellations. An example of this is where there is a specified offer period for an investment product prior to the date the trade is executed for the investor. It may also be possible for an investor to be given a short period of time, perhaps 24 hours, after placing his or her order before the product provider executes that order, and for investors to have the right to cancel the order within this 24-hour period. It may, however, be burdensome for distributors and product providers to implement this waiting period for each individual investor. In addition, investors would not be entitled to any return on the investment in the period between placing the order and the date of execution of the trade, thus creating the risk of disputes about when a trade should have been executed.
9. After the trade date, the investor would in effect be seeking to sell the product back to an issuer or its agent. The relevant price would need to take account of market movements during the intervening period and, in addition, reasonable costs incurred by the issuer in unwinding applicable hedging transactions. In these cases, our review of other major jurisdictions indicates that, where cooling-off periods apply to sales of investment products, the amount investors can expect to receive in respect of the product is generally the principal amount invested less certain deductions. The deductions take into account matters such as market losses incurred since the trade date, break funding costs and administrative costs, and vary depending on the type of product.
10. A cooling-off period may enhance investor protection in appropriate circumstances. We do not believe, however, that a “one-size-fits-all” approach should be adopted across all types of investment products. Investment products vary widely, and cooling-off periods may not be compatible with the nature of some products. Additionally, in some cases, investors may already be able to avail themselves of secondary market trading in the product or regular dealing days or other liquidity provision in order to exit the investment.
11. Cooling-off periods already apply in the case of ILAS. ILAS are insurance policies where policyholders are making a long-term commitment, either with a single premium payment or regular premium payments, and where substantial surrender or withdrawal charges may apply should they need or wish to terminate or redeem the policy earlier than its scheduled maturity date. In addition, therefore, to the situations described in paragraph 8 above, where there is a period during which orders could simply be cancelled before the trade date, we believe that a cooling-off period would be of most benefit for investors in situations:
  - (a) where there will be a relatively long lock-up period for the investment; and/or
  - (b) where there will not be dealings in the product or other liquidity provision on a frequent basis.
12. Consideration would also need to be given to whether this right, if proposed in respect of some types of investment products, should be limited in its application depending on an investor’s circumstances, or whether it should be available to all retail investors<sup>35</sup>.
13. Aside from the additional costs involved, consideration also needs to be given to other potential negative effects of the imposition of cooling-off periods. These include the

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<sup>35</sup> Some of the jurisdictions we have reviewed exclude certain transactions, for example situations where the investor has invested in the same product previously or where the investor has already exercised a right or power under the terms of the product.



danger that investors will assume that they will receive a full refund of the principal amount invested, when in fact this is unlikely to be achieved in most circumstances, the potential for investors to become less vigilant in reviewing products at or prior to the point-of-sale, and the danger that the right may be abused by those investors who take advantage of the ability to exit an investment to engage in short-term trading without having to be penalised for costs incurred. To discourage speculation, the amount payable in respect of the product upon exercise of such a right would need to be capped at the total principal amount invested. There is also a question of whether, depending on the nature of the product, exercise of cooling-off rights by one or more investors would be fair to other investors who maintain their investment positions<sup>36</sup>.

14. If this consultation indicates broad support for the introduction of cooling-off rights, consideration will need to be given to the regulatory means by which this should be achieved. We note that, in some of the jurisdictions we have reviewed, cooling-off periods, where they apply, are a statutory requirement. This would be one means by which Hong Kong could consider implementing this requirement and the consideration of whether the statutory route should be adopted is a subject for separate study and consideration by the legislature.

**Question (29)**

Do you believe that a cooling-off period would generally be beneficial for investors, or do you believe that costs associated with its implementation would outweigh the benefits for investors?

**Question (30)**

Please provide your views on whether investors should be given a period of time after placement of their orders during which execution of the trade is delayed and the investor is given an opportunity to cancel the order before the trade is executed. If your view is that this would generally be beneficial to investors, please provide your views on the types of investment products for which it should be considered and the appropriate cooling-off timeframe.

**Question (31)**

Please provide your views on whether, and in what circumstances, you think a window could or should be provided to investors after the date the trade in the relevant product is executed during which an issuer should be required to buy back the product at an investor's request.

<sup>36</sup> For example, fixed costs associated with a product, such as fees charged by trustees or custodians or legal fees, would typically need to be met out of the investors' subscription or purchase amounts, and thus the proportion of these costs borne by the remaining investors would increase.



## Refund by distributors

15. Some distributors have indicated that the implementation of a cooling-off period with respect to sales of investment products would impose an administrative burden on them due to the need to process each client's cancellation request. As reflected in paragraph 7 above, some financial institutions have also mentioned that this may lead to higher product prices as product issuers need to build additional margin into the price of the products to cover product unwinding costs.
16. The distributors' view was that, since they have provided distribution services and incurred costs, they should be remunerated for the work done.
17. Where a cooling-off period is incorporated in an investment product, the Commission considers that distributors could facilitate such a cooling-off arrangement by promptly passing on to the client the full amount of refund (including the sales commission) received from the product issuer less a reasonable administrative charge.

### Question (32)

On the basis that a cooling-off period is incorporated in an investment product and a client has exercised his right under the mechanism, do you consider that a distributor should promptly pass on to the client the full amount of refund (including the sales commission) received from the product issuer less a reasonable administrative charge? Please explain your views.



## List of consultation questions in Part IV

- Question (29)** Do you believe that a cooling-off period would generally be beneficial for investors, or do you believe that costs associated with its implementation would outweigh the benefits for investors?
- Question (30)** Please provide your views on whether investors should be given a period of time after placement of their orders during which execution of the trade is delayed and the investor is given an opportunity to cancel the order before the trade is executed. If your view is that this would generally be beneficial to investors, please provide your views on the types of investment products for which it should be considered and the appropriate cooling-off timeframe.
- Question (31)** Please provide your views on whether, and in what circumstances, you think a window could or should be provided to investors after the date the trade in the relevant product is executed during which an issuer should be required to buy back the product at an investor's request.
- Question (32)** On the basis that a cooling-off period is incorporated in an investment product and a client has exercised his right under the mechanism, do you consider that a distributor should promptly pass on to the client the full amount of refund (including the sales commission) received from the product issuer less a reasonable administrative charge? Please explain your views.