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

Consultation Conclusions on Proposals to Enhance Protection for the Investing Public

May 2010

Section 3 - Consultation conclusions with respect to the regulation of intermediary conduct and selling practices

Part I Executive summary

1. Part III of the Consultation Paper sought public views on proposed measures to effectively enhance intermediary conduct and selling practices relating to the sale of investment products that are securities and futures ("investment products") in Hong Kong.

2. The consultation period ended on 31 December 2009. Significant number of submissions[1] was received in response to the conduct proposals. The respondents include industry associations, professional bodies, brokers, fund managers, investment advisers, banks, insurance companies and individuals.

3. The respondents were supportive of the Commission's objective to enhance the regulation of the sale of investment products. Taking into account the submissions received and comments raised in the various discussions with industry participants, the Commission has made some amendments to the original proposed revisions where appropriate.

4. The respondents' major comments and the Commission's conclusions on the specific proposals are summarised as follows: –

Scope of application

(a) Many respondents indicated that some of the proposals in the consultation should only apply to unlisted investment products. However, other respondents indicated that they could not see any reason for the delineation and that the proposals should apply to all investment products.

(b) The Commission considers that the proposals should generally apply to the selling activities of all investment products, although consideration should be given regarding the circumstances of the business activities or mode of operation of intermediaries.

Investor characterization

(c) Respondents were generally supportive of the concept of characterizing clients based on their knowledge of derivatives, although some respondents commented that investors are already adequately profiled under the existing requirements.

(d) The Commission will codify the current practice by requiring an intermediary to assess a client's knowledge of derivatives and characterize the client (other than professional investors for the purpose of paragraph 15 of the Code of Conduct) based on his knowledge of derivatives.

[1] Separately, the Commission has received over 700 responses which appear to contain similar suggestions on banks' detailed operational procedures mainly relating to selling of structured products. These suggestions have been duly noted when developing our proposals. Our requirements are principle based and intermediaries are expected to develop their own systems and procedures to ensure compliance with such requirements.

(e) In this regard, for a client without knowledge of derivatives who wishes to purchase a derivative product, and the intermediary has not solicited the client or made a recommendation to the client in relation to the proposed transaction:

   (i) Where the product is traded on an exchange, the intermediary should explain the relevant risks associated with the product to the client.

   (ii) Where the product is not traded on an exchange, the intermediary should warn the client about the transaction and provide appropriate advice to the client as to whether or not the transaction is suitable for the client in all the circumstances. Records of the warning and other communications with the client should be kept. If the transaction is assessed to be unsuitable for the client, the intermediary may only proceed to effect the transaction if to do so would be acting in the best interests of the client in accordance with the general principles of the Code of Conduct.

Professional investors

(f) As the majority of respondents considered that the existing HK$8 million portfolio requirement should be maintained, the portfolio requirement will remain unchanged. Separately, while it is already a regulatory requirement that an investor's *knowledge* and *expertise* must be assessed prior to treating the investor as a professional investor under the Code of Conduct, the Commission will amend the Code of Conduct to make it explicit that an intermediary should assess a professional investor's knowledge and expertise in the relevant products.

Pre-sale disclosure of monetary and non-monetary benefits

(g) Most respondents were generally supportive of the proposal for distributors to provide relevant disclosure regarding the benefits they receive from product issuers for distributing investment products. However, some respondents suggested specific disclosure as this provided more relevant information to investors, while others suggested generic disclosure as they were concerned that specific disclosure would reveal sensitive commercial information.

(h) Taking into account the comments received, the Commission will require specific disclosure in terms of percentage ceiling for business models 1 (distributing third party investment products) and 3 (back-to-back transactions) and *generic disclosure* for business model 2 (distributing in-house products). The Commission takes the view that this strikes a reasonable balance between enhancing transparency and assisting investors in making informed decisions by identifying any potential conflicts of interests arising from the transactions.

(i) For benefits which are not quantifiable prior to or at the point of sale, generic disclosure of the existence and nature of the benefits will be required.

Use of gifts by distributors in promoting a specific investment product

(j) As many respondents supported this initiative, the Commission will adopt the proposal on restricting intermediaries from offering gifts (except for discount of fees and charges) for the purpose of promoting a specific investment product to investors.

Sales Disclosure Document

(k) Many respondents were supportive of the proposal for the disclosure of sales related information although they suggested that a degree of flexibility should be allowed in the way such information is disclosed to investors.

(l) Intermediaries will be required to disclose sales related information to investors (i.e. capacity in which a distributor is acting, affiliation with product issuer, monetary and non-monetary benefits received by distributor and discount of fees and charges) prior to or at the point of sale. The information may be disclosed under different formats by the intermediaries in accordance with their mode of operations.

Audio recording

(m) The majority of the respondents did not support the proposal to make audio recording of the selling process mandatory, as the consensus was that the existing record keeping requirements are sufficient. In addition, other major jurisdictions do not generally mandate audio recording of the selling process.

(n) The Commission takes the view that the current standards of record keeping are appropriate and does not propose to make audio recording of the client risk profiling process and the advisory or selling process for investment products mandatory.

Post sale arrangements - Refund by distributors under a cooling-off period

(o) As respondents were generally supportive of the proposal, the Commission will amend the Code of Conduct to provide that on the basis that a cooling-off period is incorporated in an investment product and a client has exercised his right under the mechanism, the intermediary should promptly execute the client's instruction and pass on to the client the refund (including any sales commission[2]) received from the product issuer, less a reasonable administrative charge.

5. The Commission takes this opportunity to thank all parties who have assisted or made contributions during the consultation process. A list of respondents to the Consultation Paper is set out in Appendix E.

[2] This includes the sales commission retained by the distributor in relation to that transaction.

Part II Responses and conclusions with respect to the regulation of intermediary conduct and selling practices

Scope and applicability of the proposals

Public comments

6. As noted in the consultation paper, the conduct regulation proposals relate to the sale of securities and futures products collectively referred to as investment products. The Commission sought public views on the scope and applicability of the proposals.

7. Many respondents indicated that some of the proposals in the consultation paper should only apply to unlisted investment products, such as unlisted structured products or derivative products. This is because listed investment products are generally less complex, relatively standardized, and are subject to oversight by relevant exchanges and public disclosure requirements and often transact on an execution basis.

8. Other respondents indicated that they could not see any reason for the delineation and that the proposals should apply to all investment products, irrespective of their listing status.

Commission's response

9. The Commission is grateful for all the comments and agrees that the conduct regulation proposals which aim to enhance investor protection should not be delineated based on the listing status of an investment product. In this regard, consideration of the scope and applicability of the proposals should be made on the circumstances of the business activities or mode of operation of intermediaries. This approach is, in fact, consistent with the existing application of the Code of Conduct.

Investor characterization

Public comments

10. Respondents are generally supportive of the concept of characterizing clients based on their knowledge of derivatives. However, some respondents queried the need to create a new category of "clients with knowledge of derivatives", on the grounds that investors are already adequately profiled under the existing "know your client" requirements as provided under the Code of Conduct.

11. Some respondents commented that many derivative products are not inherently riskier than those which do not contain embedded derivatives. They noted that some of these derivative products are simple and can be easily understood by investors. In particular, some respondents suggested that investment products authorized by the Commission could be carved out.

12. Some respondents commented that providing adequate explanation of the product features and risks to the clients and/or enhancing the training and education of frontline staff are more important than ensuring clients have the relevant product knowledge and experience in derivatives, before investing in such products.

13. Many respondents commented that the three proposed factors for the purpose of gathering information about clients' knowledge of derivatives are too narrowly focused. For instance, some clients may gain knowledge through other means. Some respondents also took the view that it is difficult or costly to establish objective standards to determine whether a client satisfies the factors stipulated.

14. Some respondents provided feedback in relation to the promotion of derivative products. They pointed out that investors' choice of investments may be limited under the proposal. Some were of the view that the proposal may impact on the derivative products' market. Some also queried why the proposal only applies to unlisted derivative products.

Commission's response

15. Under the existing "know your client" requirements, an intermediary is already required to collect information from each client, including information on their investment knowledge[3]. When derivative products are involved, the intermediary is further required to assure itself that the client understands the nature and risks of the products and has sufficient net worth to assume the risks and bear the potential losses of trading in the products (paragraph 5.3 of the Code of Conduct).

16. It is understood that intermediaries have been seeking information about a client's knowledge in derivatives during the account opening stage. The Commission has therefore decided to codify this practice (as part of the "know your client" procedures) of characterizing investors (other than professional investors for the purpose of paragraph 15 of the Code of Conduct) based on their knowledge of derivatives.

17. As professional investors are subject to a separate regime governed by paragraph 15 of the Code of Conduct, the new requirement for characterization will not apply to such professional investors. Nevertheless, an intermediary providing services to such professional investors in derivative products still has to comply with paragraph 5.3 of the Code of Conduct.

18. Hence, in view of paragraphs 15 and 16 above, in the circumstances where a client without knowledge of derivatives wishes to purchase a derivative product which is traded on an exchange and the intermediary has not solicited the client or made a recommendation to the client in relation to the proposed transaction, the intermediary is required to explain the relevant risks associated with the product to the client. The requirement to ensure suitability under paragraph 5.2 of the Code of Conduct will apply as normal if the intermediary solicits the client or makes a recommendation to the client to purchase a derivative product.

19. As proposed under paragraph 24 under Part III of the Consultation Paper, another requirement will be introduced such that where a client without knowledge of derivatives wishes to purchase a derivative product which is *not* traded on an exchange and the intermediary has not solicited the client or made a recommendation to the client in relation to the proposed transaction, the intermediary should warn the client about the transaction and, having regard to the information about the client which the intermediary has or should have acquired through the "know your client" procedures, particularly the fact that he is a client without knowledge of derivatives, the intermediary should provide appropriate advice to the client as to whether or not the transaction is suitable for the client in all the circumstances. Records of the warning and other communications with

[3] Circular on Questions and Answers on Suitability Obligations issued by the Commission on 8 May 2007

the client should be kept. If the transaction is assessed to be *unsuitable* for the client, the intermediary may only proceed to effect the transaction if to do so would be acting in the best interests of the client in accordance with the general principles of the Code of Conduct.

20. In any event, an intermediary when providing services in derivative products should ensure compliance with all relevant requirements under the Code of Conduct (including paragraph 5.3).

21. Since funds authorized by the Commission may enter into derivative transactions in varying degrees, depending on the underlying investments and the investment strategy of the fund, it is considered that funds authorized by the Commission cannot be carved out from this requirement.

22. In response to public comments, it should be noted that explaining product features and risks to clients as well as enhancing the training and education of frontline staff are all existing requirements for intermediaries in order to comply with the relevant general principles under the Code of Conduct.

23. In view of the comments from the industry and acknowledging that there are other considerations that can be taken into account in characterizing an investor, the Commission considers the proposed criteria for assessing whether or not a client has knowledge of derivatives should be viewed as examples only and will not be included in the Code of Conduct. The Commission will issue guidance on this separately.

24. The Commission considers that under the existing regulatory regime, intermediaries can promote derivative products to any client provided that all relevant requirements under the Code of Conduct (including paragraphs 5.2 and 5.3) are complied with.

25. The amendments to the Code of Conduct in connection with investor characterization are set out in Appendix D (Code ref.: 5.1A).

Professional Investors

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

Public comments

26. Most respondents agreed with the Commission's proposition that an intermediary, prior to treating an investor as a professional investor[4] under the Code of Conduct, should assess the investor's knowledge and expertise in the relevant product. In response to the proposal that an investor's relevant working experience or attendance of relevant training or courses could be taken into account in the assessment, some respondents suggested that the recency of the experience or attendance should be considered. Further, some respondents expressed concern about the difficulty in determining whether attendance of certain training or a particular course was relevant and suggested that the Commission or other institutions specify or endorse a list of approved training/courses.

[4] An investor referred to in paragraph 15.2B of the Code of Conduct.

27. The proposed detailed considerations (as set out in paragraph 38 of the Consultation Paper) in assessing a professional investor's knowledge and expertise were considered to be restrictive by some respondents.

28. Some respondents wished for more guidance be given on assessing an investor's knowledge, expertise and investment experience. In discussing the relevant considerations for the assessment, respondents made a number of suggestions which included considerations such as whether the investor's net worth and investment amount in that transaction is of a reasonable ratio, years of trading experience and education level etc. Some also expressed the view that the existing criteria are stringent.

29. General comments in relation to the professional investor's regime and the assessment criteria under the Code of Conduct were also received. A few respondents sought clarification on certain terms used in paragraph 15.3 of the Code of Conduct. Other respondents suggested that there should be no waiver of the requirement to ensure suitability and some went further to say that there is no need for a special category of professional investors as they should be treated as normal retail investors.

Commission's response

30. At the outset, the Commission would like to emphasize that the requirement for an intermediary to assess a professional investor's knowledge and expertise is already embedded in paragraph 15.3 of the Code of Conduct. The current proposal makes it explicit that the intermediary should assess a professional investor's knowledge and expertise.

31. In view of the comments from the industry and acknowledging that there are other considerations that can be taken into account in assessing a professional investor's knowledge and expertise, the Commission agrees that the proposed considerations for assessing whether or not a professional investor has the requisite knowledge and expertise should be viewed as examples only and will not be included in the Code of Conduct. The Commission will issue guidance on this separately.

32. The Commission also takes this opportunity to clarify that while intermediaries are required to consider all criteria set out in the proposed paragraph 15.3(a) – (e) of the Code of Conduct, the wording in brackets in paragraph 15.3(b) and (c) of the Code of Conduct (which is existing wording) is intended to give some suggestions and guidance to intermediaries on how the assessment could be conducted. Intermediaries may adopt a holistic approach in conducting the assessment and reach a reasonable conclusion as to whether the investor could be treated as a professional investor under the Code of Conduct in the particular product and/or market in question.

33. Regarding the public comments on the terms "relevant product" and "relevant market" in paragraph 15 of the Code of Conduct, the Commission has provided guidance in the form of a FAQ dated 16 July 2001. Regarding the term "relevant products", as set out in the Consultation Paper, products would be regarded as "relevant products" if they have similar nature, features and inherent risks.

34. Finally, in response to the suggestions that there should be no separate category of professional investors and/or no waiver of the requirement to ensure suitability, the Commission considers that similar arguments have been considered and discussed in the Consultation Conclusions on the Code of Conduct for Regulated Persons Serving the Professional or Sophisticated Markets issued in February 2001. The current professional

investor regime in Hong Kong is in line with other major international financial markets and should not be changed significantly.

Reviewing the minimum portfolio requirement under the Securities and Futures (Professional Investor) Rules ("Professional Investor Rules")

Public comments

35. The majority of respondents were of the view that the minimum portfolio requirement should be maintained at HK$8 million. Many respondents were concerned about the adverse impact that any increase in the minimum portfolio amount would have on the private placement market in Hong Kong.

Commission's response

36. The Commission values the views expressed that any changes to the minimum portfolio requirement would impact upon private placement activities in Hong Kong. The Commission notes that the current minimum portfolio requirement of HK$8 million is comparable to other jurisdictions (e.g. higher than that in the United Kingdom and lower than that in Australia and Singapore).

37. Further, the Commission would like to highlight that the minimum portfolio requirement is only for the purpose of classifying an investor as a professional investor under the Professional Investor Rules. Before such professional investor can be treated as a professional investor under the Code of Conduct, the intermediary must be reasonably satisfied that the investor has the requisite knowledge, expertise and investment experience in the relevant product and/or market, as set out in paragraph 15.3 of the Code of Conduct, and fulfil the requirements under paragraph 15.4 of the Code of Conduct including obtaining the investor's written consent to be treated as a professional investor. All in all, the Commission considers that it is in the best interests of the investing public to maintain the existing minimum portfolio requirement at HK$8 million. With respect to the evidential requirements for establishing this minimum portfolio threshold of HK$8 million and other evidential requirements in the Professional Investor Rules for professional investors, the Commission will study this matter further and consult the market in due course.[5]

38. The amendments to the Code of Conduct in relation to the professional investor regime are set out in Appendix D (Code ref.: 15.3).

Pre-sale disclosure of monetary and non-monetary benefits

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)

Public comments

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[5] See paragraph 31 of the Consultation Conclusions on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance published by the Commission on 22 April 2010 on the SFC's website at www.sfc.hk.

39. Most respondents were generally supportive of the proposal to disclose the benefits received by distributors from product issuers for distributing investment products. However, they had diverse views on the disclosure options.

40. Some respondents suggested to make specific disclosure under option 1.1 (i.e. specific disclosure of dollar amount or precise percentage) as they considered this option provided the most relevant and easily understandable information to investors. Some opted for option 1.2 (i.e. specific disclosure of percentage band or ceiling) as they considered this option struck a good balance between transparency and commercial secrecy and provided more flexibility to the industry as compared with option 1.1.

41. However, some respondents suggested generic disclosure as they were concerned that specific disclosure would reveal sensitive commercial information and distract investors' attention from the features and risks of the products. They also commented that generic disclosure could avoid confusion to investors as benefit arrangements could vary by product and some arrangements may be too complicated for investors to understand. Some respondents suggested that intermediaries be required to make generic disclosure but upon specific request from investors, they would then make specific disclosure of benefits such as in the form of percentage ceiling of the investment amount.

Commission's response

42. The Commission is of the view that under business model 1, specific disclosure should be made for benefits which are quantifiable prior to or at the point of sale as this provides investors with more information to assist them to make informed decisions by identifying any potential conflicts of interest arising from the transactions and brings us on par with other major financial markets.

43. The Commission concludes that under business model 1, as a minimum, a distributor should disclose the monetary benefits that are receivable by it and/or any of its associates in the form of a percentage ceiling of the investment amount rounded up to the nearest whole percentage point or the dollar equivalent. However, a distributor may go further and disclose a specific percentage or the dollar equivalent instead.

44. For example, where a distributor receives a commission rebate of 2.6% from the product issuer, the distributor must at least disclose a percentage ceiling of up to 3% of the investment amount but may disclose the specific percentage of 2.6% instead.

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

Public comments

45. We noted that while some of the respondents were supportive of specific disclosure under this business model, the rest preferred generic disclosure.

46. Those who preferred generic disclosure commented that intermediaries had varied practices to account for in-house transactions and allocated profits and costs between the manufacturing and distribution arms of their organizations. Thus the figures disclosed would not be comparable between different intermediaries due to different bases of estimation. It would be difficult to achieve consistency and provide meaningful comparison for investors.

47. Some respondents were concerned that if the Commission required disclosure of distribution reward for in-house products, such rewards might be kept in the trading book instead of being disclosed as distribution rewards. In-house products might then become more marketable than third party products and place external product providers at a disadvantage.

48. Some respondents commented that specific disclosure was not appropriate for fund managers undertaking their own internal distribution. This was because in the fund context, the fund manager would often assume a distributor role, in which case the distribution reward would be a component of the management fee. It would be difficult and seem very arbitrary for the manager to segregate the fee ascribed to the distributor function as it is related to its asset management function.

Commission's response

49. No other major jurisdiction requires such disclosure for distribution of in-house products, apart from the UK whereby the disclosed benefits are calculated in accordance with a set formula. Taking into account also the respondents' comments, the Commission agrees that the generic disclosure option could be adopted for distribution of in-house products under business model 2. As such, the distributor should disclose that it or any of its associates will benefit from the origination and distribution of the in-house product.

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

Public comments

50. Some respondents supported specific disclosure of the profit made from a back-to-back transaction. In the consultation paper, this refers to a transaction when the distributor sources the product externally and re-sells the product to the investor. A respondent commented that this proposal should apply when distributors sell the product on a "riskless principal" basis, meaning that those transactions that were technically structured as back-to-back principal transactions, but through which the distributor did not take on any significant principal risk and it does not have any ongoing exposure to the product issuer. Another respondent also commented that the disclosure should apply to back-to-back transactions and not to "warehoused transactions" where the distributor sources the investment product from its own inventory.

51. Many respondents expressed concerns about making specific disclosure of trading profits under business model 3 as they considered that this would reveal sensitive commercial information and the trading profits might include revenue from additional risks taken on by the distributor and not necessarily the distribution reward only.

Commission's response

52. The Commission is of the view that this disclosure requirement should apply to profit made from back-to-back transactions, as such trading profit is similar to commission rebates received for distribution of third party products under business model 1 and hence should be disclosed. Having regard to the comments received from the respondents, the Commission considers that back-to-back transactions should refer to those transactions where a distributor, after receiving a purchase order from an investor, purchases an investment product from a third party and then sells the same investment product to the investor and no market risk is taken by the distributor save for settlement and other risks involved in dealing with the counterparty and the investor.

53. As per business model 1, the distributor, as a minimum, should disclose the profit from the back-to-back transaction in a percentage ceiling of the investment amount rounded up to the nearest whole percentage point or the dollar equivalent but may disclose the specific percentage or the dollar equivalent instead.

Generic disclosure for monetary or non-monetary benefits which are not quantifiable prior to or at the point of sale

Public comments

54. Some respondents suggested that the Commission provide examples of a generic disclosure statement for non-monetary benefits.

55. Other respondents commented that there was no need to spell out the complicated formula in generic disclosure as this was not readily understandable to clients.

Commission's response

56. As proposed in paragraph 54 of the Consultation Paper, for non-monetary benefits and benefits which are not quantifiable prior to or at the point of sale, a distributor is required to disclose the existence and nature of such benefits.

57. The extent of disclosure would inevitably vary and depend on the facts and circumstances of each case. The guiding principle is that the disclosure is prominent, is presented in a clear and concise manner and is easy for average investors to understand.

58. Regarding the Commission's response to the request for exemption from compliance with this requirement, please refer to the section on "Sales Disclosure Document".

59. The amendments to the Code of Conduct to give effect to the requirements for the 3 business models mentioned above are set out in Appendix D (Code ref.: 8.3).

Use of gifts by distributors in promoting a specific investment product

Public comments

60. Many respondents supported the Commission's proposal to restrict distributors from offering investors gifts that have monetary value (except discount of fees and charges) in promoting a specific investment product to investors. Nevertheless, some respondents commented that there should not be a total ban on the offering of gifts. Instead, safeguards could be built in to achieve the desired objective. Some respondents also considered that the suitability assessment and risk disclosure are more relevant for the protection of investors than prohibition of gifts, and that regulations should not act to impede commercial decisions. Some of them suggested that instead of restricting the use of gifts, the Commission should enhance its work on investor education.

61. Some respondents commented that there should be flexibility in the offering of gifts. For instance, they suggested that gifts should be allowed for brand promotion, relationship building and general non-product specific activities, as such gifts do not serve to entice an investor to invest in a specific investment product. Some respondents also enquired specifically whether gifts such as bonus units, additional shares, discounted price for multiple purchases, special pricing for elite groups, loyalty based reward programs,

waiver of front-end loads, reduction of insurance premiums, medical check-ups and travel packages would be allowed. A respondent also commented that corporate gifts of low resale value should be allowed.

Commission's response

62. The Commission agrees that it is important for distributors to perform a suitability assessment and disclose the features and risks of the investment products to investors. However, to help protect investors, particularly unsophisticated investors, from being distracted by the gifts without paying sufficient attention to the features and risks of the investment product, the Commission maintains the view that there should be restrictions on the offering of gifts when distributors promote a specific investment product to investors.

63. The Commission would like to clarify that it is not our policy intent to impose a complete ban on the offering of gifts. Distributors are only restricted from offering gifts (except discount of fees and charges) such as supermarket gift coupons and audio visual equipment when they promote “a specific investment product”. It follows that incentives in the form of, say a waiver of a front-end load amounts to a reduction of fees and charges and the offering of any gifts for brand promotion, relationship building or other purposes not directly related to the promotion of a specific investment product will not be bound by this requirement. However, other kinds of gifts that are used for promoting a specific investment product to investors will be restricted.

64. Further, the Commission has revised the proposal such that reference to monetary value of the gift under the previous proposal has been removed. The Commission believes that it would be more appropriate to focus on the purpose of the gift offered rather than the “monetary value” of the gift.

65. The amendment to the Code of Conduct regarding use of gifts by distributors in promoting a specific investment product is set out in Appendix D (Code ref.: 3.11).

Sales Disclosure Document

Public comments

66. Many respondents were supportive of the proposal to disclose the following information to investors prior to or at the point of sale:

- The capacity (principal or agent) in which a distributor is acting;
- Affiliation of the distributor with the product issuer;
- Disclosure of monetary and non-monetary benefits (For details of disclosure options, please refer to the section on “pre-sale disclosure of monetary and non-monetary benefits” of this paper); and
- Terms and conditions in generic terms under which an investor may receive a discount of fees and charges from a distributor.

67. Many respondents also suggested that flexibility should be allowed in the way the information is disclosed to investors. Some respondents commented that some of the abovementioned information is already contained in documents such as account opening documents, subscription forms and trade confirmations. Thus, instead of issuing another document with similar content that may distract investors' attention, these respondents requested for more flexibility in terms of the format in which information is to be provided

to the investors. A respondent also requested for flexibility in terms of the means of distribution (e.g. electronic means).

68. Given that the sales process may be made via telephone and certain transactions may be time critical, some respondents suggested that the document containing the required information be provided to the investors after the completion of these transactions.

69. Some respondents suggested that this requirement be waived for certain classes of investors, in particular those investors that possess better investment knowledge and experience as well as greater bargaining powers to negotiate fees and charges.

70. Some respondents also requested more guidance as to the format, length and language of the disclosure.

Commission's response

71. The Commission agrees that the information can be provided to investors under different formats in accordance with the mode of operation of each distributor.

72. As our proposal focuses mainly on the sale of investment products to retail investors, distributors should have adequate measures to ensure that the information is provided to investors at various stages of the selling process prior to the point of sale and that investors are aware of such information. For instance, certain information can be disclosed in the account opening document, while other information can be set out in other documents, such as subscription forms. The disclosure must be made in writing whether electronically or otherwise.

73. As mentioned in paragraph 85 of the Consultation Paper, in circumstances where delivering a document containing the required information is not possible before a transaction is concluded (e.g. telesales for a time-critical investment), the distributor should make a verbal disclosure prior to the point of sale and disclose such information again in writing as soon as practicable after the conclusion of the transaction.

74. The Commission also wishes to clarify that distributors are only required to disclose the terms and conditions "in generic terms" under which an investor may receive a discount of fees and charges. This would not involve sensitive commercial information and therefore distributors should be able to provide it without major practical difficulties.

75. Consistent with those provisions under the Code of Conduct that may be waived for professional investors for the purpose of paragraph 15 of the Code of Conduct, the Commission agrees not to apply this requirement to professional investors for the purpose of paragraph 15 of the Code of Conduct.

76. The Commission does not mandate the length and style of presentation, as long as the requirement is observed. However, distributors should ensure that such disclosure in writing is prominent, is presented in a clear and concise manner and is easy for average investors to understand.

77. The amendments to the Code of Conduct to give effect to the requirements mentioned above are set out in Appendix D (Code ref.: 8.3A).

Audio Recording

Public comments

78. The vast majority of the respondents considered that audio recording of the client risk profiling process and the advisory or selling process for investment products should not be made mandatory. Some respondents considered that such requirement is impractical as it might not fit into different business models operated by the intermediaries and would increase administrative burden. Some respondents were also concerned that audio recording might cause inconvenience to investors. Other respondents expressed concerns over the issue of confidentiality of investors' information, and were of the view that some investors might be reluctant to have certain personal information audio recorded. Above all, they considered that the existing record keeping requirements are sufficient.

79. Some respondents took the view that the proposed requirement should be made optional and considered that alternative measures of compliance with the regulatory requirement and objective should be allowed. Certain other respondents suggested that exemptions should be granted in certain circumstances.

Commission's response

80. The existing regulatory requirements on record keeping are in place to ensure that intermediaries retain proper and sufficient records which could adequately explain their financial position and business operations, and to ensure that material information and recommendations given to each investor are properly documented. Specifically, the Securities and Futures (Keeping of Records) Rules set out a broad requirement that intermediaries must retain such records as 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.

81. 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 clients.

82. The Commission recognizes the concerns highlighted by the respondents and is mindful of the need to take into account the operational burden on intermediaries when considering measures to enhance the protection of the investing public. In overseas jurisdictions such as Australia, Singapore, the UK and the US, although audio recording may be required under specific circumstances, audio recording of the client risk profiling and selling process is generally not mandatory. The Commission takes the view that the current standards of record keeping are appropriate, and are also in line and compatible with international standards.

83. Having considered the comments received from respondents, and given that the existing record keeping requirements are considered appropriate, the Commission concludes that audio recording of the client risk profiling process and the advisory or selling process for investment products is not to be made mandatory. Nevertheless, given the different nature of operations of some types of intermediaries, additional audio recording

measures as required by their regulators may be justified and adopted in their particular circumstances.

Post sale arrangements - Refund by distributors under a cooling-off period

Public comments

84. In general, respondents agreed with the proposal that if a cooling-off mechanism (i.e. a period in which a client has the right to cancel his order, sell the product back to the issuer or its agent, or otherwise unwind the transaction) is incorporated in an investment product and the client has exercised his right under the mechanism, then the distributor should facilitate such a cooling-off arrangement by passing on to the client the refund received from the product issuer.

85. A few respondents expressed the view that since distributors have provided services and incurred costs in the selling and distribution process, they should be remunerated for their work. These respondents further stated that refunding sales commission to clients would be unfair to distributors in the absence of any wrongdoing on their part. Thus, distributors should be allowed to keep their sales commission. However, one respondent who supported the proposal expressed the view that if distributors are required to return the sales commission, they will be encouraged to ensure that the products sold are suitable for their clients.

86. In relation to how promptly a distributor should pass on the refund to its client, one respondent commented that it is not possible for the distributor to commit to a definite time to provide a refund for all eligible products because the administrative work involved varies from one product to another.

87. Respondents generally supported the view that distributors should be allowed to impose an administrative charge to cover the costs associated with the handling of the refund. Several respondents suggested that the administrative charge should cover the costs in processing the refund.

Commission's response

88. The Commission acknowledges certain distributors' concerns on refunding the sales commission, in particular when there is no wrongdoing on their part. However, the concept of a cooling-off period is to cancel an order or exit from the investment within a short period after an investor makes the investment by refunding the investment amount less any market value adjustment (including break costs attributable to the unwinding or cancellation). As such, the Commission takes the view that sales commissions should also be refunded.

89. Given the broad support for the proposal, the Commission will require distributors to pass on as soon as practicable to their clients the refund (including sales commission[6]) received from product issuers less a reasonable administrative charge should the clients exercise their cooling-off or unwinding rights.

90. Clients should be informed of the amount of administrative charge at or prior to the point of sale. Administrative charges are the handling fees in processing the refund. They should only cover the direct cost incurred in processing the request for refund and not

6 This includes any sales commission retained by the licensed or registered person in relation to that transaction.

recoup any of the sales commission or contain any profit margin. Under paragraph 2.2 of the Code of Conduct, the charges etc. affecting a client should be fair and reasonable in the circumstances, and be characterised by good faith.

91. The Commission notes that in many cases a distributor or its nominee holds the products on behalf of its clients. As far as the clients are concerned, the distributor is their point of contact. Therefore, it is incumbent on distributors to put in place proper procedures to facilitate their clients to exercise their cooling-off or unwinding rights smoothly. Under paragraph 3.1 of the Code of Conduct, distributors are required to promptly execute clients' instructions for processing a refund. This is now also reflected in the new paragraph 13.5 of the Code of Conduct.

92. Separately, under General Principle 5 of the Code of Conduct, distributors are required to make adequate disclosure of relevant material information in their dealings with clients. In this regard, distributors should disclose the cooling-off mechanism prior to or at the point of sale (including information on how clients can exercise their cooling-off right), and as an ongoing obligation pass on relevant information provided by product issuers to their clients. Generally, the information to be disclosed includes the relevant market value adjustment attributable to unwinding a transaction, the possibility that the clients may not be able to obtain a full refund of the principal invested, what the amount of the refund will be and when the clients will receive the refund.

93. The amendment to the Code of Conduct regarding the refund obligation of a distributor in relation to a product which has incorporated a cooling-off period is set out in Appendix D (Code ref.: 13.5).

Transitional arrangements

94. The requirement relating to the restriction on the use of gifts in promoting a specific investment product will become effective in 3 months upon the publication of the amendments to the Code of Conduct in the Government Gazette. Except for the refund obligation which will become effective as and when the Code on Unlisted Structured Investment Products takes effect, the other requirements, such as disclosure of benefits and investor characterisation etc., will become effective 12 months following the gazettal of the amendments to the Code of Conduct.