



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



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Section 1 Introduction

Background

1. In September 2009, the Securities and Futures Commission (SFC or Commission) launched a three-month consultation on a package of proposals to strengthen the regulatory regime with respect to investment products and conduct of intermediaries.
2. The proposals were directed at updating the regulatory framework in view of market developments, enhancing protection for the investing public and addressing issues highlighted in the report submitted by the SFC to the Financial Secretary¹ in December 2008.
3. The proposals covered investment products and conduct of intermediaries, and spanned the three key stages of the life of an investment: the pre-sale, sale and post-sale periods.
4. The proposed measures included the introduction of a consolidated SFC Handbook comprising revised product codes for unit trusts and mutual funds and for investment-linked assurance schemes and a new product code for unlisted structured investment products, a requirement for product key facts statements that summarise the key features and risks of investment products, a post-sale “cooling-off” or “unwind” period for certain unlisted structured investment products, and new requirements to enhance regulation of intermediaries conduct and selling practices relating to the sale of investment products.
5. The public were invited to comment on the proposals. In finalising our proposals, we held discussions with a diverse group of industry participants including banks, brokers, fund managers, investment advisers, insurance companies, professional firms and industry groups, as well as consumer groups and academics.
6. We also organised a forum to exchange views with some 240 industry participants on two key proposals, and invited experts from major overseas regulators to share their insights on the implementation of similar measures in their respective jurisdictions.

Submissions and conclusions

7. At the end of the consultation period, we had received over 100 submissions from a diverse group of stakeholders. Many of the responses were very detailed, and we thank the respondents for their feedback. A list of respondents is set out in Appendix E.
8. Respondents were generally supportive of the objectives underpinning our proposals. On certain specific measures, differing views were received. We have carefully analysed and considered the comments and adopted a balanced approach in arriving at the conclusions.

¹ Issues raised by the Lehmans Minibonds crisis, Report to the Financial Secretary, December 2008



9. As noted in the consultation paper, we had in mind, first and foremost, the need to enhance investor protection. At the same time, we are aware of the potential compliance costs of some of the proposed measures to the market. We believe that the regulatory framework should afford investors an appropriate level of protection whilst providing scope for the market to develop. We have therefore decided to implement the majority of the proposals outlined in the consultation paper, with modifications made in light of comments, suggestions and feedback received during the consultation process.
10. We believe the measures are proportionate, reasonable and in line with our regulatory objectives. They will enhance protection for the investing public as well as strengthen Hong Kong's position as an international financial centre.

How to read this conclusions paper

11. For readers' convenience, we have grouped the measures in the conclusions in separate sections as set out below:
 - Section 1 - Introduction
 - Section 2 - Products
 - Section 3 - Conduct of Intermediaries
12. Section 2 sets out the consultation conclusions in relation to the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products.
13. Section 3 sets out the consultation conclusions in relation to the regulation of intermediaries conduct and selling practices relating to the sale of investment products.
14. A post-sale "cooling-off" period was discussed separately in Part IV of the consultation paper. This will be incorporated as a code requirement imposed on issuers of unlisted structured investment products, as detailed in Section 2 of this conclusions paper. The obligations imposed on relevant intermediaries in the event that investors exercise this right are set out in Section 3.
15. We have also provided an analysis of the comments received on each individual proposal and set out the rationale for our conclusions.

The way forward

16. Some of the measures will take effect immediately after publication of the revised codes in the Government Gazette. We are mindful of the adjustments required of industry participants to comply with some of the new requirements, and therefore have provided transitional arrangements in some areas. Further details about the effective dates are set out in Sections 2 and 3.
17. We will work closely with the industry and may issue additional guidance on transitioning to the revised regime where necessary. We plan to organise seminars or workshops on the new requirements. We will also launch a series of focused investor



education programmes aimed at informing the investing public of the details of these new measures.



Section 2 – Products

Consultation conclusions with respect to the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products

Part I Executive summary

Introduction

1. On 25 September 2009, the Commission issued a consultation paper (Consultation Paper) on proposals for enhancements to the regulatory regime governing the sale of retail investment products in Hong Kong. The three-month consultation ended on 31 December 2009.
2. Part II of the Consultation Paper introduced the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (the Handbook), a draft of which was attached as Appendix A to the Consultation Paper.
3. The Handbook is a consolidation of the two existing codes on Unit Trusts and Mutual Funds (UT) and Investment-Linked Assurance Schemes (ILAS) and a new Code on Unlisted Structured Investment Products (formerly known as the “Code on Unlisted Structured Products”, SIP Code). We took this opportunity to review and update the existing product codes, namely Code on UT (UT Code) and Code on ILAS (ILAS Code), in view of the market developments. The submissions made in response to the products proposals represented comments from a diverse group of industry participants such as banks, brokers, financial advisors, fund managers, and insurance companies, professional firms, representative bodies and the general public. We thank all respondents for their feedback and comments. The rest of this Part gives an overview of the submissions that we have received. We also set out our conclusions on a number of cross-product proposals and outline the transitional arrangements. Further details of our conclusions in relation to specific investment products are provided in the parts on the SIP Code, the UT Code and the ILAS Code below. Unless otherwise defined, capitalised terms used herein shall have the same meaning as defined in the applicable codes.

Overview of submissions

4. Respondents to the questions posed in the Products section of the Consultation Paper were generally supportive of the objectives underpinning the proposals.
5. The responses we received reflected various perspectives on the proposals themselves. These ranged from “yes” or “no” responses to particular proposals, to requests for clarification of, or modifications to, a number of the measures proposed in the draft Handbook, to suggestions for further measures to be included or alternative approaches to be adopted, through to more technical comments with respect to implementation. In addition to responses to the questions posed in Part II of the Consultation Paper, we received many detailed comments on specific provisions



within the draft Handbook. Some industry participants also raised concerns over compliance costs.

6. As already mentioned in the Consultation Paper, recent events have exposed issues in connection with the sale of investment products and have negatively impacted the reputation of our market both locally and internationally. While mindful of the potential impact on the financial markets, our first priority is additional investor protection.
7. We have carefully analysed the comments received and adopted a balanced approach in coming to our conclusions.
8. We understand the concerns that some of our proposals might increase compliance costs for the industry. We have also taken into account the submissions we received objecting to certain proposals, or seeking limits on their application. However, on balance, we consider that the Handbook proposals contained in our Consultation Paper are reasonable measures that will be beneficial to the development of Hong Kong's financial markets and to the protection of the investing public. We have retained the majority of these proposals accordingly.

Conclusions with respect to cross-product proposals

9. The Handbook contains a set of overarching principles that will apply across the different types of products governed by the Handbook. These are intended to enhance product transparency and to set an overall disclosure standard for all offering documents in respect of different investment products being offered to the public in Hong Kong.
10. The responses received to this part of the Consultation Paper are generally supportive of the introduction of these cross-product principles. The responses indicate that the principles are viewed as consistent with the objective of enhancing investor protection.

Product Key Facts Statements (Product KFS)

11. The Commission received overwhelming support, particularly from general members of the public coming from the non-industry sector, for the proposal to introduce Product KFS. Product KFS are intended to serve as concise product summaries, written in plain language, and feedback indicated that respondents felt that this would help investors understand the key features and risks of investment products.
12. A majority of the comments received in relation to the requirement for Product KFS focused on technical issues. One such issue was the question of whether or not the Product KFS should form part of the offering document for a particular investment product. On a separate point, industry participants also asked if the Product KFS had to be physically bound together with the offering document.
13. We believe that, given the nature and importance of Product KFS, Product KFS should be stipulated to form part of the offering document for investment products, although they may be produced as physically separate documents. However, we recognise the specific practical issues raised by some non-Hong Kong funds in relation to this requirement, discussed further in the body of the conclusions below. We are prepared to grant an exception from this requirement in cases where such funds adopt uniform global offering documents for distribution in all jurisdictions where their funds are



marketed. While the fund issuer in such case may elect not to stipulate that the fund's Product KFS forms part of the fund's global offering document, the issuer would remain subject to applicable laws in Hong Kong imposing civil and/or criminal liability in respect of misrepresentations in the Product KFS.

14. We received a number of comments on the form and contents of the Product KFS templates that were annexed to the Consultation Paper. We have revised the Product KFS templates after taking into account these comments. As further detailed below, we propose to permit a degree of flexibility for issuers to adjust or modify the Product KFS templates where necessary, while bearing in mind the key objectives of brevity, clarity and comparability.

Advertising guidelines

15. The Overarching Principles Section sets out further guidance to issuers of advertisements in respect of all products covered by the Handbook. The Handbook introduces new advertising guidelines for unlisted structured investment products (SIP Advertising Guidelines). Most industry respondents who commented on this section supported the introduction of advertising guidelines for unlisted structured investment products. We have revised the SIP Advertising Guidelines to take into account many of the comments we received.

Ongoing disclosure

16. We believe that investors should be kept informed of matters that may affect their investments after they purchase investment products. The Handbook requires ongoing disclosure to investors of material information in relation to unlisted structured investment products in addition to the ongoing disclosure requirements already imposed under the UT Code and the ILAS Code.
17. Most respondents accepted the principle of ongoing disclosure but several had comments and suggestions about the nature and amount of information that investors would find useful, and the distribution of the information. We have therefore revised and clarified some of the relevant provisions in Handbook.

Post-sale arrangements – cooling-off period

18. In the Consultation Paper, we sought views on the feasibility of introducing a “cooling-off” period such that issuers will be required to provide an exit channel to investors after placing the order. We indicated that we saw the greatest benefit to investors, taking into account the attendant costs of introducing this requirement, in the case of products with a relatively long lock-up period and/or no dealings or other liquidity provision on a frequent basis. We received a substantial amount of feedback on this part of the Consultation Paper. After considering the responses received, we will require that issuers provide a “cooling-off” or “unwind” right to all classes of investors without distinction for unlisted structured investment products with a scheduled tenor of more than one year in respect of which authorization is sought under the Securities and Futures Ordinance (SFO). We will not impose this requirement on authorized funds, which are already required to provide regular dealing days, with offer and redemption prices calculated on the basis of the scheme's net asset value divided by the number of units/shares outstanding, subject to adjustments for fees and charges. As we noted in the Consultation Paper, ILAS are already subject to cooling-off periods.



Conclusions with respect to the proposals in relation to the SIP Code, the UT Code and the ILAS Code

19. Our conclusions with respect to the key proposals in the SIP Code, the UT Code and the ILAS Code are set out in the relevant parts below. We have highlighted in the following paragraphs our principal responses to proposals that are of significant interest to the market.

The SIP Code

Product Arranger

20. In the Consultation Paper, we proposed requiring at a minimum the appointment of a Hong Kong-regulated Product Arranger for unlisted structured investment products issued by special purpose vehicles, and asked for the public's views on whether a Hong Kong-regulated Product Arranger should also be mandatory where neither the issuer nor the guarantor was Hong Kong-regulated.
21. Respondents broadly accepted the proposal to appoint a Hong Kong-regulated Product Arranger where the issuer was a special purpose vehicle, although a few respondents argued that the mandatory appointment of Product Arrangers would increase costs and deter SPV-issued products and asset re-packaging. The responses also indicated support from some respondents for the proposal to extend this requirement to unlisted structured investment products where neither the issuer nor the guarantor (if applicable) was a Hong Kong-regulated entity. Taking into account the feedback we received, we have amended the SIP Code to require appointment of a Hong Kong-regulated Product Arranger in both cases.

Market-making and indicative valuations

22. The draft SIP Code included various post-sale obligations, including indicative valuations and market-making. After taking into account the feedback received, we have revised the requirement in the SIP Code by removing the requirement for daily indicative valuations, and by providing for market-making on a committed basis and for indicative bids to be made available on a bi-weekly basis for all unlisted structured investment products with scheduled tenors of more than 6 months. The SIP Code sets out the principles under which issuers or their market agents will be required to provide liquidity.

Definition of "structured investment products" in the SIP Code

23. The Commission draws attention to the fact that pursuant to a recently-concluded consultation on possible reforms to the prospectus regime in the Companies Ordinance and the offers of investments regime in the SFO, there is a concurrent proposal to reform the Companies Ordinance (CO). If the proposed legislative amendments are enacted, a definition of "structured product" will be inserted into both the CO and the SFO and the prospectus regime under the CO will be disapplied with respect to structured products in the form of debentures so that all structured products will be regulated under the SFO regime.



24. The definition of “structured investment products” in the SIP Code is intended to cover only those which involves derivative arrangements and is commonly regarded in the market as equity-, index-, commodity- and credit-linked investment products, regardless of their legal form, where the product or the related offering document or advertisement falls within the scope of Part IV of the SFO. While the SIP Code already covers products that are similar in nature to structured investment products offered to the public in Hong Kong in the past, it is not meant to be exhaustive. As the market develops, the Commission will consider whether further guidance should be issued and, where necessary, the Commission may consult the public on issuance of additional product codes/guidelines.

Inter-relationship with the CO reform proposals

25. Prior to the enactment of the legislative amendments currently proposed, offering documents (i.e. prospectuses) in respect of debenture-type structured products will continue to be subject to the prospectus regime under the CO, whereas for non-debenture type structured products, the offer of investments regime in the SFO continues to apply to their offering documents and advertisements. In any event, however, issuers of structured investment products will be expected to comply with the SIP Code. The Commission will monitor progress with respect to the legislative proposals noted above. Where appropriate, consequential changes to the provisions in the Handbook may need to be made to accommodate the changes made in the SFO.

Priority of investors’ claims to the proceeds of realisation of collateral

26. In the Consultation Paper, we proposed to mandate that investors’ claims to the proceeds of collateral should always rank in priority to all other claims, save for fees, costs and other payments given priority under applicable laws.
27. Most industry respondents strongly objected to this proposed requirement. They suggested that priority of claims should be a disclosure point, and indicated that the requirement could increase costs, or could result in some prospective counterparties to transactions underpinning the structure of products being unwilling to enter into transactions on this basis. Some respondents pointed out that, in some jurisdictions, collateral proceeds may be subject to priority imposed by applicable laws.
28. The Commission notes that it would not be feasible to come up with a one-size-fits-all model for the use of collateral in all structured investment products, and has therefore revised the SIP Code such that the issue of whether to require that investors be given first priority claims to the proceeds of the collateral upon enforcement will be a decision to be made by the Issuer at the design stage having regard to a wide range of factors including the structure and pricing of the relevant product. However, issuers are required to disclose in offering documents the implications for investors where their claims to collateral proceeds do not have first priority.
29. The Commission will monitor developments in Hong Kong and other markets, and where appropriate may revisit this issue. The Commission also intends to carry out investor education efforts in this aspect.



The UT Code

Annual reports – bilingual versions

30. The responses were generally in support of the proposals relating to the UT Code except for the proposal regarding bilingual annual reports, which proved controversial. We understand from the industry that the preparation of a Chinese-language annual report is both costly and time-consuming, and that investor requests for a Chinese-language annual report have been rare in the past, as the information contained in the annual report is likely to be stale by the time that it is issued. Key information relating to SFC-authorized funds is already required to be provided to investors in the offering documents and the Product KFS (once this requirement is implemented) which are prepared in both English and Chinese. Further, notices which inform investors of significant changes that may affect the compliance of SFC authorized funds with the regulatory requirements under the UT Code are also prepared in both languages and are available to investors on a timely basis. We understand from the industry that investors are generally provided with monthly fact sheets, which are in English and Chinese to keep them informed.
31. Taking into account the concerns of the industry participants and weighing up the utility to investors of preparation of Chinese annual reports in addition to the key fund documents noted above, we will not make it mandatory for SFC-authorized funds to provide annual reports in both the English and Chinese languages. SFC-authorized schemes may, of course, provide annual reports in both languages on a voluntary basis. However, where a scheme does not issue bilingual annual reports, the distributor in Hong Kong must take steps to make investors aware that annual reports are available only in English or Chinese (as the case may be), and the offering documents must clearly disclose this fact. The same also applies to interim reports.

Distinction between structured funds and funds that invest in financial derivative instruments

32. We received requests for further guidance on the applicability of 8.8 (for structured funds) and 8.9 (for funds that invest in financial derivative instruments) of the revised UT Code. We have therefore revisited the relevant sections of the revised UT Code to differentiate between these two types of funds more clearly.

The ILAS Code

33. The responses were, in general, supportive of the proposed changes to the ILAS Code, as they enhance transparency through measures such as the use of Product KFS and other on-going disclosure requirements. Some respondents sought clarifications in certain areas, such as the computation of surrender values and the transitional arrangements. Further enhancements to improve disclosure have also been made to the Product KFS template for ILAS.

Transitional arrangements

34. The Handbook will become effective upon its publication in the Government Gazette (Effective Date). Different transitional arrangements will apply to different products under the applicable codes.



Funds and ILAS

35. New funds and ILAS (those for which applications for authorization are submitted on or after the Effective Date) will be required to comply with the Handbook in its entirety on and from the Effective Date. New applications submitted to the Commission on or after the Effective Date must include a Product KFS.
36. Where funds have been authorized prior to the Effective Date and remain authorized as of that date, or where applications for authorization have been submitted prior to the Effective Date, we will implement different parts of the revised UT Code on different dates to ease the transition for market participants.
37. In the case of ILAS, we will provide for a transitional period of 12 months for compliance with the Product KFS and other relevant disclosure requirements in the case of (i) ILAS in respect of which documents have been, and remain, authorized as of the Effective Date and which continue to be marketed to the public in Hong Kong, and (ii) ILAS in respect of which applications for authorization of documents were submitted to the Commission prior to the Effective Date.

Unlisted structured investment products

38. In the case of unlisted structured investment products, a transition period will be provided for offering documents and advertisements in respect of which authorization has been granted prior to the Effective Date.
39. The transition arrangement should be, in the case of a structured investment product where offering document(s) or advertisement(s) have been authorized as of the effective date of the SIP Code, compliance with the SIP Code is not mandatory for the remaining validity period of the current authorization, provided that the validity period is no more than 12 months from the effective date of the SIP Code. Where the Issuer submits an application to renew the authorization thereafter, and for all applications in respect of which authorizations are not granted as at the effective date of the SIP Code, the SIP Code will take immediate effect.

Implementation details

40. For details of the transitional arrangements, please refer to the specific parts on the SIP Code, UT Code and the ILAS Code below.
41. We intend to arrange seminars and workshops to provide further guidance to market participants in adopting the requirements in the Handbook during this transitional period.

Analysis, conclusions, the final Handbook and the final Product KFS templates

42. A discussion of responses received, our analysis and our conclusions with respect to the proposals in the Overarching Principles Section, the SIP Code, the UT Code and the ILAS Code is provided below.



43. The final form of the Handbook and Product KFS templates, which have been revised to reflect our conclusions, are set out in Appendix A and Appendix B to this Paper respectively.
44. Consequential amendments proposed to be made to the SFC Code on MPF Products and the Code on Pooled Retirement Funds in connection with the proposed establishment of the Products Advisory Committee are set out in Appendix C to this Paper.



Part II Responses and conclusions with respect to key proposals in the Overarching Principles Section of the Handbook

Introduction

45. This is the first time that a set of overarching principles will be issued by the Commission on a cross-product level. It is understandable that a number of industry participants asked for further guidance as to how these principles will be applied in practice and the implications of non-compliance with any of the general principles.
46. The overarching principles are intended to augment and to help achieve consistencies in the interpretation of the specific, detailed requirements in the product codes within the Handbook and should be read in that context. This part of the Handbook is principle-based so as to accommodate new product development and enable application across a wide range of products. Where necessary, the Commission will issue circulars and lists of frequently-asked questions and the Commission's responses to these questions (FAQs) to assist the industry in complying with the Commission's requirements. The effect of breaches of applicable provisions of the Handbook is also set out in this section of the Handbook.

Product KFS

47. As we noted above, respondents raised some technical issues relating to the proposal to require Product KFS for investment products offered to the public in Hong Kong.

Whether the Product KFS should form part of the offering document

Public comments

48. Some respondents, most of whom are issuers of unlisted structured investment products, or affiliates or sponsors of issuers of these products, took the view that the Product KFS should form part of the offering document for an investment product. Issuers would then seek to rely on the disclosure in the entire offering document, and not an offering document and a Product KFS each on a standalone basis, in satisfying their overall disclosure obligations in respect of the product.
49. Other respondents requested more flexibility on this point. Certain managers of non-Hong Kong funds noted that some funds were marketed in several jurisdictions on the basis of a global offering document, and that the inclusion of a Product KFS in this global document would not only add a significant administrative burden but would necessitate submission of the document (including the Product KFS) to the fund's home regulator for approval. It was also submitted that overriding legal requirements in the home jurisdiction might not allow the Product KFS to form part of the offering document.
50. Another, separate, question raised by respondents was whether the Product KFS for a particular product could be physically separate from the other part(s) of the offering document for that product.



Commission's response

51. The basic requirement will be that the Product KFS should be stipulated to form part of the offering document for investment products covered by the Handbook.
52. We acknowledge the practical issues noted above and we have conducted various rounds of discussions with the funds industry to resolve these issues. We are mindful of the need to ensure that investors in Hong Kong are able to access products from various countries whilst maintaining appropriate levels of investor protection. We are prepared to grant an exception from the requirement to include the Product KFS as part of the offering document in cases where a Product KFS is prepared in connection with a non-Hong Kong fund which issues a uniform global offering document for distribution in all jurisdictions where it is marketed. Notwithstanding that in such cases the Product KFS would not be part of the offering document, it should be noted that the Product KFS would be subject to applicable laws in Hong Kong imposing criminal and/or civil liabilities for misrepresentation. The Commission will not consider it an acceptable practice if product providers seek to insert disclaimers or limitation statements in the Product KFS or other parts of the offering document with a view to minimising or avoiding liability in this regard.
53. The Product KFS may be physically separate from the other part(s) of the offering document for a particular product (or, in the exception cases noted above, from the global offering document for the fund).

Length of the Product KFS

Public comments

54. Many respondents raised questions about the format and the contents requirements for Product KFS. Some commented that the limit of four pages should be made flexible to accommodate products with features and/or risks which require more extensive description. Others believed that the page limit should be strictly observed. Some respondents requested the flexibility to modify the templates that we provided, where necessary, to cater to different products. Other respondents, however, felt that a standardised template would better enable comparison across different products.

Commission's response

55. It is expected that Product KFS should generally be no more than four pages in length, but we will permit product providers some flexibility where they believe that a slightly longer Product KFS is warranted to explain the key features and risks of the product or to provide illustrations, such as graphics, charts and diagrams, which would be particularly useful for investors. Product providers are reminded, however, that Product KFS should be concise and easily-understood.
56. We will also permit some flexibility to adapt or modify the templates we have provided to meet the needs of particular product providers or products. However, product providers must ensure that their Product KFS include the required information and must be mindful of the objectives underpinning the requirement for the Product KFS, in this instance, to serve as a basis for investors to compare investment products.



Language

Public comments

57. Some respondents, particularly those from the unlisted structured investment products sector, were concerned about the explicit requirement that the English and Chinese versions of an offering document had to be of equivalent standing. They noted that in some cases the terms and conditions of the relevant product would be included in their global issuing programmes, and, where applicable, that the terms and conditions would be lodged with the relevant clearing system in English, without the need to lodge a Chinese version as well. In addition to the practical difficulties presented, they noted that legal interpretation difficulties may arise if there were any inconsistencies between the English-language version and the Chinese-language version of the terms and conditions.

Commission's response

58. We are mindful of the concerns that have been raised. The requirement in this section of the Handbook that the English and Chinese versions of an offering document should be of equivalent standing was not intended to create additional liabilities beyond the current legal requirements. In view of the possible unintended implications for the contractual arrangements or transactions underpinning the structure of certain investment products, we have removed this explicit requirement. Nonetheless, issuers are reminded that their obligations to investors under applicable laws, including requirements with respect to disclosure in offering documents, remain unaffected.

Issue of advertisements

59. We included a specific proposal to require that, prior to the issue of an advertisement in respect of an investment product, the advertisement should be reviewed by a competent delegate designated by senior management of the issuer of the advertisement, to ensure that the advertisement was in compliance with the applicable advertising guidelines.

Public comments

60. Some respondents sought clarification on the eligibility and duties of the delegate and asked whether the delegate would be personally liable for the advertisement in these circumstances. A few respondents objected to the proposal, and argued that the approval of advertisements should be addressed by procedures established by advertisement issuers, who would in any event bear corporate liability in connection with the advertisements.

Commission's response

61. The proposed requirements will enhance the standard of internal controls with respect to the issue of advertisements for investment products. It is generally expected that issuers of advertisements should have gone through their own internal procedures to ensure that such advertisements comply with applicable requirements. As such, we believe that this requirement should not create an additional burden for advertisement issuers. There is no intention to impose liability in connection with the issuing of



advertisements beyond what is currently the case under applicable laws. We will issue further practical guidance to the industry in this regard if necessary.

Avoidance of conflicts of interest

Public comments

62. Most respondents recognised the importance of identifying and addressing conflicts of interest. Many respondents sought guidance on how this principle should be implemented in practice in specific situations. Some respondents asked whether certain conflicts would be viewed as adequately addressed if full disclosure were made and either explicit or implicit consent given, or whether additional measures would be required.

Commission's response

63. We note the views expressed by many respondents, and in particular that a certain degree of inherent conflicts of interest inevitably exist between the “sell side” and the “buy side” with respect to an investment product because of the different roles and interests each side is pursuing at the time the product is designed and offered. Product providers are nevertheless expected to manage and minimise these, and any other, conflicts by adopting appropriate measures such that investors’ interests can be sufficiently protected. To the extent that the conflicts of interest cannot be properly managed, product providers are expected to consider whether it is still appropriate for such a product to be generally offered to the public.

Product providers’ general duties and obligations

Public comments

64. The general duties and obligations of product providers in this section of the Handbook included the requirement to notify the Commission in the event of any breach of the Handbook. Some respondents felt that product providers should be required to inform the Commission only if a breach was material. Some respondents suggested that a product provider should not be required to inform the Commission where breaches had been rectified within a reasonable period of time or where breaches resulted from factors outside the product provider’s control.

Commission's response

65. Having regard to similar standards imposed elsewhere in the Handbook, we will modify the requirement so that product providers will be required to notify the Commission of material breaches of the Handbook.
66. We are concerned that the impact of a breach on investors would not necessarily diminish because the breach was of a short duration or was caused by factors outside the product provider’s control. We do not, therefore, propose to limit the disclosure requirement further, and maintain that product providers should notify us of all material breaches regardless of duration or cause.



Selection of distributors

Public comments

67. Several respondents sought clarification on the extent of product providers' responsibility in the selection and appointment of distributors for an investment product. Some were concerned that the standard of due care and diligence imposed by the Handbook may be overly burdensome, particularly given that distributors are already licensed by or registered with the Commission and are required to comply with the Commission's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct). Some noted that product providers may have limited influence over distributors' operations.

Commission's response

68. The requirements in the Handbook are intended to be practical and capable of implementation on an operational level by market participants. After assessing the respondents' comments and taking into account the safeguards offered by the existing regulations governing the conduct of distributors, we have amended this provision to clarify that product providers should exercise reasonable care and diligence in the selection and appointment of distributors.

Products Advisory Committee

Public comments

69. Most respondents were supportive of the proposal to establish a new cross-product Products Advisory Committee to replace the existing Committee on Unit Trusts (the CUT) and the Committee on Investment-Linked Assurance Schemes and Pooled Retirement Funds (the ILAC). Some respondents felt that this would help to streamline the authorization process. Some respondents submitted that the Commission should ensure transparency with respect to the Committee, including its remit and its membership.

Commission's response

70. We will proceed to establish the Products Advisory Committee to replace the existing CUT and ILAC as originally proposed. As with other committees set up by the Commission, the Products Advisory Committee will be established pursuant to section 8 of the SFO. It is intended that the Products Advisory Committee will be advisory in nature and have a balanced composition of representation from the industry, professionals, academics and other stakeholders with diverse market knowledge and expertise on products- and/or markets-related issues.
71. The terms of reference and membership of the Products Advisory Committee will be determined by the Commission.
72. Since the respective remits of the CUT and the ILAC include products under the SFC Code on MPF Products and the Code on Pooled Retirement Funds, we will make the necessary consequential amendments to these Codes. These amendments are set out in Appendix C to this Paper.



Part III Responses and conclusions with respect to key proposals in the Code on Unlisted Structured Investment Products

Proposal 1: Disclosure enhancements

Product KFS – 6.3 of the SIP Code and item 6 of Appendix C

Public comments

73. Product KFS were proposed in the Consultation Paper for all investment products covered by the Handbook. A full analysis of the comments can be found in the section relating to the Overarching Principles Section of this Paper. In the context of unlisted structured investment products, it is worth noting that most respondents supported the proposal for offering documents to include Product KFS, while at the same time industry respondents generally sought flexibility on the “four page limit”. Respondents agreed that it should be made clear to investors that Product KFS are not an alternative to the full offering documents. One industry respondent took the view that the Product KFS might have the opposite effect to the one intended and further discourage investors from reviewing the full offering documents.

Commission’s response

74. The Commission’s response in the section relating to the Overarching Principles Section of this Paper lays down the general principles for Product KFS which are also applicable to unlisted structured investment products.
75. At this stage, for the sake of simplicity and consistency, the Commission believes that it is adequate to have one single illustrative template for Products KFS for structured investment products. The Commission will keep in view and consider whether more templates need to be prepared to cater for new products as the market develops.
76. Upon the suggestion of one respondent to align 6.3 of the SIP Code with the wording in 6.7 of the Overarching Principles section of the Handbook, the word “sufficient” has been deleted from 6.3 of the SIP Code such that Product KFS are required to contain information to enable investors to comprehend the key features and risks of the relevant structured investment product. The Commission agrees with the respondent that sufficiency of information should be determined with respect to the entirety of the offering document(s) for the relevant structured investment product, instead of just the Product KFS.

Disclosure in offering documents – Appendix C of the SIP Code

Introduction

Public comments

77. Respondents were in general supportive of the overarching disclosure principles set out in 6.1(b) of the SIP Code. With respect to Appendix C, where guidance is laid down for the contents of offering documents, most industry respondents gave comments on the drafting of the disclosure requirements from a technical perspective. Specific comments were raised by industry respondents on a wide range of contents requirements proposed in Appendix C, including the requirement to disclose the



details of the key components making up a structured investment product and its embedded derivatives, the rights of investors in the event of an early termination, the rights of investors vis-à-vis each Key Product Counterparty, the offer price of the structured investment product, historical information for non-Hong Kong-listed reference securities, valuation methodologies, conflict of laws and conflict of interest.

78. Some respondents asked for clarification or revision of the drafting of the requirements to make responsibility statements and to disclose tax implications. Some industry respondents suggested that the Commission should work with them to develop standard language to explain credit ratings.

Commission's response

79. In view of the general support, the Commission has largely retained the contents requirements in Appendix C, and our revisions are mainly focused on the technical and drafting comments raised by the industry. Most of these revisions are self-explanatory, however, some of them warrant the more detailed explanation in the following paragraphs.

Disclosure of financial information – items 26-30 of Appendix C

Public comments

80. Some respondents suggested that, in the case of financial information, the Commission should not insist upon the proposed requirement for the auditor's report to be included in offering documents to conform to either International Financial Reporting Standards (IFRS) or Hong Kong Financial Reporting Standards (HKFRS). Respondents argued that a wider range of accounting standards should be acceptable, since foreign Issuers and Guarantors would prepare their financial statements in accordance with accounting standards accepted in their home jurisdictions, and a conversion would, in their view, be unduly burdensome and impracticable both in terms of time and resources.

Commission's response

81. The Commission notes that a large number of Issuers seeking to offer structured investment products to the public in Hong Kong are financial institutions based and regulated overseas or are part of global groups with whom their accounts are consolidated. Their audited financial statements therefore have to comply with accounting standards of their home jurisdictions or those of their parent entities, which may be neither IFRS nor HKFRS. The Commission is aware of the practical difficulties, and is prepared to accept other internationally-recognised financial reporting standards. Item 28(b) has been revised accordingly.

Key Product Counterparties – various items in Appendix C, and 5.5 of the SIP Code

Public comments

82. A few industry respondents asked for clarification of the definition of "Key Product Counterparty" in 5.5 of the SIP Code. In particular, these respondents were concerned whether the definition would include balance-sheet hedging counterparties to substantive Issuers, since various disclosure requirements in the SIP Code apply to a Key Product Counterparty. For example, Appendix C of the SIP Code requires disclosure in the offering documents of certain information with respect to a Key Product Counterparty (including regulatory status, key responsibilities and the basis upon which any eligibility requirements are satisfied, financial information, and certified



true copies of all material documents in relation to all arrangements with any Key Product Counterparty). Respondents questioned whether the scope of this disclosure requirement would result in Issuers having to provide commercially sensitive information about Key Product Counterparties.

Commission's response

83. The Commission has fine-tuned the definition of "Key Product Counterparty" to focus on entities whose credit or counterparty risks may have an impact on the risks and returns of a structured investment product. A full discussion of this point can be found in paragraph 202 below.

Disclosure of key components and embedded derivatives – item 2(f) of Appendix C

Public comments

84. Some respondents argued that it would not be useful (and in some circumstances, could well be confusing) to investors for the Issuer to disclose the key components of a structured investment product and its embedded derivatives. They argued that such disclosure might distract investors from the actual or potential return or loss in respect of the product, which they believed were the most crucial features for investors.

Commission's response

85. The Commission believes that disclosure of the key components of the structured investment product and its embedded derivatives in offering documents should be made in the context of the risks and returns of the structured investment product and should be comprehensible to investors. Accordingly, item 2(f) should not be taken to require highly technical descriptions of the key components/embedded derivatives, nor should it lead to the use of jargon or short-hand terms in offering documents. It is the Issuer's obligation to decide in each case the appropriate level of description, in light of the overall disclosure standard for offering documents to contain information that is necessary for investors to be able to make an informed judgment of the investment.

Historical information for non-Hong Kong-listed reference securities – item 10(c)(iv) of Appendix C

Public comments

86. Item 10(c)(iv) sets out the requirement for disclosure with respect to reference assets comprising shares of a company not listed on The Stock Exchange of Hong Kong Limited to include market statistics for a period of at least 5 years but not more than 6 years or a period equal to the maximum tenor of the structured investment product, whichever is the longer. Some respondents commented that this requirement was too burdensome.

Commission's response

87. In order to maintain a certain level of transparency for reference assets where information is not readily available to the investing public in Hong Kong, the Commission believes that it is necessary to retain this requirement. In line with the requirements of item 11(e) of Appendix C (which applies where the structured investment product is linked to an index or indices), item 10(c)(iv) of Appendix C has been revised such that, in the case of structured investment products linked to equity securities of a company not listed on The Stock Exchange of Hong Kong Limited, Issuers are required to disclose market statistics for a historical period of 5 years up



until the latest practicable date before the issue of the offering document, irrespective of the maximum tenor of the structured investment product. The Commission reiterates that historical performance information for reference securities which are listed on The Stock Exchange of Hong Kong Limited is not required to be disclosed in offering documents or advertisements, although, where an Issuer chooses to make this disclosure, the disclosure will be subject to the requirements under Appendices C and D respectively. For consistency purposes, corresponding amendments have been made to the Note to item 13 of Appendix C and the Note to item 15 of Appendix D.

Disclosure of risk relating to conflict of laws – items 8, 23 and 24(g) (formerly 24(f)) of Appendix C

Public comments

88. Some respondents argued that Issuers would be unable to identify all possible conflict of laws risks in advance, and that it might be difficult for Issuers to comply with the disclosure requirement to explain “any relevant issues” relating to conflict of laws or recognition of judgments. They sought guidance on the extent to which Issuers would be expected to explain the choice of law (other than Hong Kong law) and issues relating to conflict of laws and recognition of judgments in connection with enforcement of a guarantee or rights conferring credit support (e.g. security interest). They suggested that this disclosure obligation should be able to be discharged by the inclusion of a generic risk factor.

Commission’s response

89. It is the Issuer’s obligation to decide in each case the appropriate level of risk disclosure, in light of the overall disclosure standard for offering documents to contain information necessary for investors to be able to make an informed judgment of the investment. In a case where a structured investment product involves a foreign element, for example, Issuers should consider explaining in plain language why there are conflicts of laws, how the conflicts would affect investors’ rights, and that it might not be possible to identify all conflicts of law issues in advance, as well as explaining the difficulties in obtaining and enforcing judgments outside Hong Kong against an overseas Issuer, Guarantor or Key Product Counterparty, and in respect of any collateral located outside Hong Kong. Investors should be warned of the extent of such difficulties, the likelihood that such judgments would not be able to be executed or enforced, and the repercussions for their investments.

Responsibility statement – item 34(b) of Appendix C

Public comments

90. Some respondents sought clarification as to the scope of the responsibility of a Guarantor for information contained in the offering document(s).
91. Some respondents also pointed out that it would be unreasonable to require an Issuer to give a confirmation that a structured investment product would continue to comply with the SIP Code in circumstances where this would be subject to certain factors outside the Issuer’s control.

Commission’s response

92. The Commission wishes to point out that the responsibility statement requirement under item 34(b) of Appendix C to the SIP Code does not seek to change the existing



practice. In fact, this requirement is just a codification of existing practice that both the Issuer and the Guarantor are required to take full responsibility for the contents of, and the completeness and accuracy of the information contained, in the entire offering document. Both are also required to confirm that having made all reasonable enquiries and to the best of their knowledge and belief, there is no untrue or misleading statement or other fact the omission of which would make any statement untrue or misleading.

93. The Commission acknowledges the difficulty Issuers would face if required to make a statement that the Issuer will “ensure that the structured investment product continues to comply with the SIP Code”. With or without this statement, the provisions of the SIP Code would apply regardless. The Commission will therefore not insist upon the Issuer making this statement.

Incorporation by reference

Public comments

94. Amongst the industry respondents, there were also proponents of “incorporation by reference” of information located outside the offering documents.

Commission’s response

95. The Commission notes the industry voice proposing incorporation by reference, and agrees that there are merits in this proposal as it would result in shorter offering documents and facilitate the presentation of information to retail investors in a manner which may better suit their needs. However, any proposal to cater for incorporation by reference must be supported by a carefully thought-out mechanism so as to ensure that investors receive sufficient notice of the information so incorporated. Those investors who wish to study the additional materials referred to in the offering document should be able to view them from an easily and readily available source free of charge. This may affect the documentation structure across different product types and may have a wide range of implications not just for structured investment products, but also for a broad spectrum of products offered to the public in Hong Kong. Depending upon the actual mechanism proposed to be employed, this might not be possible without legislative change, which falls outside the remit of this consultation.

Disclosure in advertisements – Appendix D of the SIP Code

Disclosure – Note (1) to item 1 of Appendix D

Public comments

96. Most industry respondents who commented on this section supported the introduction of advertising guidelines for unlisted structured investment products. Some expressed the view that the requirement for a description of the “derivative components” of a product would not be appropriate in the context of advertisements. They suggested that the focus should instead be on the risks and potential returns of structured investment products.

Commission’s response

97. Advertisements are not offering documents and they should not be used as replacements for offering documents at the point of sale. Hence, by their nature, advertisements would not contain the same level of detail as offering documents.



Nevertheless, issuers of advertisements must not forget the overriding principle that advertisements must not be misleading, and must present a balanced picture of the structured investment product with adequate and prominent risk disclosure. Therefore, a “balanced” advertisement is expected to contain, at least, a brief description of the key derivative components in the context of the risk and return of the structured investment product.

TV or radio commercials – item 24 of Appendix D

Public comments

98. Some industry respondents asked the Commission to relax the requirement for warning statements in TV or radio commercials. They argued that it would be too onerous and impractical to include all prescribed risk warning statements set out in item 13 of Appendix D in audio and visual advertisements.

Commission’s response

99. The Commission would like to point out that the requirement to insert warning statements in TV or radio commercials is one which has been applied to other investment products, such as unit trusts under the *Advertising Guidelines applicable to Collective Investment Schemes Authorized under the Product Codes*, is well understood by the industry and has been practised widely for over a decade. The Commission firmly believes that highlighting the relevant warning statements is of paramount importance for investor protection, and hence this requirement should not be compromised for the sake of facilitating sales or marketing of products. Issuers proposing to issue TV or radio commercials in respect of unlisted structured investment products should consider in each case, in light of the features and risks of the product, whether this is an appropriate channel of advertising.

Withdrawal of authorization – 6.7 of the SIP Code

Public comments

100. Several respondents sought clarification regarding situations where the Commission may review its authorization, modify, add to, or withdraw such authorization as it deems fit.

Commission’s response

101. The Commission would like to point out that item 6.7 of the SIP Code is a reiteration of the Commission’s power to review and withdraw authorization under section 106 of the SFO. As stated in 6.7 of the SIP Code, the Commission would only exercise its power in accordance with the SFO.

Ongoing disclosure of material information – 7.6 of the SIP Code

Continuing disclosure of financial statements

Public comments

102. Most respondents generally accepted the requirement for financial information to be made available to existing investors during the life of a structured investment product, although a few respondents indicated that the four-month time limit might not be enough taking into account the requirement to provide translations. Some suggested that only the profit and loss account and the balance sheet should be required to be translated within the four-month time frame. A respondent asked for clarification as to



whether further issuances of a product would need to be suspended until a supplemental offering document containing the updated financial information was published.

103. Some respondents asked the Commission to dispense with the translation requirement for any financial information other than the annual and interim reports. They also sought clarification that the requirement to disclose financial information which might be provided to “any other securities or financial regulator, stock exchange or market” referred to publicly-available filings.

Commission’s response

104. The SIP Code contains requirements for disclosure of financial information both upon issuance of a structured investment product and on an ongoing basis once a structured investment product has been issued. Upon issuance of a structured investment product, Issuers are required to comply with the contents requirements in Appendix C of the SIP Code with regard to disclosure of financial information in offering documents (in the form of a replacement / supplemental document / addendum to the offering documents already issued).
105. In the case of ongoing disclosure after a structured investment product is issued, the Commission is of the view that Issuers should provide investors with up-to-date financial information in respect of the Issuer, the Guarantor (if applicable) and any Key Product Counterparties. This should include annual financial statements, interim financial statements, (where published) quarterly financial statements and any other financial information that is required to be filed by an Issuer with any regulator or stock exchange as a matter of public record. Such financial information should, ideally, be made available in both Chinese and English. However, having considered the practical difficulties and the nature of the different types of financial information to be provided to investors, the Commission is prepared not to mandate full translations for these ongoing financial disclosures in limited circumstances. Subject to the conditions elaborated below:- (a) in the case of annual and interim financial statements the Commission is prepared to accept translations in the form of summaries; and (b) in the case of quarterly financial statements and other financial information, the information may be made available in either Chinese or English.
106. In the case of annual and interim financial statements, the Commission accepts that, for the purpose of ongoing financial disclosure, Issuers / Guarantors / Key Product Counterparties who are not otherwise required by any law, code or regulation to publish financial statements in both Chinese and English should make available the annual and interim reports to investors in full in one language – either in Chinese or English. A version in the other language (whether in Chinese or English depending on the case) may be made available to investors in the form of a summary.
107. Where the Issuer, the Guarantor or a Key Product Counterparty is separately required by other applicable laws, codes and regulations, whether in Hong Kong or elsewhere, to produce full annual or interim reports in both Chinese and English within the same or a shorter time frame than that stipulated in the SIP Code, the Issuer will have the same obligation to make ongoing disclosure of full annual or interim reports in both languages under the SIP Code.
108. A summary is expected to contain the balance sheet and the profit and loss statement, as well as applicable qualifying notes. The Commission notes that it is a requirement



in some leading financial centres for financial institutions to publish press releases containing highlights of the annual or interim financial results and these press releases could generally be acceptable as summaries for the purposes of the SIP Code. However, the Commission believes that, subject to the aforesaid, important and up-to-date financial information should be made available to investors in both Chinese and English to enable them to monitor their investments.

109. In respect of quarterly financial statements (where published) and other financial information filed by an Issuer with any regulator or stock exchange as a matter of public record, which are required to be disclosed on an ongoing basis under 7.6(a)(iii) and (iv) of the SIP Code, the Commission reiterates the importance of making these available to investors in a timely manner. Taking into account the feedback received, the Commission has adopted the following approach:
- (a) for financial reports/information required to be continuously disclosed under 7.6(a)(iii) and (iv) of the SIP Code, given that these reports/information are usually brief in nature, no summary will be permitted; and
 - (b) to the extent that any such financial report/information under 7.6(a)(iii) and (iv) also constitutes a material adverse change which triggers the ongoing disclosure obligations under 7.6(b) of the SIP Code, Issuers will need to make such disclosure in Chinese and English. In this regard it should be noted that the Commission has expressly clarified that any ongoing disclosure of a material adverse change will need to be made in both Chinese and English - see paragraph 115 below. Subject to this, the Commission accepts that financial reports/information under 7.6(a)(iii) and (iv) may be provided in either Chinese or English.
110. The Commission also confirms that “other financial information” to be disclosed pursuant to 7.6(a)(iv) of the SIP Code means filings made as a matter of public record.

Continuing disclosure of “material adverse changes” – 7.6(b) and (c) of the SIP Code

Public comments

111. Most respondents supported this proposal in principle, or at least acknowledged the importance of providing information to investors on an ongoing basis. Many had substantive comments on the drafting of the relevant provisions. Several argued that the scope of 7.6(b) of the SIP Code was too wide and would be difficult to apply in practice, and that it overlapped with the original 7.6(c). Specifically, many industry respondents were of the view that ongoing disclosure should not extend to changes in the business of the Issuer or Guarantor, or to information about the Issuer’s or Guarantor’s corporate groups.
112. Most industry respondents also claimed that it would be difficult for them to assess what would constitute a “material adverse change”.

Commission’s response

113. The Commission’s view is that ongoing disclosure of information is important to keep investors informed after the structured investment product is sold. Intermediaries are likewise under a duty to pass on such information to investors in a timely manner.



114. The Commission also takes the view that “material adverse change” is a commonly used term in commercial arrangements and a concept not unfamiliar to the industry. An Issuer is best positioned to determine what information is material having regard to the specific situation of its product and the Issuer’s or Guarantor’s or Key Product Counterparty’s ability to fulfil its obligations under the relevant structured investment product. The Commission recognises that making this determination requires a degree of professional judgment on the part of the Issuer and, in the final analysis, the Issuer (and its directors) is in the best position to determine materiality. The drafting of the relevant provisions has been revised to bring out these considerations.
115. On the other hand, the Commission has taken on board some of the respondents’ comments (including drafting suggestions) so as to streamline these requirements. The Commission has accordingly revised 7.6(b) and (c) of the SIP Code such that Issuers are required to keep the Commission and all investors in the structured investment product informed as soon as reasonably practicable if the Issuer or the Guarantor (as the case may be) ceases to meet any of the core requirements in Appendix A; and to the extent permitted by applicable laws, of changes in financial condition or other circumstances which could reasonably be expected to have a material adverse effect on the ability of the Issuer or, if applicable, the Guarantor or a Key Product Counterparty, to fulfil its commitments in connection with the structured investment product. In light of the demographics of the Hong Kong investing public, the Commission also believes that it is appropriate to expressly require that such ongoing disclosure of matters under 7.6(b) to (e) of the SIP Code be made in both Chinese and English.

Continuing disclosure of failure of collateral to meet eligibility criteria – 7.6(d)(i) of the SIP Code

Public comments

116. Some respondents also sought clarification on the meaning of “any failure of a material portion of the collateral” – whether it would mean a technical default or a severe reduction or total loss in the value of the collateral.

Commission’s response

117. The Commission considers that no change needs to be made to 7.6(d)(i) of the SIP Code regarding continuing disclosure obligation of Issuer of “*any failure of a material portion of collateral*” to meet any of the eligibility criteria and the relevant reasons for such failure. The Commission believes that “material” is a common and widely-used term in commercial arrangements and the market should not be unfamiliar with this concept. The “failure” of the collateral only refers to failure of the collateral to continue to meet the eligibility requirements under the SIP Code. The Commission believes that there should be no uncertainty and Issuers should exercise their professional and reasonable judgment as to whether any disclosure is necessary under 7.6(d)(i).
118. On a separate note, the Commission has revised 7.6(d)(i) of the SIP Code to expressly require an Issuer, as part of its ongoing disclosure obligations, to notify the Commission and all investors in a collateralised structured investment product, of any event of default in respect of the collateral.



Continuing disclosure regarding breach by trustee or custodian – 7.6(d)(ii) of the SIP Code

Public comments

119. Some respondents argued that it would be impractical or impossible for Issuers to monitor trustees and custodians, and to give notification of any breach by them of applicable requirements in Appendix B of the SIP Code.

Commission's response

120. The requirement to notify in respect of a breach by a trustee or custodian is already qualified to the extent the Issuer is "aware or ought to be aware after reasonable inquiry". In light of the commercial arrangements between Issuers and trustees or custodians, and the importance of the roles played by trustees or custodians to investors throughout the life of a product and in particular when there is a default, the Commission believes that the requirement in the SIP Code is reasonable.

Means of dissemination of information – 7.1 of the SIP Code

Public comments

121. One respondent from the brokerage sector remarked that it would be administratively onerous and costly for distributing intermediaries if ongoing disclosure of information by Issuers was to be made via the intermediaries. That respondent argued that it would be difficult for the intermediaries to control the timeliness of communication to retail investors. That respondent also suggested that such ongoing information should be disseminated via Issuers' websites or a centralised Commission website.
122. Some industry respondents asked the Commission to clarify what sort of channel should be used for dissemination of the information. Some respondents suggested that the ongoing disclosure obligations should be able to be discharged by posting the information on an "official SFC website".

Commission's response

123. The Commission has no present intention to create an "official SFC website" as a repository for ongoing information disclosure as suggested by some respondents, but otherwise has no strong preference as to the means of dissemination of ongoing information disclosures, so long as the information is made available to investors in a timely manner. Issuers are reminded of their obligations under various provisions of the SIP Code to make continuing disclosure. Where Issuers choose to despatch the information to investors via intermediaries, the Commission expects Issuers to have the necessary arrangements in place with distributing intermediaries such that information required to be made available to investors by the SIP Code is efficiently disseminated to investors in a timely manner. The Commission notes that, under the Code of Conduct for Persons Licensed by or Registered with the SFC (see General Principle 5), intermediaries are under a duty to disclose relevant material information in dealings with their clients.



Proposal 2: Increasing product transparency

Eligibility requirements for Issuers and Guarantors

Eligibility – 3.1 to 3.4 of SIP Code

Public comments

124. Most respondents supported the codification of eligibility requirements for Issuers and Guarantors of unlisted structured investment products. Some sought clarification or expressed comments on a few drafting points.
125. Some respondents also expressed concerns over the requirement under 3.3(a)(ii) and 3.4(a) of the SIP Code that the Issuer or Guarantor should be in “good standing”, and not be “the subject of any disciplinary proceeding in respect of its licence or registration to conduct any regulated activity”, or the subject of any action by an exchange, regulated market or self-regulatory organisation for breach of any applicable rules, or has been convicted of any offence under applicable securities or corporate laws or other laws involving fraud or dishonesty. Some argued that this would be onerous in particular for international institutions.
126. Some respondents asked for the introduction of a “materiality” threshold and a time limit to the above “good standing” requirement, and, while most respondents had no objection to the core requirements set out in Appendix A to the SIP Code, one respondent suggested adding a “materiality” threshold to the core requirement that the Issuer / Guarantor shall not have entered into any restructuring agreement which resulted in a debt compromise with its creditors (i.e. item (1)(c)(iii) of Appendix A).
127. Most industry respondents also took the view that eligibility requirements should only apply at the time of issue but not on a continuing basis throughout the tenor of a structured investment product. Some argued that a continuing obligation to comply with eligibility requirements would be tantamount to providing a covenant as to future financial performance beyond the Issuer’s or Guarantor’s control. These respondents were also concerned about the consequences of breach of a continuing compliance requirement of this nature.
128. The SIP Code provides for the Commission to be able to request a legal opinion on the Issuer’s or Guarantor’s compliance with the laws of its home jurisdiction, as set out in Note (1) to 3.2(c) of the SIP Code, and some respondents argued that any such legal opinion would likely be subject to qualifications. They asked the Commission to clarify the factors for consideration and suggested that the Commission publishes a list of acceptable jurisdictions.

Commission’s response

129. The Commission understands from the feedback received that the main difficulty in demonstrating compliance with the concept of “good standing” is that it is a relatively general concept, the meaning and the scope of which may vary from one jurisdiction to another. The Commission agrees that it would help clarify the regulatory requirement if specific benchmarks are set out. Hence, the eligibility requirement in 3.3(a)(ii) of the SIP Code has been revised to clarify that it focuses on disciplinary proceedings which may materially affect the Issuer’s or the Guarantor’s financial condition, status as a licensed or regulated entity, or ability to perform its licensed or regulated activity.



130. The Commission intended that the eligibility requirements for Issuers and Guarantors should apply in each case only at the time of issue of the structured investment product, since these products are pre-packaged. For structured investment products issued under a programme, the Issuer (or the Guarantor) must meet the eligibility requirements at the time of issue (and annual renewal) of the programme document, as well as at the time of issue of each series of structured investment product under such programme. Since structured investment products are pre-packaged products and therefore, the credit risk of the Issuer and any Guarantor to which investors are exposed is a matter which should be disclosed and explained to investors upfront in the offering document. After investors have bought a structured investment product, they should be notified promptly of relevant adverse changes in the standing of the Issuer or the Guarantor on an ongoing basis. It is, however, important to note that, if an existing Issuer or Guarantor no longer meets applicable eligibility requirements, it may not issue or guarantee any new structured investment products, whether under the existing documentation or not, until it meets the eligibility requirements again. Investors have to be aware, and intermediaries have the duty to advise them, that once investors have purchased the products they will be exposed to risks such as market risks and credit risks of the Issuer, Guarantor and other counterparties.
131. The Commission believes that it is the duty of the Issuer to satisfy the Commission in each particular case that the Issuer or the Guarantor is eligible to issue or guarantee structured investment products under the SIP Code. Different Issuers and Guarantors may be incorporated or established in, and therefore be subject to the laws of, different jurisdictions. The Commission will request that Issuers support their applications with legal opinions where appropriate to assist the Commission with its consideration of the applications. The Commission will consider the circumstances of each case but does not consider it appropriate to prescribe a list of acceptable jurisdictions.

General obligations of the Issuer – 3.5 to 3.7 of the SIP Code

Public comments

132. Some respondents sought clarification of the requirements in 3.5 of the SIP Code, namely, (i) that it would not give rise to a continuing obligation on the part of the Issuers to monitor operational procedures of intermediaries, and (ii) as regards the obligation to maintain appropriate systems and controls in relation to “independent” valuation of the structured investment product and any collateral.
133. Some industry respondents objected to the requirement to provide information and undertakings to the Commission in such form as the Commission may require from time to time, arguing that this would create compliance and commercial burdens for Issuers.

Commission’s response

134. On item (i) of paragraph 132 above, the Commission believes that any prudent Issuer should have established procedures to conduct appropriate due diligence on prospective distributors which may be appointed to sell its products.
135. On item (ii) of paragraph 132 above, as elaborated in paragraphs 182 to 194 below, on the basis that indicative bid prices may serve more practical purposes from investors’ perspective given investors are likely to find it more meaningful to know the possible realisable value of the product concerned, Issuers will be required to provide indicative bids rather than indicative valuations. The SIP Code has been revised accordingly.



136. Although the requirement for Issuers to make available indicative valuations has been changed to an obligation to provide indicative bid prices, Issuers are nonetheless expected to have measures in place to value structured investment products and any collateral as may be appropriate. Such valuations must be independent. The Commission wishes to clarify that this requirement for the “independent” valuation of a structured investment product or of any collateral means functional independence. Such valuations may be conducted by the Issuer, the Guarantor, the Product Arranger or their affiliates in circumstances where there is a clear and effective segregation of functions within the organisation when assuming different responsibilities in relation to the structured investment product.
137. Depending on the specific circumstances of each case, Issuers of unlisted structured investment products have in the past provided the Commission with information and undertakings in support of their applications for authorization of documents. While the information and undertakings required from different Issuers for different products have so far been fairly similar, they varied depending on the particular circumstances of the case. Where appropriate, the Commission may consider publishing standardised undertakings that are required from Issuers. However, depending on the particular circumstances of the case, the Commission may request an Issuer to provide certain confirmations or undertakings specific to the case.

Appointment, obligations and responsibilities of Product Arranger – Chapter 4 of the SIP Code

Public comments

138. No respondent objected to the proposal to appoint a Hong Kong-regulated Product Arranger where the Issuer is a special purpose vehicle. In the Consultation Paper, the Commission also invited views from the public on whether a Hong Kong-regulated Product Arranger should be appointed for structured investment products issued or guaranteed by overseas, non-Hong Kong-regulated entities. Some respondents believed that the requirement to appoint a Hong Kong-regulated Product Arranger should also apply to structured investment products issued or guaranteed by a non-Hong Kong-regulated entity. Others took the view that where the Issuer or the Guarantor is a substantive entity and subject to foreign regulatory oversight in respect of activities analogous to Type 1 and Type 4 regulated activities, this would suffice and there should be no need to appoint a Hong Kong-regulated Product Arranger.
139. A few respondents opined that the requirement for a Product Arranger to “ensure that the Issuer at all times complies with the applicable requirements in the Handbook” (not including financial obligations) was impracticable, disproportionate and unjustifiable. They argued that the role of Product Arranger should be limited to a communication channel between the special purpose vehicle Issuer, Hong Kong investors and regulators.
140. Some respondents opined that the mandatory appointment of Product Arrangers would increase costs and deter most special purpose vehicle-issued products and asset repackagings, on the basis of the onerous obligations imposed on Product Arrangers coupled with the proposed requirements relating to collateral.
141. A few respondents questioned the need for a Product Arranger to be licensed or registered for both Type 1 and Type 4 regulated activities. According to these



respondents, Product Arrangers would not conduct activities within the scope of “advising on securities”.

142. On eligibility requirements for Product Arrangers, some respondents suggested introducing a “materiality” threshold and a time limit as they believed that a firm should not be barred from acting as Product Arranger for non-material breaches.
143. Some respondents further sought clarification on what information and undertakings would be required to be given by a Product Arranger to the Commission.

Commission’s response

144. The Commission considers that having a Hong Kong-regulated entity answerable for regulatory compliance in respect of a structured investment product is of paramount importance. This is particularly so where the structured investment product is issued by a special purpose vehicle, or issued or guaranteed by an overseas, non-Hong Kong-regulated entity.
145. In view of the wide support from the investing public, and for the purpose of enhancing investor protection, the Commission considers that a Product Arranger should be appointed for a structured investment product in the following situations:-
 - (a) where the Issuer is a special purpose vehicle, or
 - (b) where neither the Issuer nor the Guarantor (in the case of a guaranteed structured investment product) is a licensed bank regulated by the HKMA or a corporate entity licensed by the Commission.
146. The Commission considers that it is not appropriate or justifiable to reduce the scope of obligations and responsibilities of Product Arrangers as proposed in the SIP Code. Based on past experience, it is evident that products issued through a special purpose vehicle structure are invariably arranged by Hong Kong subsidiaries of the financial groups originating the products. The Commission understands that commercially there is little incentive for a third party to be the Product Arranger for a structured investment product, but this task would most usually be undertaken by a group company in Hong Kong. Accordingly, the Commission believes that, from a regulatory perspective, it is not satisfactory if a Product Arranger merely acts as a “post-box” between overseas Issuers/Guarantors and Hong Kong investors and regulators.
147. As regards the eligibility of Product Arrangers, amendments have been made to 4.2(b) of the SIP Code (eligibility of Product Arrangers) to align with the requirements applicable to Issuers and Guarantors under 3.3(a)(ii) of the SIP Code with regard to disciplinary proceedings.
148. The Commission has also revised 4.2(a) of the SIP Code so that a Product Arranger is required to be licensed or registered in Hong Kong for Type 1, but not Type 4, regulated activities. However, this should not be interpreted as reducing the scope of the duties of Product Arrangers, and the Commission expects Product Arrangers to hold the relevant licence(s) or registrations depending on the scope of work they undertake.



149. As in the case of Issuers, Product Arrangers for unlisted structured investment products must provide the Commission with the information and undertakings required for each particular case. Where appropriate, the Commission may consider publishing standardised undertakings that are required from Product Arrangers. However, depending on the particular circumstances of the case, the Commission may still request that a Product Arranger gives certain confirmations or undertakings specific to the case.

Collateral – 5.13 to 5.20 of the SIP Code

Eligibility criteria – 5.13 of the SIP Code

Public comments

150. There was significant opposition from the industry on the introduction of eligibility criteria for collateral to be used in unlisted structured investment products. These respondents further argued that the criteria were overly restrictive and, if adopted, should be used as a guide only.
151. On the other hand, several respondents (investors side as well as financial firms and industry bodies) supported the proposal and the eligibility criteria for collateral.
152. Some respondents asked for specific guidance on what types of collateral would be considered as “liquid and tradable”, as required by 5.13(a).
153. A small number of respondents suggested that the requirement for collateral to have a top three investment grade rating should be removed and that any rating should be a matter for disclosure instead.
154. There was also opposition from the industry on: (i) the prohibition of the use of structured products or securities issued by special purpose vehicles as collateral, (ii) the requirement that the collateral issuer should not be related to the Issuer, the Product Arranger or a Key Product Counterparty involved in the structured investment product, and (iii) the requirement that the collateral should be used solely for the purpose of securing the interests of investors and not used primarily to enhance the return on the product. These respondents were of the view that the collateral eligibility criteria would be difficult to satisfy in practice and would effectively prohibit many existing structures.
155. Furthermore, most industry respondents asked for clarification of the requirements that the collateral should be “appropriately diversified”, and that the collateral should not subject investors to any “undue risks”.
156. The feedback received indicated that respondents (mainly from the industry sector) felt that there was no need for any further criteria to be imposed in relation to selection of collateral in addition to those proposed in the SIP Code.

Commission’s response

157. The Commission firmly believes that it is important to establish criteria for the eligibility of collateral in order to enhance the transparency of collateralised structured investment products. The Commission set out these criteria in general terms so that Issuers may choose the appropriate collateral from a relatively wide range of assets



without at the same time compromising investor protection. However, the Commission is prepared to clarify the following points raised by the industry.

158. Having regard to the importance attached to the choice of collateral for a structured investment product issued by a special purpose vehicle, where investors' ultimate recourse is against the collateral, the Commission maintains the view that the proposed eligibility criteria for collateral are appropriate. Some of the proposed criteria that have attracted more criticism are clarified below.
159. One point raised was whether and to what extent eligibility criteria for collateral should continue to apply after the issue of a product. Since structured investment products are pre-packaged products, the collateral (if any) is selected before (or shortly after) the product is sold and no substitution of any collateral is in general permissible or practicable. It follows that the eligibility criteria for collateral should apply as at the date of issue of the structured investment product (or if later, the date of acquisition of the collateral). The SIP Code already spells out clearly that should there be any subsequent failure of a material portion of the collateral to continue to meet any of the requirements in 5.13 of the SIP Code, this would trigger an ongoing disclosure obligation under 7.6(d)(i) of the SIP Code and investors would have to be informed accordingly.
160. As regards the requirements for the collateral to be "liquid and tradable", to have an active secondary market and to have a top three investment grade credit rating (i.e. 5.13(a), (b) and (c) of the SIP Code), the Commission prefers to set out high level principles as opposed to prescriptive rules. These requirements are essential in ensuring transparency of collateralised structured investment products. The terms "liquid" and "tradable" are commonly used by the industry. The Commission expects that any collateral chosen is able to be readily liquidated. Collateral should normally trade in a deep, liquid market with transparent pricing. The Commission notes that regulators in a number of leading jurisdictions are adopting, or are moving towards adopting, a similar approach.
161. The Commission notes the point made by some respondents that, so long as the collateral meets the criteria of being liquid and tradable, which goes to enhance product transparency, the requirement for diversification of the collateral may hinder, rather than serve, the purpose for which a specific product is designed. 5.13(j) of the SIP Code has been revised to the effect that, where appropriate, an Issuer should decide whether the collateral should be diversified having regard to the interests of investors. Where an Issuer considers that there is no need to diversify, the Commission reiterates that the Issuer ought to ensure, and must disclose in the offering document, that the Issuer is satisfied that investors' interests are not prejudiced and the reasons for this view.
162. The Commission believes that the requirements in 5.14 of the SIP Code (formerly 5.15) and other provisions with respect to collateral address concerns that the collateral might subject investors to undue risks. The Commission has therefore deleted 5.13(k) of the SIP Code.
163. In the case of 5.13(e) of the SIP Code, the Commission believes that, when structuring a product and choosing collateral, the Issuer should be mindful of concentration risk. Accordingly, the Commission generally expects that the issuer of collateral will not be related to the Issuer, the Product Arranger or any Key Product Counterparty. The



Commission reiterates that Issuers ought to ensure that investors' interests are not prejudiced, and where the issuer of the collateral is indeed so related, the Issuer must disclose all relevant relationships in the offering document and explain how a default by any of the parties may affect the collateral and the interests of investors.

164. The Commission wishes to clarify that the requirement in 5.13(h) of the SIP Code was intended to remind Issuers of their obligation to give the highest regard to investor protection in selecting collateral for a structured investment product. As was mentioned by some industry respondents, for some structured investment products the collateral may be used as credit support for certain features of the product, e.g. swap arrangements. Having discussed this issue with the industry and reviewed commonly-seen collateralised structured investment products, the Commission notes that, without such credit support, the structure may not be commercially feasible. In the case of these types of products, therefore, the collateral is unlikely to be used "solely" for the purpose of securing the interests of investors, but rather for the purpose of making the transactions underpinning the structured investment product more commercially viable for counterparties. The drafting of 5.13(h) has been revised to cater for a wider range of situations under which collateral may be used. As a related matter, please also refer to paragraphs 169 to 174 below regarding priority of investors' claims to the proceeds of collateral. Investor education in this regard will be needed to further strengthen investors' understanding of the risks involved in collateralised structured investment products.
165. On the basis that the collateral meets the "liquid and tradable" criterion, and the obligation of the Issuer to provide market-making in the structured investment product pursuant to 7.3 of the SIP Code, the Commission has removed the requirement under the original 5.14 of the SIP Code for collateral to be marked-to-market daily. The Commission believes that it suffices for the Issuer (or its market agent) to quote one single price (i.e. the indicative bid price for the structured investment product) since this price will reflect Issuer's view of value of the collateral.
166. The Commission has clarified 5.15(a) of the SIP Code (formerly 5.17(a)) to the effect that each series or tranche of a collateralised product issued by the same Issuer must be separately collateralised with such collateral segregated from collateral in respect of the other series or tranches.

Substitution of collateral – Note (1) to 5.15(a) of SIP Code (formerly 5.17(a))

Public comments

167. Note (1) to 5.15(a) of the SIP Code (formerly 5.17(a)) provides that the Commission generally expects that there will be no power on the part of the trustee/custodian or any Key Product Counterparty to direct the trustee/custodian to substitute collateral. A few industry respondents commented that this would limit collateral arrangements commonly used to boost creditworthiness of products, such as an ISDA credit support annex. They argued that being able to substitute credit support was a common key feature of a credit support annex, and taking this away would have negative effects.

Commission's response

168. The Commission would like to reiterate that Note (1) to 5.15(a) of the SIP Code (formerly 5.17(a)) is framed as a general expectation. In exceptional circumstances where such substitution is justified, an Issuer should alert the Commission when submitting its application and explain the reasons why substitution should be permitted.



Priority of investors' claims – the original 5.17(c) of the SIP Code

Public comments

169. Most industry respondents strongly objected to the requirement to give priority to investors' claims to the proceeds of the collateral, as they believed this would be inconsistent with the way many structured investment products worked, and would mark a significant departure from international market practice. They suggested that priority of claims should be a disclosure point. Industry respondents indicated that, while it would be possible to structure products this way, the products would be low-yield and would be restricted in terms of the features and exposures they could offer. Certain industry respondents expressed views that the inability of an Issuer, particularly in the case of special purpose vehicle Issuer, to provide sufficient (or any) collateral to a transaction counterparty to mitigate that counterparty's credit risk, or the requirement that a counterparty's security interest in collateral be subordinated, could increase costs, making products more expensive, or the return less attractive, to investors, or could result in some prospective counterparties being unwilling to enter into transactions with Issuers of structured investment products on this basis and therefore operate to limit the range of feasible products and product structures.
170. Some respondents pointed out that, in some jurisdictions, applicable laws may operate to give priority to certain interests in collateral assets regardless of contractual priorities as agreed between the Issuer, relevant counterparties and the security trustee/investors. Thus, as a technical matter, it may not always be possible to ensure priority of investors' claims even in the absence of the commercial considerations above.

Commission's response

171. Given the myriad of products in the market and the evolving landscape of product development, the Commission understands that it would not be feasible to come up with a one-size-fits-all model for the use of collateral in all structured investment products. Upon reviewing the feedback received, the Commission believes that, on balance, the requirement to structure products giving first priority to investor claims to collateral proceeds might disproportionately restrict the breadth and depth of products available in the market relative to the potential benefits to investors, taking into account some of the inherent limitations in implementation and enforceability of claims to collateral proceeds. The Commission believes that it would be in the interests of the investing public and Hong Kong as an international financial centre that there continue to be a wide variety of structured investment products. Therefore, the issue of whether to require that investors be given first priority claims to the proceeds of the collateral upon enforcement will be a decision to be made by the Issuer at the design stage having regard to a wide range of factors including the structure and pricing of the relevant product.
172. As noted in paragraph 164 above, for the most commonly seen collateralised structured investment products available to the public in Hong Kong, as a matter of commercial arrangements, the collateral needs to serve as credit support for certain features of the product, e.g. swap arrangements. Without the credit support, the structure may not be commercially feasible. In such cases the collateral will have to be used to provide credit support in respect of the obligations owed to the investors and other parties (such as swap counterparties), as such the priority of their respective entitlement to the proceeds could vary depending on contractual agreements



necessary to structure the deal, and investors may not always be able to be afforded first priority.

173. The Commission has revised the SIP Code such that Issuers are no longer required to accord first priority to investors' claims to the proceeds of realization of the collateral, although they are encouraged to do so. However, where investors' claims are subordinated, or are likely to be subordinated, to those of other parties, whether this is by way of contractual priorities or priorities determined under applicable laws in the relevant jurisdiction, Issuers must ensure that sufficient disclosure is made in the offering documents and, where applicable, advertisements, by way of prominent and upfront risk warnings. The Commission has added further specific disclosure requirements on this subject (in particular, a requirement that the Issuer discloses the payment waterfalls upon enforcement) to Appendix C and Appendix D to the SIP Code. The Commission notes that these items supplement, and do not replace, the applicable disclosure standards. Issuers will still be required to explain in offering documents:- (a) the purpose for which the collateral is held, (b) how the collateral will be used (for example, whether as credit support or otherwise, and which parties' interests will be secured by such collateral and to what extent), and (c) the priority of claims to the proceeds. Issuers should also disclose clearly any implications for investors where their claims to collateral proceeds are not given first priority. In some cases it is possible that the claims of a party or parties (for example, a custodian, a trustee or a derivative counterparty) to proceeds of realisation of collateral are accorded priority, whether by operation of law or by contractual agreement, over investors' claims to the same proceeds.
174. The Commission will monitor developments in Hong Kong and other markets and where appropriate may revisit this issue. The Commission cautions that Issuers and intermediaries should be careful in using the term "collateral" where this may cause investors to form an inaccurate view about their interests (if any) and ranking of priorities in such assets. The Commission also intends to carry out investor education efforts in this aspect.

Confirmation to the Commission – 5.17 of the SIP Code (formerly 5.19)

Public comments

175. Some industry respondents argued against the requirement for the Issuer or the Product Arranger to confirm to the Commission that the collateralisation of the structured investment product "adequately protects the interests of investors", pointing out that this would need to be based on certain assumptions, including judgments of factors beyond the Issuer's or the Product Arranger's control.

Commission's response

176. The Commission has removed the requirement under 5.17 of the SIP Code (formerly 5.19) to give confirmation to the Commission in these terms. However, 5.17 still imposes an obligation on the Issuer and each Product Arranger to satisfy itself that the collateralisation of the structured investment product adequately protects the interests of the investors.



Reference assets – eligibility criteria – 5.7 and 5.8 of the SIP Code

Public comments

177. 5.7 of the SIP Code provides that the reference assets to which a structured investment product is linked must be acceptable to the Commission. 5.8 of the SIP Code sets out the requirements for reference assets and the Notes to 5.7 set out some of the factors that the Commission will generally take into account in considering whether certain reference assets are acceptable. Some industry respondents argued that the requirement under 5.7 of the SIP Code that reference assets should be “acceptable to the Commission” was too broad and uncertain. Some respondents further called for more prescriptive eligibility criteria for reference assets, notwithstanding the guiding factors in the Notes to 5.7 of the SIP Code. Yet other industry respondents disagreed with these factors, and felt that reference assets should not be subject to any eligibility criteria and that this should be a matter for disclosure only. Some respondents sought clarification of some of the factors to be taken into account, namely Notes (4) and (5) to 5.7 of the SIP Code.
178. Most industry respondents also claimed that the requirement that information relating to the reference assets should be readily available in Chinese was onerous. These respondents were concerned that this requirement might preclude the use of a large number of non-Hong Kong related reference assets, and might otherwise place a considerable burden on Issuers to translate information not available from public sources. They claimed that this would deprive Hong Kong investors of investment opportunities which would give them exposure to overseas assets to which they may not otherwise have access, and that this practice contrasted with the approach with retail investment funds.

Commission’s response

179. The Commission believes that, by setting certain basic requirements for selecting reference assets for unlisted structured investment products intended to be offered to the public in Hong Kong, the SIP Code enhances product transparency. The Commission does not, however, believe that the interests of the market would be best served by laying down a pre-determined list of acceptable reference assets. The provisions in the SIP Code, including the notes setting out further guiding factors, are intended to provide high level guidance to enable the market to develop within a framework of appropriate investor-protection measures. The Commission has therefore retained most of these provisions in the SIP Code.
180. It is important for the industry to note that the Notes to 5.7 of the SIP Code already set out certain factors which the Commission will generally take into account in considering an application. In order to protect investors’ interests, the Commission believes that it is important to consider whether sufficient information relating to the proposed reference assets is readily available to investors. Given the demographics of Hong Kong’s investing public and their use of both the Chinese and English languages, the Commission believes that regard should be had to whether information in respect of a reference asset is available to the public in both English and Chinese. As explained above, this is one of the factors that the Commission will look at.
181. In light of comments from some respondents, Note (4) to 5.7 of the SIP Code has been revised. For the sake of clarity, all of the Notes, which were originally under 5.8 (b), have been moved to 5.7 of the SIP Code.



Indicative valuations – original 7.4 of the SIP Code

Public comments

182. Certain respondents felt that indicative valuations of structured products could be useful for investors to assess the product's performance. However, others noted that daily fluctuations in value would be of limited relevance for investors in "buy-to-hold" products and argued that valuations on a less frequent basis than originally proposed would be more appropriate. Some respondents noted that it might not be possible to provide daily valuations, depending on the reference assets or other product features.
183. Many respondents argued that indicative bid prices, rather than valuations, would be of more use to investors. Some argued that valuations might lead to confusion, since they would generally not reflect the price at which an Issuer or its market agent would be willing to buy back the structured investment product and might, if provided more frequently than market-making in the product, give a false impression of liquidity.

Commission's response

184. While the Commission expects Issuers to establish and maintain sufficient internal measures for valuation of structured investment products and any collateral, the Commission agrees that indicative bids would be more useful as a guide to product performance for investors, particularly as investors will primarily be concerned with the price at which they can sell their investments. Taking into account the views expressed, the Commission has revised the SIP Code to remove the requirement for daily indicative valuations, and instead Issuers will have to make available indicative bid prices and provide market-making on a bi-weekly basis to investors. Issuers should clearly explain in the offering document the implications of indicative bids to investors. Market-making (or liquidity provision) in unlisted structured investment products is further discussed in paragraphs 185 to 194 below.

Liquidity provision – 7.3 of the SIP Code

Public comments

185. The original 7.3 of the SIP Code required Issuers to make "firm price quotations" available to investors on at least a weekly basis, except in the case of products with a scheduled tenor of one month or less. Most industry respondents argued that Issuers might not be able to give firm price quotations before an order was confirmed. Firm prices would result in a binding contract if accepted by an investor and would therefore only be given after taking into account all prevailing factors. If Issuers were required to provide firm price quotations regularly to investors at large, only the most conservative firm price quotations would be provided. Most industry respondents counter-proposed that indicative bids should be made available, noting that they would provide an indication of the price at which the Issuer would be willing to buy back the product.
186. There were also diverse comments from the respondents about the provision of indicative bids. Some suggested that this should be limited to a "best efforts" basis; others suggested a "reasonable efforts" basis. Respondents also varied in their suggestions for frequency of bids. Some respondents supported the proposal that indicative bids should be required to be made available weekly; others suggested that indicative bids should be made available monthly. Some respondents suggested that prices should be made available only on request.



187. Some respondents supported the proposal that structured investment products with a scheduled tenor of one month or less should be exempted from the requirement for market-making. Still others pressed for a larger exemption, suggesting that structured investment products with scheduled tenors of six months or less should be exempted.

Commission's response

188. The Commission sees merits in the submission that indicative bid prices may serve more practical purposes from investors' perspective given that investors are likely to find it more meaningful to know the possible realisable value of the product concerned. The Commission is of the view that with the exception of unlisted structured investment products with a scheduled tenor of six months or less, market-making for unlisted structured investment products should be made available to all investors at least bi-weekly. The Commission notes that this is a minimum requirement and Issuers may at their own volition provide market-making on a more frequent basis.
189. The Commission does not agree with the suggestion that market-making should be on a "best efforts" or "reasonable efforts" basis only. Market-making should be on a "committed" basis, in the absence of force majeure events (please see paragraph 192 below).
190. The Commission considers that Issuers should be permitted to set reasonable limitations on their market-making obligations. All such limits, as well as the timeframes within which investors should place their sell orders and other logistics, must be clearly set out in the relevant offering document.
191. Although indicative bid prices must be made available on each market-making day, they may be subject to intra-day change. The Issuer or its agent should also have the ability to decide the actual mechanism and mode of execution for any particular product, although the Commission will require that the minimum buy-back to be equivalent to the product's minimum denomination, and expects the market-making mechanism and settlement logistics to be reasonable and disclosed in the relevant offering documents.
192. Taking into account the feedback received, the principles in 7.3 and 7.4 of the SIP Code to provide market making have been revised. They are summarised as follows:
- (a) An Issuer (or its market agent) must provide indicative bid prices and market-making at least bi-weekly on a committed basis, subject to the exceptions set out in (b) and (c) below.
 - (b) The obligation to provide indicative bid prices and market-making does not apply to structured investment products with scheduled tenors of 6 months or less.
 - (c) Provision of indicative bid prices and market-making may be suspended when the relevant structured investment product is affected by events such as market disruption or suspension of trading of the reference asset(s), provided that these limits must be disclosed to investors in the offering document.
 - (d) The indicative bid prices must be made available throughout the whole market-making day but can change during the day. Issuers must provide a firm (actual) bid price upon request by an investor on a market-making day.



- (e) The minimum market-making order size must be the minimum denomination of the structured investment product. The Issuer may set a maximum order size or a maximum aggregate buy-back limit on a given market-making day, provided that these are reasonable. The minimum market making order size and any maximum limit must be clearly disclosed to investors.

193. Item 39 of Appendix C of the SIP Code provides that the market-making mechanism for a particular structured investment product must be disclosed in the offering document. The Commission has added an explicit requirement in item 39 for Issuers to explain in offering documents the implications of indicative bids.
194. The Commission has not prescribed the means by which indicative bid prices are to be provided to investors. Bid prices must, however, be readily accessible by all investors. Issuers may decide upon the most effective ways to make their indicative bid prices available to the investors, whether via websites or otherwise.

References to annualised returns – item 18 of Appendix C and item 20 of Appendix D

Public comments

195. Most respondents supported the use of annualised return figures, indicating their belief that this would make product comparisons easier for investors. Some respondents cautioned, however, that care should be taken in presenting annualised rates of return, that emphasis should be placed on the fact that this is not an actual rate of return, and that a clear explanation should be provided in the relevant disclosure document or advertisement of the basis for calculation of the annualised rate of return.
196. One respondent did not support the use of annualised rates of return, and felt that they could be confusing and potentially misleading. Certain respondents pointed out that they would not be suitable for certain types of product.

Commission's response

197. Given the overwhelming support received on this proposal, the Commission believes that no changes are necessary to the provisions in the SIP Code relating to the use of annualised returns.
198. One respondent suggested that the relevant period for the purposes of calculating annualised returns should run from the subscription or purchase day to the day on which the proceeds of redemption of sale are returned to investors. The Commission is of the view that the relevant period may vary between different types of products and should be the subject of clear disclosure (both of the period and the basis upon which it was chosen) on a case by case basis.
199. One respondent queried if it was technically accurate to refer to the “expected return”. Item 18 of Appendix C to SIP Code now refers to “return or potential return” instead.

Other proposals

Definition of “structured investment product” – 2.1 (g) of the SIP Code and inter-relationship with the CO reform proposals

200. Respondents called for a clear definition of “structured investment product”. The Commission draws attention to the fact that, pursuant to a recently-concluded



consultation on possible reforms to the prospectus regime in the Companies Ordinance and the offers of investments regime in the Securities and Futures Ordinance, there is a concurrent proposal to reform the CO. If the proposed legislative amendments are enacted, a definition of “structured product” will be inserted into both the CO and the SFO and the prospectus regime under the CO will be disapplied with respect to structured products in the form of debentures so that all structured products will be regulated under the SFO regime. The definition of “structured investment product” for the purposes of the SIP Code is intended to cover only those which involve derivative arrangements and is commonly regarded in the market as , equity-, index-, commodity- and credit-linked investment products, regardless of their legal form where the product or the related offering document or advertisement falls within the scope of Part IV of the SFO. While the SIP Code already covers products that are similar in nature to structured investment products offered to the public in Hong Kong in the past, it is not meant to be exhaustive. As the market develops, the Commission will consider whether further guidance should be issued and, where necessary, the Commission may consult the public on issuance of additional product codes/guidelines. Prior to the enactment of the legislative amendments currently proposed, offering documents (i.e. prospectuses) in respect of debenture-type structured products will continue to be subject to the prospectus regime under the CO, whereas for non-debenture type structured products, the offer of investments regime in the SFO continues to apply to their offering documents and advertisements. In any event, however, Issuers of structured investments products will be expected to comply with the SIP Code. The Commission will monitor the progress with respect to the legislative proposals noted above. Where appropriate, consequential changes to the provisions in the Handbook may need to be made to accommodate the changes made in the SFO.

Requirement to give confirmation that a structured investment product is designed fairly and is appropriate for the target market – 5.1 of the SIP Code

201. Industry respondents generally expressed strong concerns about this requirement, noting that an Issuer would normally have an internal product approval process. After taking into account their concerns about their potential liability as a result of the original requirement to give a confirmation to the Commission, the Commission has removed the requirement for Issuers and Product Arrangers to provide confirmations to the Commission under 5.1 of the SIP Code. However, Issuers and Product Arrangers must satisfy themselves that a structured investment product is designed fairly and is appropriate for the market(s) for which it is intended. This does not replace the obligation on the part of distributing intermediaries to conduct suitability assessments.

Definition of “Key Product Counterparty” – 5.5 of the SIP Code

202. Some respondents asked for further guidance on the definition of “Key Product Counterparty” in 5.5 of the SIP Code. The Commission would like to take this opportunity to clarify that entities whose credit or counterparty risk may have an impact on the risks and returns of the structured investment product should be considered Key Product Counterparties, whereas counterparties to so-called “balance-sheet” hedging transactions are not included. Accordingly, 5.5 of the SIP Code has been revised such that a “Key Product Counterparty” means a party where the Issuer’s payment obligations to investors or the investors’ economic return from the structured investment product depend(s) or will depend wholly or substantially upon payments made or to be made pursuant to an agreement or arrangement between the Issuer



and such party, and where such party's creditworthiness may have an impact on the risk and return of the structured investment product. Any other party guaranteeing or providing credit support for such party's obligations will also be a "Key Product Counterparty".

Chinese and English offering documents carry "equal weight" – original 6.9 of the SIP Code

203. Many respondents raised concerns about the requirement in the original 6.9 of the SIP Code that the English and Chinese versions of any offering document should carry equal weight. The Commission understands that Issuers may have particular problems in complying with this requirement with respect to the terms and conditions of the structured investment product if they are inserted as part of the offering document. Where the Issuer is or belongs to a global financial institution, the English version of the terms and conditions is usually used in the Issuers' global issuing programme and is lodged with the relevant clearing system, without the need to lodge a Chinese version as well. In line with the approach taken in the Overarching Principles section of the Handbook, the requirement in the original 6.9 of SIP Code for "*the English and Chinese versions of offering document to carry equal weight*" has been removed. However, the Commission wishes to remind Issuers that both the Chinese and the English versions would respectively remain subject to sections 107 and 108 of the SFO, which impose liability in respect of fraudulent, reckless or negligent misrepresentations respectively.

"Compensation" for failure to comply – 7.8 of the SIP Code

204. Many respondents noted that the Commission does not have power to order compensation in the case of a disciplinary breach and argued that the SIP Code should not, therefore, contain a reference to "compensation". The Commission has taken note of the feedback received. The original intent behind this proposed wording was to oblige Issuers to take the necessary steps to remedy (where appropriate) any breach of the SIP Code that would adversely impact investors. The wording has been revised to clarify the intent and the reference to "compensation" has been removed to avoid any confusion.

Post-sale arrangements – cooling-off period – Chapter 8 of the SIP Code

Public comments

205. This proposal received support from individuals and respondents representing consumer groups. The main industry bodies also indicated in their respective responses that it would generally be feasible to introduce some form of cooling-off period or option to unwind for investors, subject to certain conditions. This would afford those who had placed an order for purchase of or subscription for a product a right to change their minds and cancel the order or exit from the investment within a set period of time after placing the order. Some industry respondents also suggested that any cooling-off or unwind right should not apply to professional investors. Industry respondents indicated during follow-up discussions, however, that professional investors generally invest in products not offered to the public and hence these do not require the Commission's authorization under Part IV of the SFO. Those respondents agreed that there would be no need to include a carve-out for professional investors for the cooling-off provisions.
206. Some industry respondents made the point that giving investors a cooling-off right would place a significant administrative burden on Issuers and intermediaries, which



would result in higher pricing for investors as a whole. Some further argued that this would create moral hazard and expressed concerns that it might undermine the distributing intermediaries' duty to assess suitability. Other industry respondents also questioned whether a cooling-off right would add benefit to investors where Issuers would already provide regular market-making.

207. As requested in the Consultation Paper, respondents gave their views on when this right would be of most potential benefit to investors and when the costs of providing this right to investors might outweigh the potential benefit. Respondents also provided many detailed comments as to how this right could or should work in practice as well as limitations that the right should be made subject to.

Commission's response

208. The Commission believes that a post-sale cooling-off period or unwind right should be provided by Issuers in addition to their market-making obligations under the SIP Code. The cooling-off or unwind right is intended to be provided to all investors in an eligible structured investment product for a set period of time after the investment decision is made. The market-making obligations of Issuers under the SIP Code, as discussed earlier in this Paper, may be subject to certain limits set by the Issuers which, while reasonable in light of the ongoing nature of the requirement throughout the term of the product, would permit Issuers to limit this exit avenue. In many cases of structured investment products, therefore, liquidity provision by Issuers would not be equivalent to the cooling-off or unwind right. The case is different for publicly offered funds as they are required to facilitate regular redemptions at net asset value.
209. It was noted in the Consultation Paper that provision of a cooling-off or unwind right would come at a cost, and that Product Arrangers and intermediaries might seek to pass on certain costs to investors. It was also noted that steps would need to be taken to guard against abuse by investors who might take advantage of this right by engaging in short-term trading or speculation.
210. The Commission has taken these factors into account, in addition to weighing up the various views of respondents on this specific point. The Commission has decided that in respect of unlisted structured investment products for which authorization is sought under the SFO, subject to certain exceptions, Issuers should be required to give investors a post-sale cooling-off or unwind right.
211. This requirement will apply to unlisted structured investment products with a scheduled tenor of more than one year.
212. Issuers will be required to make the right available to all investors except where the structured investment product has been terminated or has been sold or transferred by the investor prior to exercise of the right.
213. The cooling-off or unwind right must comprise a period of at least five business days in Hong Kong after the investor places an order for the relevant structured investment product during which the investor has the right to change his/her mind. The investor should be able to exercise the right in respect of the whole of the order, but not part of it, and exercise should be irrevocable.
214. Issuers will have the flexibility to determine how to implement this requirement within the product terms and conditions, depending on the nature of the structured



investment product in question – for example, whether it amounts to a cancellation or a buy-back. The Commission believes that Issuers are in the best position to consider what cooling-off mechanism best suits their products, and to implement the mechanism through distributing intermediaries as appropriate. The mechanism and the time period during which the right may be exercised by investors must be clearly disclosed in the offering document.

215. Investors should be entitled to a refund of, or payment equivalent to, the principal invested less (if applicable) a market value adjustment (including break costs attributable to the unwind or cancellation) and any handling fee, and a refund of sales charges/commissions.
216. The amount required to be paid or refunded will be capped at the principal amount invested (not including sales charges/commissions). The refund or payment amount must be provided to investors as promptly as practicable after exercise of the right by the investor.
217. Respondents' views varied on the question of whether Issuers and intermediaries should be entitled to deduct handling or administrative fees, although most respondents felt that reasonable fees should be permitted (and in any event most believed that an approximate cost would be passed on indirectly in pricing the product if specific fees were not permitted to be deducted). The Commission believes that deduction of a reasonable handling fee, both at the Issuer and the intermediary level, to cover administrative costs should be acceptable, but this must be a fixed amount or an amount ascertained by reference to a pre-determined formula and fully disclosed upfront to the investor. The handling fee must not contain any profit margin for the Issuer or the intermediary.
218. The disclosure requirements under the SIP Code have accordingly been revised to require that offering documents include details of any cooling-off or unwind right provided to investors. The Commission intends to provide investor education with respect to the required cooling-off or unwind arrangements.

Transitional arrangements

Public comments

219. Authorization of the issue of offering documents and advertisements for unlisted structured investment products is typically given for a period of 12 months. Where authorizations have been given and remain in force at the time of effectiveness of the SIP Code, therefore, the Commission proposed allowing a transition period of 6 to 9 months. Most respondents agreed with this approach, although certain respondents felt that a 12-month period should be given and one respondent indicated that 3 months would suffice.

Commission's response

220. After reviewing the responses received, and taking into account the number of currently valid offering documents for unlisted structured investment products, and the fact that authorization of the issue of offering documents and advertisements for unlisted structured investment products is typically given for a period of 12 months, the Commission has decided that the transition arrangement should be, in the case of a structured investment product where offering document(s) or advertisement(s) have



been authorized as of the effective date of the SIP Code, compliance with the SIP Code is not mandatory for the remaining validity period of the current authorization, provided that the validity period is no more than 12 months from the effective date of the SIP Code. Where the Issuer submits an application to renew the authorization thereafter, and for all applications in respect of which authorizations are not granted as at the effective date of the SIP Code, the SIP Code will take immediate effect.



Part IV Responses and conclusions with respect to key proposals in the revised Code on Unit Trusts and Mutual Funds

Summary of Responses

221. The responses to this part of the Consultation Paper were generally in support of the proposals, which were seen as measures to allow for more product development, while at the same time enhancing transparency through means such as use of Product KFS and other on-going disclosure requirements.
222. Some respondents sought clarifications in certain areas, such as the distinction between applicability of 8.8 (for structured funds) and 8.9 (for funds that invest in financial derivative instruments) of the revised UT Code, risk management requirements and implementation details for Products KFS.

Proposal 1: Structured funds

Public comments

223. Respondents generally supported the proposal to introduce a new scheme category for structured funds under 8.8 of the revised UT Code to codify the prevailing practices for the authorization of these schemes. Major comments were:
- (a) Definition of structured funds

A number of respondents were of the view that the definition of structured funds should be clearly distinguished from that of funds that invest in financial derivative instruments (FDI) under 8.9 of the revised UT Code. Some sought clarification with respect to the application of other Chapters of the UT Code to structured funds with other specific features (for example, those tracking indices, or those supported by a guarantee).
 - (b) Independence of the manager and FDI issuers

Most respondents requested further elaboration on the independence requirements for managers of structured funds and issuers of FDIs, particularly in cases where a manager and an FDI issuer were separate entities within a corporate group.
 - (c) Independent valuation of FDI

A number of respondents sought clarification of the requirement for independent valuation of FDI for structured funds, arguing that most FDI valuations are based on proprietary models of the FDI issuer and that independent third parties may not have the expertise or capability to carry out the same valuation.
 - (d) Acceptability criteria for collateral

A number of respondents sought clarification of various collateral requirements such as “short settlement cycles” and “high credit quality”.



Others asked whether certain industry-accepted forms of legal opinion would suffice to demonstrate the enforceability of interests in collateral. Some expressed reservations about the requirement that securities comprising the collateral not be concentrated in one country, arguing that this may preclude the use of a portfolio of securities listed in a single market.

(e) Quarterly disclosure of information about collateral

Submissions received on this point did not support the proposed quarterly disclosure of information about collateral for schemes where the aggregate value of collateral held represents 30% or more of the net asset value. The general view was that the nature of collateral would not deviate significantly over time and that there were already requirements for disclosure of information about collateral in annual and semi-annual financial reports. As such, respondents argued that quarterly disclosure of collateral information may be of limited benefit to investors.

Commission's response

224. Definition of structured funds

Both structured funds and funds that invest in FDI under 8.8 and 8.9 of the revised UT Code respectively may make substantial investments in derivatives in furtherance of their investment objectives. The structured funds requirements in 8.8 of the revised UT Code are intended to apply to passively-managed funds which offer structured pay-outs or which track the performance of indices. 8.9 of the revised UT Code is intended to apply to actively-managed funds which invest in FDI. The definition of structured funds under 8.8 of the revised UT Code has been clarified accordingly.

Where schemes have features falling within the scope of one or more specialized scheme categories in Chapter 8 of the revised UT Code, they are expected to comply with the requirements of the applicable Chapters of the revised UT Code unless otherwise stated. For example, structured funds with guarantee features shall comply with both 8.5 and 8.8 of the revised UT Code. For the purpose of clarification, a statement has been included in the preamble to Chapter 8 of the revised UT Code.

225. Independence of the manager and FDI issuers

When compared to investing directly in certain assets, FDI may offer greater benefits, such as delivering exposure to a wide range of underlying exposures with greater efficiency and minimising uncertainties with respect to funding, operation or execution slippages. Fund managers may also wish to adopt a "one-stop-shop" approach in using intra-group resources in support of the operation of structured funds. In this regard, where a manager transacts with an affiliated entity as an FDI issuer, it is expected to adopt additional measures to ensure operational and functional independence of the manager and the FDI issuer and all relevant transactions must be carried out at arm's-length and on normal commercial terms in order to mitigate potential conflicts of interest. A detailed explanation of the expected measures will be published in the form of frequently-asked questions and responses (FAQs) on the Commission's website.



226. Independent valuation of FDI

As the return of most structured funds is derived primarily from FDI, regular and independent verification of FDI valuation is important in ensuring proper pricing of the fund as well as accurate measurement of the fund's risk exposure to the FDI issuer. The Commission acknowledges submissions from industry participants that it is common practice for valuations of FDI held by structured funds to be carried out by the FDI issuers. However, such valuations will be required to be regularly verified by the manager, the trustee or their delegate, who in each case must be functionally independent of the FDI issuer.

227. Acceptability criteria for collateral

The use of collateral is an important safeguard to mitigate a fund's risk exposure to individual counterparties. A set of high-level principles regarding collateral has been recommended by the Committee of European Securities Regulators (CESR)¹. Given the relevance of these principles in general, the Commission proposes to adopt substantially the same principles in assessing the acceptability of collateral received by SFC-authorized funds. While these principles are subject to interpretation, the Commission recognises the benefits of a principle-based approach to guide application in the different circumstances of individual cases. The Commission will supplement these principles and provide guidance by way of FAQs from time to time where appropriate.

Enforceability of interests in collateral is important for investor protection. Where a fund proposes to enter into collateral arrangements with counterparties, the manager should satisfy itself that the interests in collateral are legally enforceable, for example by obtaining legal advice, so as to fulfil its fiduciary duty to investors. The manager should determine what legal advice should be obtained based on the product structure and specific circumstances of the case, including industry best practice. The Commission may request the submission of the relevant supporting documents in processing an application for authorization of a fund where appropriate.

The proposed diversification requirement for securities constituting collateral was primarily intended to reduce the concentration risk exposure of a fund to individual issuers of such securities. In light of this, and the industry comments noted above, subject to the collateral meeting the remaining acceptability criteria set out in 8.8(e) of the revised UT Code, the Commission has removed the requirement that collateral not be concentrated in one sector or country. This is, however, subject to the manager's overriding duty to investors to manage the quality of the collateral held by it for a fund, having due regard to the changing circumstances of the market. The revised UT Code has been amended accordingly.

228. Quarterly disclosure of information about collateral

The Commission notes that the revised UT Code already includes enhanced requirements for disclosure of information relating to collateral holdings in offering documents and semi-annual and annual reports where such holdings are significant to the relevant scheme. Managers of SFC-authorized schemes are additionally required

¹ CESR's technical advice at level 2 on Risk Measurement for the purposes of the calculation of UCITS' global exposure – 15 June 2009



under the revised UT Code to inform investors of material adverse changes in the financial condition or business of key counterparties to schemes. In light of these provisions, the Commission will not require further quarterly disclosure of information about collateral. The revised UT Code has been amended accordingly.

Proposal 2: Funds that invest in FDI

Public comments

229. Respondents in general supported the Commission's initiative to provide a framework for the authorization of non-UCITS schemes that invest in FDI, and to provide a level playing field between UCITS and non-UCITS schemes. However, some sought clarification with respect to the types of schemes that would fall within this new category. Some also emphasised the importance of schemes that invest in FDI providing specific information on these instruments. Major comments are summarised below:

(a) Suitability and adequacy of risk management policies (RMP)

Some respondents sought guidance on the specific requirements for risk management and control systems, and enquired whether systems had to be reviewed and pre-approved by the Commission. In particular, questions were raised as to whether:

- (i) the Interim Measures² adopted by the Commission in 2005 for processing UCITS III schemes would remain valid; and
- (ii) the guide to the information relating to risk management and control processes that must be submitted to the Commission in support of applications for authorization of UCITS III funds that use expanded investment powers would also be applicable to schemes authorized under 8.9 of the revised UT Code.

(b) Calculation of global exposure to FDI:

The Commission proposed that managers of schemes that are authorized under 8.9 of the revised UT Code should adopt the commitment approach in calculating a scheme's exposure to FDI. However, some respondents commented that, while such an approach may generate lower levels of leverage than would be allowed were the same positions measured using the value-at-risk (VaR) approach, there are no express requirements among E.U. regulators that managers should use the commitment approach in calculating exposure to FDI. They added that a number of global fund houses have already adopted the VaR methodology for risk calculation in respect of their sophisticated UCITS schemes.

Some respondents suggested that the Commission should provide flexibility in 8.9 of the revised UT Code by allowing the use of VaR on a case-by-case basis, while others suggested that both approaches should be allowed and that the manager should be required to justify to the Commission why a

² General circular to SFC-approved fund management companies, titled "Interim Measures on the Disclosure and Submission Requirements for the authorisation of UCITS III Funds domiciled in Luxembourg, Ireland and the United Kingdom by the SFC".



particular methodology may be appropriate and acceptable for a particular scheme, taking into account such managers' risk management processes as a whole.

(c) Others

Some respondents sought clarifications as to whether UCITS III schemes would be required to comply with 8.9 of the revised UT Code.

Commission's response

230. The new requirements in 8.9 of the revised UT Code are not intended to regulate the management of UCITS III schemes that use FDI for investment purposes, as these funds are already required to comply with the relevant requirements under the E.U. regime. Therefore, these UCITS III schemes are exempt from the operational requirements and investment restrictions set out in 8.9 of the revised UT Code. However, to aid investors' understanding of the FDI investments involved and the attendant risks, such UCITS III schemes are nonetheless required to comply with the disclosure requirements set out in 8.9 of the revised UT Code.
231. As mentioned in the Consultation Paper, this chapter of the revised UT Code is intended to provide a comprehensive framework within which non-UCITS III schemes may invest in FDI. This means that, where non-UCITS schemes would previously have been subject to the investment limits laid down in Chapter 7, but because of their investments in respect of FDI such as futures and options, they will be categorised as 8.9 schemes for the purposes of SFC authorization and on-going compliance.

(a) Suitability and adequacy of RMP

Each management company has its own organisational and operational structure, and risk management controls and monitoring systems have to be established to address its specific circumstances and the nature of its activities.

At the scheme level, the investment policy and strategy for each scheme are determined with reference to the scheme's investment objectives, and each scheme will make investments in accordance with its established policies in furtherance of its investment objectives.

In light of this, it is neither appropriate nor practical for the Commission to prescribe specific types of risk management policies or systems for management companies. Management companies have the duty and responsibility to adopt risk management systems that are appropriate for their business and operational models, their level of competence, the nature of their investment activities and the potential risks involved. As clearly set out in the Commission's Fund Manager Code of Conduct, a fund manager should maintain, among other things:

- (i) sufficient human and technical resources and experience for the proper performance of its duties; and
- (ii) satisfactory risk management procedures commensurate with its business.

Further, the Commission's Code of Conduct requires senior management of a



licensed or registered person to properly manage the risks associated with the business of the licensed or registered person, including performing periodic reviews of its risk management processes.

Accordingly, where a SFC-licensed management company intends to manage a scheme that falls within the scope of 8.9 of the revised UT Code, the Commission expects such manager to be competent to do so and to have implemented sufficient and appropriate risk management systems and measures to monitor its FDI activities on an on-going basis. The Commission will assess the relevant scheme's application on this basis. The Commission takes this opportunity to remind fund managers of their obligations in this regard under the Fund Manager Code of Conduct. Fund managers will not be required to have their risk management and control processes vetted by the Commission in connection with applications for fund authorizations.

The Interim Measures with respect to UCITS III schemes domiciled in Luxembourg, Ireland and the United Kingdom remain in effect. However, in line with the approach taken above, information pertaining to risk management and control processes will no longer be required to be filed with the Commission.

(b) Calculation of global exposure to FDI:

The Commission notes that the UCITS III regime does not restrict the global exposure calculation methodology to the commitment approach and that it also accepts alternative risk measurement methodologies such as the VaR approach. However, as mentioned in the Consultation Paper, the Commission believes that, at this initial stage of implementing the new proposed FDI framework, the more conservative commitment approach is preferable. Further, a uniform approach to measuring risks provides consistency and comparability, thus facilitating investors' understanding of 8.9 schemes at their early stage of introduction.

For the above reasons, the Commission has retained the requirement for all 8.9 schemes to use the commitment approach in their calculation of exposure to FDI. At a later stage, when the market becomes more familiar with this new category of scheme, the Commission may revisit the issue and consider allowing other methodologies for calculating global exposure to FDI.

(c) Others

As mentioned above, the operational and investment requirements in 8.9 of the revised UT Code are only applicable to non-UCITS schemes. UCITS schemes that invest in FDI will continue to be expected to comply with the relevant E.U. provisions.

However, as pointed out by some respondents, it is important that schemes investing in FDI make clear disclosure of the nature and risks of the FDI. The Commission has therefore clarified in 8.9 of the revised UT Code that the disclosure requirements set out in this chapter apply to both UCITS and non-UCITS schemes.

Provisions in 8.9 of the revised UT Code have been amended to reflect the above.

It has been widely reported in the media that there has been a move among



some hedge fund managers to take advantage of the flexible investment platform provided by the UCITS III regime and to launch schemes that adopt complex, leveraged strategies, previously offered only to large and sophisticated investors, in the mainstream UCITS format. Regulators around the world have grown increasingly vigilant with respect to such developments and the Commission is no exception. The Commission would like to reiterate here that UCITS schemes falling within the list of recognised jurisdiction schemes (RJS) will be reviewed on the basis that the scheme's structural and operational requirements and core investment restrictions have already complied in substance with the UT Code. However, such streamlined processing is not (and will not be) available for authorization of specialized schemes falling within the scope of Chapter 8 (other than 8.9), or in respect of Hong Kong-specific disclosure and reporting requirements, or post-authorization requirements as set out in the UT Code.

Proposal 3: Investment in other schemes

Public comments

232. Respondents welcomed the proposal to allow schemes to invest concurrently in collective investment schemes and other financial instruments, subject to certain thresholds, thus enabling more diverse investment products and increasing investors' choice. However, clarifications were requested in the following areas:
- (a) applicability of a "see-through" approach;
 - (b) applicability of 7.1 to 7.3 inclusive;
 - (c) the extent to which RJS may be included as investments; and
 - (d) applicability of 7.11C and 7.11D to all investments in underlying schemes.

Commission's response

233. Applicability of a "see-through" approach

Diversification is very important in a retail funds context. It is expected, therefore, that when a fund invests in other scheme(s) (underlying schemes), the management company will exercise due care in the selection of the underlying schemes to ensure that, among other requirements, there is appropriate diversification of the fund's investments.

The Commission recognises that, in practice, it may not be feasible for the management company to obtain specific information about the investments made by the underlying schemes, unless such schemes are also managed by the management company or by entities that belong to the same group as the management company. However, the underlying schemes (except for those which in aggregate account for no more than 10% of the total net asset value of the investing collective investment scheme) are required to be RJS, which are already subject to relevant diversification requirements.

In view of the above, the Commission would not generally require the management company to adopt a "see-through" approach in with respect to a fund's investments in



underlying schemes. However, where the underlying schemes are managed by the same management company as the scheme that invests in them, or by other entities within the same group as the management company, the Commission would expect the management company to adopt a “see-through” approach and take into account the investments made by such underlying schemes in its investment management of the collective investment scheme as a whole.

234. Applicability of 7.1 to 7.3 inclusive

Provisions for regulating investments in underlying schemes, other than those in respect of unit portfolio management funds, are set out in 7.11 to 7.12 inclusive. Accordingly, the provisions governing spread of investments, namely 7.1 to 7.3, would not be applicable except in cases where the “see through” approach is required to be adopted as discussed in the preceding paragraph. The revised UT Code has been amended to clarify this.

235. Investments in RJS

Under the revised framework, a fund may invest up to 30% of its total net asset value in an underlying scheme which is a RJS. In light of the magnitude of the exposure allowed, the Commission considers that it is important for these purposes that such RJS be among those RJS in Luxembourg, Ireland and the UK which are currently covered by the Interim Measures. These requirements will be reflected in the List of Recognised Jurisdiction Schemes.

236. Applicability of 7.11C and 7.11D to all investments in underlying schemes

The note to 7.11C and 7.11D in the revised UT Code has been removed. 7.11C and 7.11D are applicable to all investments in underlying schemes.

Proposal 4: Bilingual annual reports

Public comments

237. Comments by respondents on this part of the Consultation Paper focused mainly on two aspects, namely the need for a level playing field between RJS and non-RJS, and the requirements for preparing and delivering a bilingual annual report.

(a) Level playing field

While a few of the respondents took the view that all SFC-authorized schemes should be required to provide bilingual annual reports given Hong Kong’s demographics, the majority of the respondents supported the proposal that, for SFC-authorized schemes that are RJS, the publication of a Chinese-language annual report should be voluntary. Some of these respondents went further to suggest that there should be a level playing field in this regard between RJS and non-RJS, meaning that the issue of bilingual annual reports should be made optional for both RJS and non-RJS.

In support of the suggestion for making the issue of bilingual annual reports optional, respondents pointed out that the preparation of a Chinese-language annual report is both costly and time-consuming and that requests for Chinese-language annual reports have been rare in the past since the



information contained in the annual report is likely to be stale by the time that the report is issued (which is within four months after the end of the scheme's financial year). Industry participants also raised with the Commission their concerns that insisting on bilingual annual reports in circumstances where the costs would outweigh the benefits could have the undesirable effect of driving issuers away, which in turn could leave Hong Kong investors with less product choice. These respondents felt that product providers should be given the flexibility to determine whether or not to issue bilingual annual reports, taking into account their clients' needs and commercial considerations.

(b) Requirements for the preparation and delivery of bilingual annual reports

The feedback on which of the three options suggested in the Consultation Paper should be adopted was diverse. However, most respondents suggested that only an abridged version of the annual report should be required to be issued in Chinese and such document should be able to be made available within a few weeks after the issuance of the English-language annual report.

Commission's response

238. Level playing field

- (a) We note the submissions made by industry participants, noted above, with respect to the time and costs involved in the preparation of a Chinese-language annual report and also the comments on the likely benefits for investors.
- (b) We note that key information relating to SFC-authorized funds is already required to be provided to investors in the offering documents and the Product KFS (once this requirement is implemented) which are prepared in both English and Chinese. Further, notices which inform investors of significant changes that may affect the compliance of SFC authorized funds with the regulatory requirements under the UT Code are also prepared in both languages and are available to investors on a timely basis. We understand from the industry that investors are generally provided with monthly fact sheets, which are in English and Chinese to keep them informed.
- (c) Balancing all factors, we believe that there are valid reasons for us to make the preparation of Chinese-language annual report optional for all SFC-authorized funds. However, as stated in the Consultation Paper, where a fund does not issue bilingual annual reports, the distributor of such fund in Hong Kong must take steps to make investors aware that annual reports for the fund will only be available in English or Chinese (as the case may be). In addition, this fact must be clearly disclosed in the offering document for the fund. The same will also apply to interim reports.

239. Requirements for the preparation and delivery of bilingual annual reports

Given that the provision of bilingual annual reports is optional, the Commission will not specify requirements for the contents or the timing of the delivery of Chinese-language annual reports.



Proposal 5: Product KFS

Public comments

240. Overall, respondents were supportive of the introduction of Product KFS among SFC-authorized schemes. Their comments focused mainly on four aspects, namely whether the Product KFS should form part of the offering document, whether issuers may adopt the key information document (KID) as proposed under the E.U. regime in place of the Hong Kong template, the contents of the Product KFS, and the implementation details.

(a) Product KFS as part of the offering document

Some industry practitioners asked the Commission to allow flexibility in treating Product KFS as part of the offering document for a scheme. They submitted that, in the case of non-Hong Kong schemes which adopt a global offering document, the inclusion of a Product KFS in this global offering document would not only add a significant administrative burden but would necessitate submission of the document (including the Product KFS) to their home regulators for approval. These respondents noted that, even if the Product KFS were not part of the offering document, the Product KFS would still be subject to regulatory requirements including liability for misleading or insufficient disclosure, as with other materials provided to investors.

(b) Adoption of KID

(i) Many industry respondents submitted that the contents of the KID were virtually the same as those of the Product KFS, except for the risk ratings and performance tables required in KIDs. They therefore took the view that KIDs could serve the same purpose as Product KFS and should be allowed to be used in place of Product KFS. Some added that, where necessary, a Hong Kong wrapper might be added to the KID to include any information required in a Product KFS but not required in a KID.

(ii) A few respondents supported the use of the Product KFS across all schemes, on the basis that it would facilitate investors' comparison among different schemes.

(c) Contents requirements

Some respondents suggested that certain information proposed to be required in the Product KFS should be optional, including:

- (i) information on total asset size; and
- (ii) information on investment mix.

Suggestions were made that some proposed Product KFS disclosures should be dispensed with. These included:

- (i) the requirement for intermediaries to answer questions relating to the differences in the regulatory requirements between Hong Kong domiciled funds and RJS; and



- (ii) details for all relevant intermediaries.

Other respondents sought clarifications regarding the form or presentation of certain information, such as:

- (i) whether it would be compulsory to use a pie chart for the presentation of an investment mix; and
- (ii) whether past performance information must be presented in the form of a bar chart.

- (d) Implementation details

The responses were generally supportive of the proposed implementation timeframe, although respondents suggested that the Commission should defer the implementation of the Product KFS until the implementation of the KID in the E.U. There were also isolated responses requesting a longer implementation period of as much as two to three years.

Some respondents also sought guidance on the vetting process for Product KFS.

Commission's response

241. Product KFS as part of the offering document

- (a) The Commission held follow-up discussions with industry practitioners to further understand the practical issues that they raised concerning treating the Product KFS as part of the offering documents for particular funds. The main practical concern seemed to be that, if the Product KFS were required to be physically bound together with the other parts of offering documents, then the offering documents would become very bulky and not user-friendly, thus defeating the original purpose of introducing the Product KFS. An additional concern related to compliance burdens. The Commission understands that certain foreign schemes use a single, global offering document in all jurisdictions in which they are distributed. For these schemes, the concern was that the Product KFS would be subject to overriding legal requirements in the home jurisdictions if it formed part of the offering document.
- (b) Product KFS do not have to be physically bound together with the other parts of the offering documents. Nevertheless, Product KFS will generally form part of the offering documents, and Product KFS must clearly disclose this fact. However, the Commission may, on an exceptional basis, permit schemes to produce a Product KFS that is not deemed to form part of the offering document for the relevant scheme in circumstances where the scheme uses a global offering document in all jurisdictions in which it is marketed.
- (c) We have considered the level of protection under the SFO that would be afforded to investors in the case where the Product KFS is not deemed to be part of the offering document for a scheme. Broadly speaking, civil or criminal liability³ (depending on the circumstances) attaches to a fraudulent, reckless

³ Under s.107 and s.108 of the Securities and Futures Ordinance (Cap. 571) respectively, it is an offence to fraudulently or recklessly induce others to acquire securities or enter into certain agreements, and civil liability may ensue for inducing others in certain cases.



or negligent misrepresentation made by a person which induces another person to enter into certain types of agreement, including for the acquisition of securities or interests in collective investment schemes. This would include misrepresentations in Product KFS. The Commission notes that it will not regard it as an acceptable practice for issuers of Product KFS to insert disclaimers in the document with a view to absolving themselves from liability in respect of that document.

242. Adoption of KID

The format of the KID is still to be finalised. The Commission will monitor developments and work closely with the industry to determine whether and if so how the KID in its final form might be used in Hong Kong in place of the Product KFS.

243. Contents requirements

The Commission has assessed comments received on the proposed contents requirements for Product KFS. In light of the feedback, the Commission has simplified the disclosure requirements with respect to the nature of the product and revised the section on “Intermediaries information” to allow alternative means to access information about the intermediaries. The Commission has also clarified in the Product KFS template that presentation of information about investment mix and past performance is at the discretion of the product issuers, provided that the format chosen is consistently adopted.

The Commission has modified the format of the Product KFS template based on the draft KID issued by CESR in February 2008, with an aim to better align the presentation of the Product KFS and KID to facilitate comparability of the two documents and reduce non-substantive differences between the two forms.

244. Transitional arrangements

- (a) The Commission would like the Product KFS to be introduced at the earliest practicable time as this is an important tool for investors’ understanding of investment products. Accordingly, the Commission will not delay the implementation of the Product KFS requirement until such time that the final form of KID is introduced in E.U. As proposed in the Consultation Paper, all New Schemes⁴ will be required to prepare Product KFS on and from the Effective Date⁵; while Existing Schemes⁶ that continue to be marketed to the public in Hong Kong will be required to provide Product KFS by no later than 12 months from the Effective Date.

⁴ “New Schemes” means, for the purposes of Part IV of this Paper, collective investment schemes for which applications for authorization are submitted to the Commission on or after the Effective Date (as defined below).

⁵ “Effective Date” means, for the purposes of Part IV of this Paper, the effective date of the *SFC Handbook for Unit Trusts and Mutual Funds, Investment Linked Assurance Schemes and Unlisted Structured Investment Products* (including the revised UT Code) declared by the Commission and published in the government gazette.

⁶ “Existing Schemes” means, for the purposes of Part IV of this Paper: (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 which are authorized on or after the Effective Date.



- (b) New Schemes will be expected to include Product KFS in their applications for vetting by the Commission.
- (c) For Existing Schemes, other than those using global offering documents and for which the Product KFS will not form part of the offering document, Product KFS will not have to be submitted to the Commission for prior approval, in light of 11.1B of the revised UT Code and the authorization arrangements already in place in those cases. However, within 7 days of the issuance of the Product KFS, such document will be required to be submitted to the Commission for surveillance purposes.
- (d) Existing Schemes using global offering documents will be required to submit Product KFS to the Commission for prior approval. The Commission will work on specific implementation details with issuers of such schemes.
- (e) Meanwhile, the Commission will monitor developments in relation to the proposed KID and work together with industry practitioners in considering whether and if so how the KID might be used as an alternative to the Product KFS once the final version of KID is made available.

Proposal 6: Miscellaneous

Public comments

245. In general, respondents supported the initiatives set out under Proposal 6 (Miscellaneous) for the UT Code. Some requested added flexibility in the selection of managers. Other responses sought clarification of disclosure requirements and criteria for the appointment of Hong Kong representatives:

(a) Multi-manager schemes

Some respondents suggested that the proposed criteria for the selection of managers for multi-manager schemes, as provided under 5.5(a) of the revised UT Code, should be extended to schemes in general, so that investment advisers to whom the investment management function had been delegated would not be required to possess the specific required experience in the management of public funds.

(b) On-going disclosures

Some respondents sought clarification of the requirement that the management company should inform holders “as soon as reasonably practicable of any material adverse change in the financial condition or business of the key counterparties to a scheme that it is aware of”, as set out in the note to 11.1B of the revised UT Code. Some felt that this obligation was onerous and asked the Commission to specify matters which would constitute a “material adverse change”.

(c) Hong Kong representative

One respondent sought clarification of the factors taken into account by the Commission when assessing the acceptability of a trust company to act as a Hong Kong representative for a scheme.



Commission's response

246. The various initiatives in Proposal 6 in the Consultation Paper are intended to allow for product design and broaden the investment choices available to SFC-authorized schemes without compromising investor protection. Managers of SFC-authorized schemes must meet the qualification requirements set out in the revised UT Code and exercise due care and sound judgment in their management of those schemes and their communication with the scheme investors.

(a) Multi-manager schemes

The key qualification requirements applicable to all management companies (and investment advisers to whom the investment management function is delegated) are clearly set out in Chapter 5 of the revised UT Code. These requirements are important in ensuring protection for investors.

The Commission acknowledges that, in the context of a multi-manager scheme, the top-level management company is typically responsible for selecting qualified sub-managers for the scheme, allocating funds for investment by the different sub-managers and managing the scheme cashflow in respect of subscriptions and redemptions. At the same time, the aim of a multi-manager scheme is to provide investors in the scheme with access to sub-managers who have investment expertise in certain strategies or investment mandates but who may not necessarily have experience in managing public funds. The top-level management company, however, remains responsible for the functions delegated to the sub-managers.

Therefore, it is only in the case of multi-manager schemes that the Commission will consider investment experience gained in managing funds other than public funds.

(b) On-going disclosures

The Commission believes that the management company of a scheme, being charged with the duty to manage the scheme on a day-to-day basis, must be able to assess whether a change in the financial condition or business of a key counterparty to the scheme is a material adverse change that should be made known to investors, taking into consideration various factors such as the nature of the change, the prevailing market conditions and the specific circumstances of the scheme. It would not be appropriate for the Commission to prescribe the types of changes that should be viewed as material and adverse. This is a matter for the professional judgment of the manager in light of the specific circumstances.

(c) Hong Kong representative

As noted in the Consultation Paper, the proposed criteria for the appointment of a Hong Kong representative represent a codification of existing practice. Hong Kong representatives must be authorized on behalf of a scheme to receive and handle application money from investors in Hong Kong. It is important that they be subject to sufficient oversight in the interests of investor protection. The proposed requirements are that a representative must either be licensed or registered with the Commission, or must be a trust company affiliated with an authorized financial institution, as that term is defined under the SFO. The Commission intends to retain the original proposal.



Transitional arrangements

Public comments

247. Respondents were generally in support of the proposed timetable for implementing the revisions to the UT Code except in the case of Product KFS, where comments on the implementation requirements were more varied, as discussed earlier.

Commission's response

248. Proposal 1 (Structured funds), Proposal 2 (funds that invest in FDI) and Proposal 3 (investments in other schemes)
- (a) New Schemes will be required to comply with the relevant provisions in the revised UT Code commencing on the Effective Date.
 - (b) Existing Schemes will be grandfathered and will not be required to make any corresponding amendments unless they change their investment objectives or strategies and any such change falls within the scope of the revisions to the UT Code. In such cases, they will be required to comply with the relevant provisions, amend their offering documents and/or constitutive documents and inform their investors in accordance with the terms of their constitutive documents and the relevant provisions of the revised UT Code. The changes and the consequential amendments to the offering documents should be submitted to the Commission for prior approval.
249. Proposal 5 (Product KFS) and other disclosure requirements set out in the revised UT Code
- (a) New Schemes will be required to comply with the relevant provisions in the revised UT Code commencing on the Effective Date.
 - (b) Existing Schemes that continue to be marketed to the public in Hong Kong will be required to comply with the relevant provisions in the revised UT Code within 12 months from the Effective Date.
 - (c) Existing Schemes that are no longer marketed to the public in Hong Kong will not be required to comply with the relevant provisions in the revised UT Code.
250. Proposal 6 (Connected party transactions, criteria for the appointment of a Hong Kong representative, performance fees, maximum interval for payment of redemption amounts, sub-managers of multi-manager schemes and distribution of financial reports)
- (a) New Schemes will be required to comply with the relevant provisions in the revised UT Code commencing on the Effective Date. In particular, where any New Scheme proposes to rely upon the new performance fee provisions set out in the revised UT Code, the manager must clearly set out the performance benchmark in the offering document of the scheme, explain the basis for the performance fee calculation method, and clearly illustrate the method of calculating the fee. In line with existing practice, the benchmark adopted must be relevant to the investment objectives and strategy of the fund, transparently and objectively measured, and consistently adopted by the fund.



Similarly, where a New Scheme proposes to apply an extended interval for the payment of redemption amounts, the manager of the New Scheme must clearly disclose in the offering document the basis for adoption of this approach and explain the mechanism involved.

- (b) These revised provisions are intended to provide a broader framework for operating and structuring a scheme, and in some cases, to deal with special circumstances (as in the case of payment of redemption amounts). Managers of Existing Schemes are not, therefore, required to adopt the revised provisions. Managers of Existing Schemes may continue to operate within the scope of their current authorizations and as already set out in the offering and constitutive documents of the for the relevant schemes, and no further action will be required from the managers in these cases.
- (c) Where managers of Existing Schemes intend to rely upon any of the provisions in the revised UT Code introduced under Proposal 6, they must take the following steps to ensure that the changes are implemented smoothly and investors' interests are appropriately protected:

- (i) Before implementing any changes in reliance upon the relevant provisions in the revised UT Code, a manager must assess the propriety of such changes in light of the nature and investment strategy of the Existing Scheme, the interests of the scheme investors and prevailing market conditions.
- (ii) In the case of longer redemption payment periods, the Commission would like to emphasize that the relevant provisions in the revised UT Code are intended as an alternative redemption arrangement for schemes that invest substantially in markets which impose foreign currency controls. Repatriation of funds from these markets may be subject to such controls and such schemes may therefore have difficulty in meeting the current one-calendar month redemption payment requirement. Our past experience has shown that these schemes generally adopt restrictive monthly dealing in order to comply with the one-calendar month requirement, or seek a waiver of the requirement if more frequent dealing is to be provided to investors.

The one-month redemption requirement will be relaxed pursuant to the revised UT Code for those schemes which have difficulties meeting this one-month period due to restrictive conditions in the market(s) in which they invest. Where schemes have already been authorized by the Commission and currently provide monthly dealing, they will not be able to avail themselves of this relaxation unless they are willing to provide dealing more frequently.

- (iii) Currently under the UT Code, managers of SFC-authorized schemes may only charge performance fees on a "high-on-high" basis with reference only to the net asset value (NAV) per unit/share of a scheme. However, fund managers have indicated to the Commission on various occasions that other leading jurisdictions accept a high-on-high basis with reference to a benchmark where the



basis upon which the performance fee is calculated is clearly disclosed and consistently applied. In view of this, the revised UT Code provides for an alternative performance fee charging mechanism whereby managers may charge performance fees with reference to the performance of a benchmark. In such case, the performance fee is payable upon outperformance of the benchmark by the net asset value per unit/share.

Where a scheme that has already been authorized by the Commission and is already charging investors for performance fees, a change in the performance mechanism from the existing high-on-high basis with reference only to the net asset value (NAV) per unit/share of a scheme to the revised benchmark approach may not create much concern, as the concept of charging performance fees is not novel to its investors. We will also conduct investor education campaign to explain the revised provisions to the general public. However, the situation would be different where a scheme is already authorized by the Commission, does not currently charge performance fees but wishes to do so pursuant to the revised provisions. We propose to deal with the issue as follows in so far as Existing Schemes are concerned:

- such schemes must provide investors with three months' prior notice, and clearly explain the basis upon which the performance fee will be charged; and
- such schemes must already have adopted, and disclosed in their offering documents, a benchmark by reference to which scheme performance will be measured.

Managers of Existing Schemes will not be able to avail themselves of this performance fees charging mechanism unless the above criteria are met. An authorized scheme which has not hitherto adopted a benchmark for performance measurement may not unilaterally adopt a benchmark and start charging performance fees. Separately, we would like to note that the introduction or variation of performance fees may not require approval from unitholders if the applicable law (in the case of foreign schemes) does not impose this or constitutive documents do not so stipulate. Where that is the case, we would not require schemes to seek unitholders' approval.

- (iv) Upon being satisfied that the adoption of the relevant measures are appropriate and in the interests of investors, managers must ensure that the offering documents and/or constitutive documents for the relevant schemes are properly amended, and that investors are duly informed in accordance with both the terms set out in the constitutive documents of the schemes and the provisions in the revised UT Code.
- (v) Investors must be provided with at least one month's (or such longer period as required under the constitutive documents of the schemes



or by the Commission as further explained below) prior notice of any such changes to be adopted.

- (vi) In the case of any changes to the performance fee mechanism, the Commission will require managers of the Existing Schemes to provide a notice period of three months, as such change involves a fundamental change in the calculation mechanism of the performance fees which would be more complicated than a revision in the maximum fee level.
- (vii) In the relevant notice(s) to investors, managers of these schemes must clearly explain the basis and rationale for implementing changes pursuant to the relevant provisions in the revised UT Code. In the case of an extension of the time for payment of redemption monies to investors, the Commission expects notices to explain clearly the change and its impact on investors. In the case of performance fees, the Commission expects the notices to explain the reason(s) for the change and the basis upon which the performance fee will be calculated, illustrate the method of calculating the fee and clearly explain the impact for investors.
- (viii) Any such changes and consequential amendments to offering documents should be submitted to the Commission for prior approval.



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)	SFC-authorized schemes as of the Effective Date and schemes that submit their applications for authorization prior to the Effective Date and which are subsequently authorized (i.e. Existing Schemes)
A. Investment activities			
Proposal 1 (structured funds)	8.8	Immediate implementation	Grandfathered (unless there is a change in investment objectives or strategies which falls within the scope of the revisions to the UT Code)
Proposal 2 (funds that invest in FDI)	8.9		
Proposal 3 (investments in other schemes)	7.11-7.11B		
B. Disclosure and reporting			
Proposal 4 (bilingual annual reports)	11.6	<ul style="list-style-type: none"> ▪ Voluntary compliance for all SFC-authorized funds 	
Proposal 5 (Product KFS) and other disclosure requirements set out in the revised UT Code	6.2A	Immediate implementation	<ul style="list-style-type: none"> ▪ Existing Schemes no longer marketed to the public in HK – compliance not required ▪ Existing Schemes that are still being marketed to the public in HK- a transitional period of 12 months from the Effective Date to comply



Proposals	Provisions of the revised UT Code	Schemes that submit their applications for authorization on or after the Effective Date (i.e. New Schemes)	SFC-authorized schemes as of the Effective Date and schemes that submit their applications for authorization prior to the Effective Date and which are subsequently authorized (i.e. Existing Schemes)
C. Miscellaneous			
Proposal 6 (connected party transactions)	10.13	Immediately effective (Note 1)	
Proposal 6 (criteria for the appointment of a Hong Kong representative)	9.4	Immediately effective (Note 1)	
Proposal 6 (performance fees)	6.17	Immediately effective (Note 1)	
Proposal 6 (maximum interval for payment of redemption amounts)	6.14	Immediately effective (Note 1)	
Proposal 6 (sub-managers of multimanager schemes)	Note to 5.5(b)	Immediately effective (Note 1)	
Proposal 6 (distribution of financial reports)	11.6	Immediately effective (Note 1)	

Note 1: As explained in further detail in paragraph 250, Existing Schemes are not required to adopt the revised provisions.



Part V Responses and conclusions with respect to key proposals in the revised Code on Investment-Linked Assurance Schemes

Product KFS for ILAS

Public comments

251. A few respondents sought the Commission's clarification as to whether a separate Product KFS would be required for each of the investment options underlying an ILAS, and sought the Commission's further guidance on the contents of the Product KFS given the variety of features that may be available under an ILAS.

Commission's response

252. ILAS insurers are reminded that, as set out in paragraph 198 of the Consultation Paper, the Product KFS template is meant for illustration purposes and it is incumbent on the ILAS insurer to highlight in the Product KFS all salient features and risks of the relevant ILAS. Products KFS are only required at the ILAS level. The Product KFS template has been modified to include disclosure of the fact that some investment options available under an ILAS may be of high risk, that some investment options may be calculated with reference to pools of assets internally managed by the ILAS insurers on a discretionary basis and that poor performance of the underlying assets and/or funds may magnify investment losses but that all charges would still be deductible. Corresponding changes have also been made to Appendix A to the revised ILAS code.
253. We will maintain a close dialogue with the industry and provide guidance to ILAS insurers in this regard. Where necessary, we may issue FAQs or enhance the Product KFS templates for the industry's reference.

Enhanced disclosure requirements

Public comments

254. Respondents generally welcomed this proposal although some expressed the view that it would be desirable to avoid product-specific regulations (i.e. singling out ILAS with "with-profits" features in this case) and that all "Class C" insurance products with market value adjustment (MVA) features should be regulated and treated alike.

Commission's response

255. We have clarified in Chapter 6 of the revised ILAS Code that the MVA disclosure requirements are applicable to ILAS with "with profits" or similar features where the ILAS insurers may reduce the rate of bonus and/or apply a market value adjustment to the policy value or withdrawal amount.

Deletion of chapters in ILAS Code

Public comments

256. Respondents welcomed this proposal.



Codification of existing practices

Computation of surrender values

Public comments

257. The respondents to this part of the Consultation Paper primarily sought to clarify whether there would be any changes to the Commission's existing policy in respect of the surrender value computational requirement.

Commission's response

258. There is, in fact, no change to the Commission's existing policy in this regard. The proposed codification of the existing practice is intended simply to highlight the surrender value computational requirement in respect of non-guaranteed payments.
259. Illustrated surrender values may still be computed based on assumed rates of return, in line with the guidelines issued by the Life Insurance Council of the Hong Kong Federation of Insurers (LIC). We understand that the assumed rates of return are currently under review by the LIC. The Commission will keep in view how any changes which may be adopted by the LIC should be reflected in the Product KFS template or illustration document and consult the market where appropriate.
260. Going forward, the existing Appendix B (Illustration Document template) to the ILAS Code will be moved to the Commission's website for ease of reference. This template will also be supplemented by further FAQs (to be posted on the Commission's website) from time to time as necessary.

Miscellaneous

Ongoing obligations of ILAS insurers

Public comments

261. Some respondents requested clarification of the meaning of "material adverse change" in 7.3 of the revised ILAS Code.

Commission's response

262. The Commission believes that ILAS insurers must be able to assess whether a change in the financial condition and business of a key counterparty to the scheme is a material adverse change that should be made known to investors, taking into consideration various factors, such as the nature of the change, the prevailing market conditions and the specific circumstances of the scheme. It would not be appropriate for the Commission to prescribe the types of changes that should be viewed as material and adverse. This is a matter for the professional judgment of the ILAS insurers in light of the specific circumstances.

Transitional arrangements

Public comments

263. Overall, respondents supported the proposed implementation timeline for changes to the ILAS Code but some requested further details on the actual implementation arrangements.



Commission's response

264. As from the Effective Date, the revised ILAS Code will apply to new ILAS for which applications for authorization are submitted to the Commission on or after the Effective Date. New ILAS applications submitted to the Commission on or after the Effective Date must include a Product KFS.
265. Existing Schemes (as defined in Section 3 of Part II of the Consultation Paper) which continue to be marketed to the public in Hong Kong as of the Effective Date must be in full compliance with the Product KFS and other relevant disclosure requirements by the end of 12 months from the Effective Date.
266. Product KFS will require authorization from the Commission prior to issue. We will work closely with ILAS insurers to facilitate a smooth transition in the vetting and approval process.



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 submissions¹ 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 commission²) 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 knowledge³. 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 investor⁴ 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

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 commission⁶) 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.