



Part II Products

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

Introduction

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

Objectives of the Handbook

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

The Handbook – framework

5. The new Handbook consists of four sections:



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

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



Key proposals in the Handbook

Principles applicable to all products covered by the Handbook

7. Section I of the Handbook sets out seven overarching principles which apply to all products within the scope of the Handbook. These principles provide guidance on certain matters described below and also provide a framework for interpretation of requirements in the specific product codes. These principles allow scope for the market to develop without forsaking appropriate investor protections.
8. Section I of the Handbook outlines general standards expected of key parties such as product providers, including guidance on matters such as selection of counterparties and other parties playing key roles in respect of investment products and dealing with conflicts of interest, to ensure greater product transparency. To enhance disclosure requirements, it also sets a cross-product disclosure standard and requirements for presentation of information about products. These general standards apply in addition to the more specific requirements for particular types of products under the three product codes.
9. Section I of the Handbook also includes further guidance on marketing materials, or advertisements, for investment products, as contemplated in the FS Report¹⁰. In the case of collective investment schemes, the principles set out in Section I of the Handbook augment existing requirements. In the case of unlisted structured products, the general principles operate in tandem with the product-specific advertising guidelines included in the SP Code and discussed below. These general principles and the guidelines specific to unlisted structured products are derived from the Commission's existing practice, and reflect our regulatory intent in setting standards for authorization of the issue of these documents.
10. As indicated in the FS Report¹¹, we do not support the most drastic solution of banning all but the most anodyne advertisements, which announce a product but give no details as to its nature. We believe that advertisements play a role in promoting interest and encouraging competition among product issuers. However, it is essential that advertisements should not be biased, false or misleading and that they present a balanced overall picture.
11. We take this opportunity to remind senior personnel of issuers of advertisements that it is their responsibility to ensure that the contents of their advertisements comply with applicable requirements and are not misleading. The new Handbook requires issuers of advertisements to ensure that each advertisement is reviewed by a person who is designated by senior management and who is authorized to issue the advertisement on behalf of such issuer.

Question (1)

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

¹⁰ Paragraph 28.7 of the FS Report

¹¹ Paragraph 28.5 of the FS Report



Product key facts statements

12. Further to our recommendation to the Administration in the FS Report¹², we will require offering documents for products covered by the Handbook to include user-friendly summaries setting out key information about the products.
13. These summaries, or Product KFS, will be standardized to the extent possible to enable investors to compare products more easily. The Handbook also sets out specific requirements for presentation of information aimed at making them easy to read.
14. Product KFS should be kept concise if they are to serve their purpose. An absolute page limit may not be appropriate, however, as it may encourage more densely-packed layout and discourage the use of illustrations and examples. The Handbook will therefore set out applicable principles, along with guidance for issuers that Product KFS should generally be no more than four pages in length, although it would be acceptable for them to be longer than this if necessary to accommodate graphics, charts and diagrams which are useful for investors.
15. We attach (as Appendix B to this consultation paper) proposed Product KFS templates for commonly-available retail investment products, namely a general fund, a guaranteed fund or fund with structured pay-outs, an index fund, an exchange-traded fund, an ILAS and an unlisted structured product. Upon the implementation of the finalised Handbook, illustrative templates for Product KFS will be made available on the Commission's website for reference.

A new code on unlisted structured products

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

¹² Paragraph 26.6 of the FS Report



- (d) the requirement that product issuers provide daily indicative valuations of their products throughout their respective terms;
 - (e) the requirement for regular liquidity provision;
 - (f) offering document disclosure requirements, including provisions concerning Product KFS and risk disclosure with respect to any collateral;
 - (g) detailed guidance on advertisements; and
 - (h) ongoing disclosure obligations: in accordance with our recommendation to the Administration¹³, the SP Code imposes obligations on issuers to provide notification in a timely manner of certain material adverse changes, and to facilitate dissemination of this information.
17. A separate public consultation is planned with respect to certain legislative reforms which will have implications for the regulation of structured products offered to the public in Hong Kong. This is discussed in paragraphs 33 to 36 below.
18. Further details of the proposals in the SP Code are set out in Section 1 of this Part II.

New advertising guidelines for unlisted structured products

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

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

20. Some parts of the UT Code have been revised. The changes are largely confined to Chapters 7 and 8 of that code.
21. The main proposals in the revised UT Code are:
- (a) to provide increased investment scope for non-UCITS schemes¹⁴, bringing applicable requirements broadly into line with those applicable to UCITS III schemes with expanded powers, thus creating the opportunity for non-UCITS funds to grow and develop;
 - (b) to codify regulatory principles for structured funds;
 - (c) to provide increased flexibility for retail funds to invest in collective investment schemes and other financial instruments concurrently; and
 - (d) to require annual reports to be published in both English and Chinese.

¹³ Paragraph 27.3 of the FS Report

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



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

Regulatory approach

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



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

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

General matters

The scope of the SP code

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



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

The Products Advisory Committee

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

Implementation and transitional arrangements for the Handbook

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



Further details, draft codes and list of consultation questions

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



Section 1

Key proposals in the Code on Unlisted Structured Products

Introduction

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

Background

Key proposals

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

Enhancing disclosure - our proposal includes:

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

and

Increasing product transparency – our proposal includes the following measures:

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



Regulation of retail structured products in other financial markets

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

The nature of structured products

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

Soft consultation

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

General remarks

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

Definition of “structured products”

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



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

Key proposals

Proposal 1: Disclosure enhancements

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

(A) Product key facts statement

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

(B) Disclosure in offering documents

Background

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

Proposals

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



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



(C) Disclosure in advertisements

Background

70. In the FS Report¹⁵, it was recommended that the Commission “revise its published guidance on marketing materials to establish general principles, supplemented where necessary by specific requirements, that assist the market to develop materials that are correct, properly balanced and are not misleading.”
71. In drafting the proposed advertising guidelines (SP Advertising Guidelines), set out in Appendix D to the SP Code, the Commission has drawn reference from the “Guidelines on use of offer awareness and summary disclosure materials in offerings of shares and debentures under the Companies Ordinance” issued by the Commission in March 2003, the “Advertising Guidelines applicable to Collective Investment Schemes authorized under the Product Codes” issued in July 2008 and Appendix 1 Part D of the Listing Rules.

Proposals

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

(D) Ongoing disclosure of material information

Background

75. As mentioned in the FS Report¹⁶, there is at present no statutory requirement for ongoing disclosure of information to investors in unlisted structured products after the initial investment. There is no statutory requirement for Issuers to ensure that investors are provided with information as to important events which may affect the value of their investments in these products.
76. The Commission believes that Issuers should be obliged to disclose a range of information to investors on a continuous basis to keep them informed of relevant information which may affect their investments. However, the Commission is mindful of the need to strike a balance as to the amount and nature of information to be provided

¹⁵ Para 28.7 of the FS Report.

¹⁶ Para 27.1 of the FS Report.



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

Proposals

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

Question (2)

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

Question (3)

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

Proposal 2: Increasing product transparency

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

(A) Eligibility requirements for Issuers and Guarantors

Background

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



- (b) subsidiaries of substantive corporations (usually banks or securities firms but less frequently “blue chip” corporations) typically issuing structured notes and equity-linked investments with guarantee support from substantive corporate parents; and
 - (c) special purpose vehicles (SPVs) issuing collateralised structured notes.
80. The SP Code requires that Issuers/Guarantors of structured products meet certain eligibility standards as to net asset value and either credit rating or regulatory status. The proposed eligibility requirements are comparable to those applicable to issuers/guarantors of listed structured products under Chapter 15A of the Listing Rules.

Proposals

81. The SP Code imposes eligibility requirements with respect to Issuers, and (in the case of guaranteed structured products) Guarantors, both at the time of issue of the structured product and for the period during which any of the Issuer’s obligations to investors under the terms and conditions of the structured product remain outstanding.
82. In the case of a direct Issuer or an entity with guarantee support from a substantive entity, Appendix A to the SP Code sets out core requirements which must be met by either the Issuer or (in the case of a guaranteed structured product) the Guarantor. The relevant entity must:
- (a) have a net asset value of not less than HK\$2 billion; AND
 - (b) either:
 - (i) be a licensed bank regulated by the HKMA or a corporation licensed by the Commission (or an overseas banking entity subject to equivalent regulatory oversight); OR
 - (ii) have a credit rating which is one of the top three investment grades awarded by at least one rating agency of international standing and reputation acceptable to the Commission;
- AND
- (c) not be subject to insolvency or other similar proceedings as more fully described in Appendix A to the SP Code.
83. In addition to satisfying the core requirements, the Issuer, or (in the case of a guaranteed structured product) the Guarantor, must also be in good standing.

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



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

Use of special purpose vehicles

Background

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

Proposals

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



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

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

(B) Appointment, obligations and responsibilities of Product Arranger

Background

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

Proposals

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



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

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

(C) Collateral

(i) Eligibility criteria

Background

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

Proposals

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



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

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

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

(ii) Basic structural requirements

Background

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

Proposals

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



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

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

Proposals

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



(D) Reference assets - eligibility criteria

Background

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

Proposals

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



(E) Indicative valuations

Background

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

Proposals

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

(F) Liquidity provision

Background

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

Proposals

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

Question (4)

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

Question (5)

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



Issuers?

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

Please explain your views.

Question (6)

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

Question (7)

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

Question (8)

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



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

Further issues for discussion

References to annualised returns in advertisements

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

Question (9)

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

General comment

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



Transition period

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

Question (10)

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



Section 2

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

Introduction

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

Background

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

Key proposals

Proposal 1: Structured funds

Background

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



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

Proposals

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



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

Proposal 2: Funds that invest in FDI

Background

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

Proposals

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



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

Implications of the proposals

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



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

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

Proposal 3: Investment in other schemes

Background

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



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

Proposals

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

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

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

Proposal 4: Bilingual annual reports

Background

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



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

Proposals

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



Proposal 5: Product key facts statement

Background

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

Proposals

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



168. To allow easy comparison of different types of products (one of the key objectives behind the Product KFS proposal), the general subject matter, layout and format adopted in the templates should be substantially similar in Product KFS. Specific disclosures under each of the broad subject matter headings must, of course, be tailored by product issuers properly to reflect the features of the scheme in question.
169. Product KFS are different from the fund fact sheets which are commonly used by fund houses as marketing tools. The Product KFS will form part of the offering document for a scheme.
170. The Product KFS in respect of a scheme will be required to be updated as necessary to reflect changes in the offering document. If a scheme chooses to include performance information in the Product KFS, the Product KFS should be updated at least every six months in order to comply with the applicable requirements in the [Advertising Guidelines¹⁷](#).
171. It should be noted that the Product KFS provides for the clear and prominent disclosure of the key risks of investing in a scheme, thus standardising the enhanced risk disclosure practice which many fund houses have adopted in recent months. Under the circumstances, fund houses may dispense with the use of the upfront disclosure box in their offering documents upon the adoption of the Product KFS.

Proposal 6: Miscellaneous

Connected party transactions

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

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



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

Criteria for appointment of Hong Kong representative

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

Performance fees

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

Maximum interval for payment of redemption amounts

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



Sub-managers of multimanager schemes

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

Distribution of financial reports

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

Proposed implementation timetable

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



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

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

Proposal 4 (bilingual annual reports)

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

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

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

Proposal 6 and others

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



Question (11):

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

Question (12):

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

Question (13):

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

Question (14):

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

Question (15):

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



Implementation schedule of the revised UT Code

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



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



Section 3

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

Introduction

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

Proposal 1: Product key facts statement

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

Proposals

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



Proposal 2: Enhanced disclosure requirements

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

Proposals

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

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

Enhanced disclosure regarding internal funds in the ILAS offering document

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

Proposal 3: Deletion of chapters in the ILAS Code

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



Proposals

Deletion of Chapter 5 regarding the appointment of Hong Kong representative

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

Deletion of Chapter 8 regarding Broker Managed Funds (BMFs)

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

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

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

Proposal 4: Codification of certain existing practices

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

Proposals

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



Question (16)

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

Proposed implementation timetable

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



Question (17)

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



Section 4

List of consultation questions in Part II

Consultation questions in relation to Overarching Principles Section

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

Consultation questions in relation to the SP Code

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

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

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

Question (5)

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

Please explain your views.

Question (6)

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



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

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

Consultation questions in relation to the revised UT Code

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



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

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

Consultation questions in relation to the revised ILAS Code

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

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