Appendix 1

Regulatory structure for financial supervision

1. **Introduction**

1.1 In October 2008, the Group of Thirty ("G30")[1] published a report entitled "The Structure of Financial Supervision: Approaches and Challenges in a Global Marketplace". The report reviewed seventeen major national supervisory systems and discusses the issues faced when using four main approaches to financial supervision. The report places recent national structural changes within the context of the evolving global financial systems and the related blurring of lines between financial sectors and businesses. It compares the commonalities and challenges faced by policymakers selecting one approach or the other. The study was based on a series of interviews with finance ministries, officials, central banks and principal supervisors in the jurisdictions reviewed. The following sections summarise the 4 main approaches to supervision discussed in the G30 report.

The Institutional Approach in which a firm's legal status (for example, a bank, broker dealer, or insurance company) determines which regulator is tasked with overseeing its activities from both a safety and soundness and a business conduct perspective.

The Functional Approach in which supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business may have its own functional regulator.

The Integrated Approach in which a single universal regulator conducts both safety and soundness oversight and conduct-of-business regulation for all sectors of financial services business.

The Twin Peaks Approach in which there is a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision function and the other that focuses on conduct-of-business regulation.

1.2 **The Institutional Approach**

1.2.1 Hong Kong's current approach is the Institutional Approach. This is one of the classical approaches in financial regulation. It is also the approach which is under most stress due to changes in financial services business models.

1.2.2 The Institutional Approach is a legal entity driven approach. The firm's legal status (for example, a bank, broker dealer, or insurance company) determines which regulator is tasked with overseeing its activities from both a safety and soundness and a business conduct perspective.

[1] The Group of Thirty or G30 is a consultative group on international economic and monetary affairs. More information about the group can be found at its website www.group30.org.

1.2.3 The legal status also determines the scope of the entity's permissible business activities. However, the G30 report says that there is generally a tendency for the regulators to reinterpret and expand the scope of permissible activities under their jurisdiction when the firms request. Hence, with the progression of time, entities with different legal status have been permitted to engage in similar activities and subject to different requirements by different regulators.

1.2.4 This approach is under stress since financial firms are now involved in a cross section of products and services rather than monoline activities. This approach therefore suffers from a potential inconsistency in the application of requirements by different regulators (such as different applications of customer protection rules) as well as other challenges associated with interagency coordination. However, the report states that, to some degree, strong leadership and qualified administrators can offset the suboptimal features of the approach but updating and modernisation should be considered to cater for developments in the market.

1.3 The Functional Approach

1.3.1 Under this approach supervisory oversight is determined by the business that is being transacted by the entity, without regard to its legal status. Each type of business may have its own functional regulator which would be responsible for both safety and soundness of the entity and business conduct regulation. This approach is used in France, Italy and Spain.

1.3.2 The benefit of this approach is that the regulator will apply consistent rules to the same activity regardless of the entity in which the activity is conducted. However, in practice, it may be extremely difficult to distinguish which type of activity comes within the jurisdiction of a particular regulator. This may give rise to disparity of regulatory positions on similar activities.

1.3.3 As with other interagency approaches, this approach may give rise to jurisdictional disputes between regulators as well. In addition, a consequence of this model is that one entity may have to deal with a number of regulators hence duplicating work and resources for the industry as well as the regulators.

1.4 The Integrated Approach

1.4.1 This is an approach which has gained in popularity in the past decade. It is one in which a single universal regulator conducts both safety and soundness oversight and conduct-of-business regulation for all sectors of financial services business. This is the approach adopted in the UK and Germany.

1.4.2 The Integrated Approach has the benefit of streamlined focus on regulation without confusion or conflict over jurisdictional lines. It also has the benefit of the regulator having a holistic view of the entity's business activities. Hence oversight is broad as well as deep.

1.4.3 However, some observers have suggested concerns related to having a single point of regulatory failure, i.e., if the regulator fails to spot an issue, there is no other regulator to fill the void. For a large market, there are also concerns that a single regulator may be cumbersome to manage. In addition, the report cited concrete examples of challenges of coordination even though an Integrated Approach is adopted.

1.5 The Twin Peaks Approach

1.5.1 There is an increasing interest in the Twin Peak Approach which is a regulation-by-objective approach. Under the Twin Peaks Approach there is a separation of regulatory functions between two regulators: one that performs the safety and soundness supervision function and the other that focuses on conduct-of-business regulation. Australia and the Netherlands have adopted the Twin Peaks Approach and other jurisdictions including France and the US have engaged in debates over adopting this approach.

1.5.2 Although like the other approaches the Twin Peaks Approach has its own benefits and drawbacks, the report suggests that this approach may be the optimal means of ensuring that issues of transparency, market integrity and consumer protection receive sufficient priority. This approach will also enable the same consumer protection rules to be applied uniformly across all financial products regardless of the entity selling the product.

1.6 The analysis conducted by G30 suggests that with market developments and financial innovation, the traditional lines demarcating services and products are blurred. Thus, there may be a need to review regulatory structures to ensure that regulatory approaches are in line with the evolution of markets. The report concludes that issues of structure and design of financial supervisory systems are important and policymakers should consider reforms to update structures so that they better reflect market realities. The report also states that although structures are important, alone they will not lead to optimal outcomes. Hence, whichever approach is adopted, it is critical for any system to have effective coordination between supervisory agencies, central banks and finance ministries.

Appendix 2

Authorisation of product documentation by the SFC

1. **Overview**

1.1 In general, unless an exemption applies documents containing an invitation to the Hong Kong public to invest in securities, RIAs or CISs must be authorised by the SFC. The authorisation requirements do not apply where the documents are not issued to the Hong Kong public.

1.2 In authorising these documents, the SFC's focus is on disclosure of information rather than on the commercial merits of the investment or suitability of the product for investors. Furthermore, SFC authorisation of product documentation does not imply any recommendation that the product is suitable for all investors. The duty to ensure suitability of a product for an investor is the responsibility of the Intermediary.

2. **What is required to be authorised by the SFC**

2.1 Regulation of documentation in relation to investment products has been influenced by historical factors with the result that the documentation in relation to some products are authorised under the prospectus regime in the CO whilst the documentation in relation to other products are authorised under the SFO. The legislative provisions which apply depend on the legal form of the product in question.

2.1.1 Where an issuer is offering shares or debentures (including structured notes) to the Hong Kong public, the prospectus regime in the CO applies.

2.1.2 Where a person is inviting the Hong Kong public either:

(a) to enter into an agreement to acquire, dispose of, subscribe for or underwrite securities;

(b) to enter into a RIA; or

(c) to acquire an interest in or participate in a CIS,

the regime in Part IV of the SFO applies.

2.2 Shares and debentures (including structured notes) : the CO prospectus regime

2.2.1 Shares and debentures[2] fall within the definition of "securities" in the SFO.

[2] The term 'debenture' is defined in section 2 of the CO to include "debenture stocks, bonds and any other securities of a company whether constituting a charge on the assets of the company or not".

2.2.2 Where the security is a share or debenture, the document containing the invitation is a prospectus that must be authorised for registration in accordance with requirements in the CO. An exemption under section 103 of the SFO is given to prospectuses which are registered under the CO[3]. Hence, once a document containing an invitation to the Hong Kong public to acquire debentures (or shares) is registered under the CO, the prohibition in section 103 of the SFO will not apply.

2.2.3 Structured notes such as ELNs, CLNs, index linked notes and fund linked notes are debt securities with embedded derivatives. Offering documents of CLNs such as Minibonds, which are structured as debentures, are authorised by the SFC under the CO.

2.3 Securities and RIAs

2.3.1 Advertisements, invitations or documents issued to the Hong Kong public in respect of securities (other than shares and debentures which are authorised under the CO) or RIAs must be authorised under section 105 of the SFO unless an exemption applies.

2.3.2 The terms "securities" is widely defined in the SFO and includes:

(a) shares, stocks, debentures, funds, bonds or notes;

(b) rights, options, interests in shares, stocks, debentures;

(c) certificates of interests in shares, stocks or debentures;

(d) interests in CISs; and

(e) interests, rights or property that are commonly known as securities.

2.3.3 The definition of RIA is complex and catches a wide variety of other investment products. RIA is defined as "an agreement the purpose or effect, or pretended purpose or effect, of which is to provide, whether conditionally or unconditionally, to any party to the agreement a profit, income or other returns calculated by reference to changes in the value of any property, but does not include an interest in a collective investment scheme"[4].

2.3.4 Offering documents of equity linked deposits, investment linked deposits and ELIs treated as securities and/or RIAs[5] are authorised under section 105 of the SFO. For equity linked deposits and investment linked deposits, in addition to authorisation under section 105 of the SFO, clearance from the HKMA is required.

[3] Section 103(3)(a) of the SFO.

[4] Part 1 of Schedule 1 to the SFO.

[5] ELIs may be classified as securities or RIAs or in some cases a hybrid of both depending on the exact form/structure of the ELI in question.

2.4 CIS

2.4.1 CISs are broadly defined in the SFO[6] to mean investment products of a collective nature and embrace familiar market concepts such as units trusts and mutual funds.

2.4.2 CISs fall under the authorisation regime in section 104 of the SFO.

2.4.3 CIS products are generally authorised by the SFC on the basis of their structural features and compliance with product codes issued by the SFC.

2.4.4 Unless an exemption applies, all CISs offered to the Hong Kong public must be authorised by the SFC. In light of the broad definition of CIS under the SFO, some products that are primarily regulated by other regulators under separate legislation are also caught and are therefore subject to SFC authorisation. For example:

(a) Investment-linked assurance schemes - these are life insurance contracts offered by insurance companies which are regulated by the Insurance Authority under the Insurance Companies Ordinance;

(b) Mandatory Provident Fund schemes – these are established and regulated under the Mandatory Provident Fund Schemes Ordinance where the primary regulator is the MPFA; and

(c) Pooled Retirement Funds - since these are primarily schemes registered under the Occupational Retirement Schemes Ordinance ("ORSO"), they have to be registered with the MPFA and areprimarily regulated by the MPFA under the ORSO.

As such, unless otherwise stated, a reference to CIS below should be construed as a reference to unit trusts and mutual funds authorised by the SFC under the Code on Unit Trusts and Mutual Funds, which represent the vast majority of the CISs authorised by the SFC.

2.5 Exemptions

2.5.1 Authorisation by the SFC may not be required when an exemption applies.

2.5.2 The major exemptions under the SFO include:

(a) an offer to professional investors– Professional investor is defined in Part 1 of Schedule 1 to the SFO to include institutional investors such as Intermediaries, authorised financial institutions, insurance companies and recognised exchange companies. The SFC also has the power to make rules under the SFO to include classes of persons as falling within the definition of professional investors. At present, four additional classes of persons have been added on the basis of the value of assets they manage or they have. These are referred to as high net worth investors. The most commonly known one is any individual (either alone or with his associates on a joint account)

[6] Part 1 of Schedule 1 to the SFO

having a portfolio of at least HK$8 million or its equivalent in any foreign currency;

(b) an offer made by Intermediaries licensed or registered for Type 1, Type 4 or Type 6 regulated activities in respect of securities[7];

(c) the issue of a prospectus registered under the CO[8]; and

(d) documents issued in relation to an offer of shares or debentures that falls within any of the exemptions under the Seventeenth Schedule of the CO[9] (see below).

2.5.3 Exemptions from the CO prospectus requirements are set out in the Seventeenth Schedule of the CO. There are a total of 12 exemptions currently set out in the Seventeenth Schedule. Examples of these exemptions include an offer:

(a) to not more than 50 persons[10];

(b) with a minimum subscription of HK $ 500,000[11]; and

(c) with a maximum size of HK $ 5 million[12]; and

(d) to professional investors[13].

3. **What the SFC Considers : Initial Authorisation**

3.1 The SFC seeks to protect the interests of the investing public by ensuring (based on the information provided by the issuer) that there is full and proper disclosure of all the relevant features and risks of the product in question in the offering document, and that the marketing materials comply with the overarching principle set out in 5.2 below, and may refuse to grant authorisations if the interests of the investing public is not protected in this manner.

3.2 Prospectuses of shares and debentures (including structured notes) authorised under the CO -

3.2.1 The SFC vets the prospectus against the content requirements in the Third Schedule of the CO. The Third Schedule sets out matters and reports that must be disclosed in a prospectus, these include:

(a) the general nature of the business of the company;

(b) the authorized share capital, a description and nominal value of the shares into which it is divided, the amount of share capital

[7] Section 103(2)(a) of the SFO.
[8] Section 103(3)(a) of the SFO.
[9] Section 103(2)(ga) of the SFO.
[10] Paragraph 2 of Part 1 to the Seventeenth Schedule.
[11] Paragraph 4 of Part 1 to the Seventeenth Schedule
[12] Paragraph 3 of Part 1 to the Seventeenth Schedule
[13] As defined in the SFO.

issued/agreed to be issued, and the amount paid up on the shares which have been issued;

(c) the names, descriptions and addresses of the directors or proposed directors;

(d) the dates of, parties to and general nature of every material contract carried on or intended to be carried on by the company;

(e) the names and addresses of the auditors; and

(f) in the case of a prospectus which invites the public to subscribe for debentures the rights conferred upon the holders including rights in respect of interest and redemption, and particulars of the security therefor .

3.2.2 Apart from the specific requirements in the Third Schedule, the CO also sets an overall disclosure standard requiring issuers to put in their prospectuses "sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of the issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them."[14]

3.2.3 Before the SFC authorises a prospectus for registration it has to be satisfied that, based on the information provided by the issuer, all the requirements in the Third Schedule and in Part II (for companies incorporated in Hong Kong) or Part XII (for companies incorporated outside Hong Kong) of the CO have been met or are otherwise exempted.

3.2.4 Under section 38A(1) or section 342A(1) of the CO, on the request of the applicant (i.e., the issuer), the SFC may waive compliance with certain provisions of the CO[15]. These provisions cover the content requirements under the Third Schedule and certain other provisions relating to allotment. However, in considering a request for waiver, the SFC considers whether compliance with the relevant provisions would be irrelevant and/or unduly burdensome and/or unnecessary and/or inappropriate. The SFC will also consider whether the waiver may be prejudicial to the interests of the investing public.

3.2.5 The SFC has granted class exemptions for unlisted public debenture offerings from compliance with certain content requirements of the Third Schedule to the CO in accordance with the Companies Ordinance (Exemption of Companies and Prospectuses from Compliance with Provisions) Notice. For example, details of (i) founder shares and directors' qualification shares; (ii) the names and addresses of, and the amount payable to, the vendors of any property proposed to be acquired and paid for out of the proceeds of issue; (iii) any amount or benefit paid or given to

[14] Paragraph 3 of Part 1 to the Third Schedule

[15] The provisions which may be waived by the SFC are set out in section 38A(4) (or section 342A(4)) of the CO.

any promoter are not required to be included in a prospectus offering unlisted debentures to the public on the basis that they are irrelevant to investors in debentures and/or unduly burdensome for issuers of prospectuses.[16]

3.2.6 There is no express requirement in the CO as to the particular risk/warning statements required except to direct potential investors to read the relevant offering documents and to obtain independent professional advice if they are in doubt about any of their contents[17]. However, a prospectus commonly contains a section on risks where the following are addressed:

(a) non-principal protection (if applicable);

(b) risks relating to the product feature;

(c) risks relating to the issuer; and

(d) risks relating to the market.

3.2.7 Failure to comply with any of the content, registration and other requirements of the CO may result in a fine. Section 40 of the CO imposes civil liabilities on directors and any other persons who authorised the issue of the prospectus, to pay compensation to all persons who subscribe for or purchase[18] shares or debentures (including structured notes) on the faith of the prospectus, by reason of any untrue statement therein (including a material omission). Section 40A of the CO further imposes criminal liabilities on persons who authorised the issue of a prospectus which includes any untrue statement (including a material omission).

3.3 Offering documents of securities and RIAs authorised under section 105 of the SFO

3.3.1 There are currently no statutory requirements dealing with the contents or the level of disclosure in offering documents authorised for issue under section 105(1) of the SFO. There are also no published guidelines in this regard.

3.3.2 In vetting and authorising documents under section 105 of the SFO, the SFC largely refers to requirements that apply to products that have broadly similar risk and reward exposure.

3.3.3 For example, as ELIs and structured notes have broadly similar risk and reward exposure, the SFC draws reference from ELN prospectuses (authorised under the CO) for disclosures in ELI offering documents.

3.3.4 In addition, it is an offence for a person to induce another, by any fraudulent or reckless misrepresentation, to invest in securities, CISs or RIAs under section 107 of the SFO. There is also a clear private right of action by investors under section 108 of the SFO to recover compensation for any pecuniary loss sustained in consequence of the reliance by that person on

[16] See SFC press release dated 28 March 2003.

[17] Parts 1, 2 and 4 of the Eighteenth Schedule to the CO.

[18] Twenty-second Schedule to the CO.

any fraudulent, reckless or negligent misrepresentation made to induce that person to invest in securities, CISs or RIAs. The potential to be prosecuted for misrepresentation and to be sued for compensation encourage issuers to ensure proper disclosures are made.

3.4 CIS authorised under section 104 of the SFO

3.4.1 CIS products are generally authorised by the SFC on the basis of compliance with the relevant product codes issued by the SFC. Similar to other codes and guidelines issued by the SFC, product codes do not have the force of law.

3.4.2 The criteria for authorisation mainly focus on compliance with the structural features (such as eligibility of scheme operators and investment restrictions) and disclosure obligations set out in the product codes.

3.4.3 Hence, in considering whether to grant its authorisation under section 104 of the SFO, the SFC would only consider whether the product seeking authorisation can demonstrate compliance with the relevant product code but not other factors such as the commercial merits of the relevant product, which depends on specific financial circumstances and risk appetite of each investor, and in relation to which the SFC seeks to ensure the investing public is properly protected by adequate disclosure under section 105 of the SFO (see 3.3.4, 5.1 and 3.5 below). It follows that authorisation does not mean an official recommendation of the product.

3.4.4 The disclosure requirements applicable to the offering documents of CISs are set out in the product codes and these offering documents are basically vetted on a disclosure basis. In essence, a CIS must issue an up-to-date offering document, which should contain the information necessary for investors to be able to make an informed judgment of the investment proposed to them. The offering documents should also contain appropriate risk warnings.

3.4.5 Similar to documents authorised under section 105 of the SFO, the potential to be prosecuted for misrepresentation (under section 107 of the SFO) and to be sued for compensation (under section 108 of the SFO) (see 3.2.4 above) encourage issuers to ensure proper disclosures are made in CIS offering documents.

4. Ongoing requirements

4.1 Prospectuses of shares and debentures (including structured notes) authorised under the CO

4.1.1 Although there is no continuing disclosure requirement under existing law, as a matter of practice, an issuer would, in response to inquiries raised by the SFC during the document vetting process, represent in the offering documents that it will make disclosure of information to avoid the establishment of a false market or disclosure of changes which may significantly affect the ability of the issuer to make payment on the structured notes.

4.2 Offering documents of securities and RIAs authorised under section 105 of the SFO

4.2.1 Although there is no continuing disclosure requirement under existing law, as a matter of practice, an issuer would, in response to inquiries raised by the SFC during the document vetting process, represent in the offering documents of ELIs that it will make disclosure of information to avoid the establishment of a false market or disclosure of changes which may significantly affect the ability of the issuer to make payment on the products.

4.3 CISs authorised under section 104 of the SFO

4.3.1 Generally, most CISs are required to comply with various degrees of on-going disclosure requirements. For example, unit trusts and mutual funds, being the more commonly available types of CISs, are required to make on-going disclosures relating to material changes such as to the constitutive documents, investment objectives, fee structures and dealing and pricing arrangements etc. They are also required to publish at least two reports in respect of each financial year, of which the annual report must be audited for the scheme.

5. **Marketing materials**

5.1 Given the general prohibition under section 103(1) of the SFO, all marketing materials (like advertisements) in relation to securities, RIAs and CISs products have to be authorised by the SFC under section 105(1) of the SFO before they can be issued to the public in Hong Kong unless they fall within one of the exemptions under section 103 of the SFO. The major exemptions are discussed in 2.5 above.

5.2 The following paragraphs provide more detail on authorisation requirements of marketing materials of different investment products. It should be noted that whilst the specific requirements may be different for each type of product, the criteria applied in authorisation all share the same overarching principle that the marketing materials should not be false, biased, misleading or deceptive and should carry proper risk warning statements.

5.3 Marketing materials for CISs

5.3.1 Pre-vetting of advertisements by SFC

(a) The pre-vetting requirements were revised in August 2008 following public consultation conducted in January/February 2008. Now, all advertisements in respect of CISs must be submitted to the SFC for authorisation prior to their issue or publication in Hong Kong, unless exempted under section 103 of the SFO.

(b) Since most issuers of the advertisements of unit trusts and mutual funds are Intermediaries licensed or registered for Type 1, Type 4 or Type 6 regulated activities who can rely on the exemption under section 103(2)(a) of the SFO, these advertisements are no longer subject to the SFC's pre-vetting or prior authorisation in practice. However, the SFC conducts active surveillance of these advertisements.

5.3.2 SFC Guidance on contents of marketing materials of CISs

(a) All advertisements and other invitations to invest in CISs must comply with the Advertising Guidelines Applicable to Collective Investment Schemes Authorised under the Product Codes ("Advertising Guidelines") issued by the SFC. Even if an advertisement is exempted from obtaining authorisation from the SFC under the SFO, the issuer must still ensure that the advertisement or invitation complies with the Advertising Guidelines.

(b) The guiding principle under the Advertising Guidelines is that advertisements for a CIS should:

(i) not be false, biased, misleading or deceptive;

(ii) be clear, fair and present a balanced picture of the scheme with adequate risk disclosures; and

(iii) contain information that is timely and consistent with its offering document.

5.4 Marketing materials of securities and RIAs (e.g., ELIs, equity linked deposits etc.)

5.4.1 Given the general prohibition under section 103(1) of the SFO, marketing materials in relation to securities and RIAs must also be authorised under section 105 of the SFO before they can be issued to the public in Hong Kong unless an exemption applies (see 2.5 for the exemptions).

5.4.2 There are currently no statutory requirements dealing with the contents or the level of disclosure required in the marketing materials of securities or RIAs.

5.4.3 The SFC largely refers to requirements that are applied to other products that have broadly similar risk and reward exposure in vetting and authorising the marketing materials to prevent regulatory arbitrage. For example, as ELIs have similar risk and reward exposure as ELNs, we apply similar standards as in the case under the CO by making reference to the Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures Under the CO (see 5.5.3 and 5.5.4 below).

5.4.4 In essence, marketing materials should not be false, biased, misleading or deceptive and should carry proper risk warning statements.

5.5 Marketing materials of debentures including structured notes

5.5.1 In relation to debentures like structured notes, an advertisement can be submitted for authorisation under both section 38B(2A)(b) of the CO and section 105(1) of the SFO or under section 105 of the SFO only.

5.5.2 There may be cases where an advertisement will be an extract from the related prospectus. As advertisements submitted for authorisation under section 38B(2A)(b) of the CO must be extracts of the related prospectus, an

application under section 105 of the SFO is also required in respect of legends and other peripheral matters like artwork . There may also be cases where an advertisement is not an extract from a prospectus. In such cases, the advertisement will be authorised under section 105 of the SFO only.

5.5.3 In vetting marketing materials, the SFC refers to the Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO. These Guidelines require, among other things, that the marketing materials must not contain anything that is inconsistent with the information contained in the prospectus, and that the contents must not be false, biased, misleading or deceptive.

5.5.4 Standard warnings that must be included in each of the marketing materials include:

(a) investment involves risks (and where applicable, non-principal protection);

(b) prospective investors should read the relevant offering documents for detailed information about the issuer/guarantor and the offer before investing;

(c) the material does not constitute an offer or an invitation to induce an offer;

(d) the offer is made solely on the basis of the information contained in the offering documents and applications will only be taken on the basis of the offering documents; and

(e) SFC's authorisation of the marketing material does not imply the SFC's endorsement or recommendation of the products and the SFC accepts no responsibility for the contents of the marketing material.

5.5.5 The objective in vetting the advertisements is to ensure the marketing materials are not inconsistent with the offering documents and comply with the overarching principle that they should not be false, biased, misleading or deceptive.

5.5.6 In any event, the SFC requires issuers to confirm for each marketing material that it is clear, unambiguous, accurate and not misleading.

6. **Issuer/manager eligibility**

6.1 Licensing

6.1.1 CIS - There are certain minimum eligibility requirements applicable to issuers/managers of CISs. For example, the fund manager of a unit trust or mutual fund has to be a management company which is either licensed by the SFC or, where applicable, licensed in an overseas jurisdiction that is considered acceptable for the purpose of managing SFC-authorised funds and has a satisfactory co-operation arrangement with the SFC.

6.1.2 Others

(a) The issuer of an equity-linked deposit or an investment-linked deposit must be an authorised institution prudentially regulated by the HKMA. Equity-linked deposit or investment-linked deposit contracts require the clearance of the HKMA before issuance.

(b) Issuers of shares and debentures that have a prospectus authorised under the CO, and issuers of securities and RIAs (e.g., ELIs and equity linked deposits) that have had their product documentation authorised under section 105 of the SFO are not subject to SFC licensing requirements.

6.2 Financial and other requirements

6.2.1 CIS – Among the minimum eligibility requirements applicable to issuers/managers of CISs is the requirement that the management company of a unit trust or mutual fund must have a minimum issued and paid-up capital and capital reserves of HK $ 1 million or its equivalent in foreign currency.

6.2.2 Others - Although there are no explicit approval or eligibility requirements on other issuers (e.g., issuers of ELIs, ELNs etc.), the SFC may mirror the eligibility requirements for issuers of listed structured products under Chapter 15A of the Main Board Listing Rules of the Stock Exchange for issuers of unlisted structured products. These include a financial requirement of a minimum net asset value for issuer/guarantor of HK $ 2 billion and for the issuer/guarantor/collateral to either be regulated or to have a credit rating of the top three investment grades.

Appendix 3

Licensing and registration requirements

1. **Overview**

1.1 Corporations carrying on regulated activities[19] must be licensed or registered under the SFO.

1.1.1 There are 2 types of legal entities which may be licensed by or registered with the SFC to carry on business in a regulated activity, namely –

(a) A corporation licensed by the SFC for the regulated activity (i.e., a Licensed Corporation); and

(b) A bank (or authorised financial institution) registered with the SFC for the regulated activity (i.e., a Registered Institution).

1.1.2 Each Licensed Corporation or Registered Institution must have at least two individuals who are responsible for each regulated activity for which it is licensed or registered. These individuals are known as "Responsible Officers" for Licensed Corporations and "Executive Officers" for Registered Institutions. Responsible Officers are approved by the SFC while Executive Officers must obtain consent from the HKMA under the BO.

1.1.3 Individuals who carry on a regulated activity for a Licensed Corporation must be licensed by the SFC. They are known as "Licensed Representatives". Staff employed by a Registered Institution to conduct regulated activities, are not required to be approved by the SFC or the HKMA. They are known as "Relevant Individuals". Their names are entered in the HKMA's Register of Relevant Individuals. The onus is on the management of a Registered Institution to ensure that its staff are fit and proper. Please see 3.3.1 below for further details.

1.2 Fitness and Properness

1.2.1 Applications by corporations and individuals for a licence or registration, or for approval or consent to act as a Responsible Officer or an Executive Officer, must be refused unless the applicant satisfies the SFC or the HKMA that it/he is "fit and proper".

[19] There are 9 types of regulated activities listed in Schedule 5 to the SFO:
Type 1: dealing in securities
Type 2: dealing in futures contracts
Type 3: leveraged foreign exchange trading
Type 4: advising on securities
Type 5: advising on futures contracts
Type 6: advising on corporate finance
Type 7: providing automated trading services
Type 8: securities margin financing
Type 9: asset management

1.2.2 Under section 129 of the SFO, in determining whether a person is fit and proper, the SFC and the HKMA must have regard to a number of specified factors, and may have regard to any other matter that it considers relevant. The specified factors are:

(a) the financial status or solvency;

(b) the educational, or other qualifications or experience;

(c) the ability to carry on the regulated activity competently, honestly and fairly; and

(d) the reputation, character, reliability and financial integrity,

of the person whose fitness and properness is being considered.

1.2.3 The above factors are elaborated in the Fit and Proper Guidelines and the Guidelines on Competence published by the SFC and applied by the SFC and the HKMA.

2. Licensed Corporations

2.1 Applications from corporations to be licensed to carry on regulated activities are made to, and are assessed and approved by, the SFC. In order to obtain a licence, a corporate applicant must satisfy the Commission that it meets a number of requirements, including, its fitness and properness and the sufficiency of its financial resources. In assessing a corporate application, the SFC considers, among other things, the applicant's business plan, internal controls and the fitness and properness of its management, including its directors and proposed Responsible Officers, and of its substantial shareholders.

2.2 One of the key requirements that a Licensed Corporation must meet is with respect to its Responsible Officers, who are responsible for directly supervising the conduct of the regulated activities of the Licensed Corporation. There must be at least two Responsible Officers for each regulated activity for which the corporation is licensed, and one of them must be an "executive director"[20]. Further, every executive director of a Licensed Corporation must be a Responsible Officer.

2.3 Individuals who carry on regulated activities on behalf of a Licensed Corporation must obtain a representative licence under section 120 of the SFO. Licensed Representatives must also apply to the SFC for approval if they want to act for another Licensed Corporation. They may not act for their new employer/principal until the SFC's approval is granted.

2.4 In considering applications for approval as a Responsible Officer and for a representative licence, the SFC actively processes the application of each applicant by vetting his/her competence, qualifications and fitness and properness by reference to the Fit and Proper Guidelines and Guidelines on Competence, and then makes a

[20] "executive director", in relation to a licensed corporation, means a director of the corporation who actively participates in or is responsible of directly supervising, the business of a regulated activity for which the corporation is licensed (section 113 of the SFO).

decision as to whether or not to issue a licence. Vetting of individual applicants is conducted in conjunction with Hong Kong and overseas regulators, as well as law enforcement agencies in Hong Kong where relevant.

2.5 In considering an application from an individual for a representative licence or approval as a Responsible Officer, much attention is given to whether the individual meets the requirements set out in the Guidelines on Competence in terms of academic qualifications and regulatory knowledge in the case of a representative licence applicant, and industry and management experience in the case of Responsible Officer candidates. Another major consideration is with respect to the information available to the SFC from the SFC's database and/or vetting replies that are relevant to the individual's fitness and properness.

3. Banks/Registered Institutions

3.1 Registration of banks to conduct regulated activities

3.1.1 The process of registration requires collaboration between the SFC and the HKMA (as described in section 119 of the SFO) prior to any such application for registration being granted by the SFC. On receiving an application from a bank to be registered to carry on regulated activities, the SFC refers the application to the HKMA by passing all information provided in the application to the HKMA. The HKMA, after considering the application, consults the SFC on the merits of the application and advises the SFC as to whether it is satisfied that the applicant is fit and proper. In making a decision on the application, the SFC must have regard to HKMA's advice, and may rely wholly or partly on its advice.

3.1.2 After registration, the Registered Institution is supervised by the HKMA and regulated jointly by the HKMA (front end and supervision) and the SFC (back end investigation and enforcement).

3.2 Executive Officers

3.2.1 As explained above, a Registered Institution must have at least two Executive Officers who are responsible for each regulated activity for which it is registered. An intended Executive Officer must seek the consent of the HKMA to have this status conferred upon him. The decision whether to give a person Executive Officer status is made by the HKMA. The HKMA advises the SFC of the names of the Executive Officers whom it has approved. All of these individuals are identified in the SFC's public register as being the Executive Officers of particular Registered Institutions.

3.3 Relevant Individuals

3.3.1 Staff employed by a Registered Institution to conduct regulated activities are not licensed or otherwise approved by the SFC. It is a statutory condition imposed on the registration of each Registered Institution that its Relevant Individuals must be fit and proper (section 119(8)(a)(ii) of the SFO). According to the "Supervisory Policy Manual – Supervision of Regulated Activities of SFC-Registered Authorized Institutions" issued by the HKMA in March 2003, Registered Institutions should ensure that Relevant Individuals meet the Fit and Proper Guidelines, the Guidelines on

Competence and the Guidelines on Continuous Professional Training issued by the SFC (3.1.7 of the manual). It is also stated in the manual that the HKMA will not assess the fitness and properness of Relevant Individuals prior to placing their names on the register, but will conduct background checks on them with the SFC and other relevant agencies if necessary (3.1.8 of the manual). Accordingly, the senior management of a Registered Institution has responsibility for ensuring that its front-line staff are fit and proper persons and that, at all times after their names are placed on the register, they measure up to the required regulatory standards.

3.3.2 The decision to include a person's name in the HKMA's Register of Relevant Individuals is made by the HKMA. The names of these individuals do not appear in the SFC's public register of licensed persons.

3.3.3 Historically, bank staff have not been subject to any form of prior approval by the HKMA. Upon the commencement of the SFO it was felt that there should be no change to this well established approach within the banking industry. Hence, there is a difference in approach in relation to Registered Institutions (as compared with that for Licensed Corporations).

3.4 Co-operation with the HKMA – exchange of information

3.4.1 Pursuant to section 378(3)(e) of the SFO and section 120(5) of the BO, the SFC and the HKMA may disclose certain information to each other, including information that will enable or assist the recipient of the information to perform its functions. The MOU between the SFC and the HKMA sets out the details in relation to the exchange of such information.

3.4.2 With respect to the licensing/registration regime, before making a decision to grant consent to a proposed Executive Officer or to include a Relevant Individual's name on its register, the HKMA seeks information from the SFC that might be relevant to the individual's fitness and properness. This process does not require anything more from the SFC than simply advising the HKMA as to whether or not there is anything on its database to suggest fitness and properness concerns. This process is similar to the usual vetting process conducted between regulators and law enforcement agencies more generally.

3.4.3 The HKMA may also request the SFC to provide its views or any relevant information in its possession concerning the appointment of an Executive Officer of a Registered Institution. For instance, because the SFC administers the Codes on Takeovers and Mergers and Share Repurchases, the HKMA might request the SFC to express its views concerning an individual's competence to advise on the Codes.

Appendix 4

Basic conduct principles for persons licensed by or registered with the SFC

1. **Code of Conduct overview**

1.1 The conduct of Intermediaries is governed by the Code of Conduct.

1.1.1 While the Code of Conduct does not have the force of law, the SFC and the HKMA are nonetheless guided by the requirements of the Code of Conduct in determining whether an Intermediary or their regulated staff is fit and proper to remain licensed or registered.

1.1.2 The Code of Conduct, which is modelled on principles developed and promulgated by the IOSCO, sets out basic conduct principles and specific requirements for selling and advising on financial products. The following sections summarize these principles and the specific requirements.

2. **Basic Conduct Principles**

2.1 Intermediaries are governed by the following general principles ("GP") which are set out in the Code of Conduct.

2.1.1 **GP1 Honesty and fairness** requires an Intermediary to act honestly, fairly and in the best interests of its clients and the integrity of the market.

2.1.2 **GP2 Diligence** requires that an Intermediary should, when conducting its business activities, act with due care, skill and diligence, and in the best interests of its clients and the integrity of the market.

2.1.3 **GP3 Capabilities** requires that an Intermediary should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.

2.1.4 **GP4 Information about clients** requires an Intermediary to seek from its clients information about their financial situation, investment experience and investment objectives relevant to the services to be provided.

2.1.5 **GP5 Information for clients** requires that an Intermediary should make adequate disclosure of relevant material information in its dealings with its clients.

2.1.6 **GP6 Conflicts of interest** requires that an Intermediary should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.

2.1.7 **GP7 Compliance** requires that an Intermediary should comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of its clients and the integrity of the market.

2.1.8 **GP8 Client assets** requires that an Intermediary should ensure that client assets are promptly and properly accounted for and adequately safeguarded.

2.1.9 **GP9 Responsibility of senior management** requires that the senior management of Intermediaries have primary responsibility to maintain appropriate standards of conduct and adherence to proper procedures by their firms.

3. **Specific obligations relating to selling and advising on investment products**

3.1 In addition to the general principles, the Code of Conduct also sets out general requirements, of specific relevance are 5.2 and 5.3.

3.2 5.2 of the Code of Conduct provides that the Intermediary should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances. The suitability requirement under the Code of Conduct is pivotal to guiding the selling practices of investment products by Licensed Corporations and Registered Institutions.

3.2.1 In May 2007 the SFC issued suitability requirement guidelines on applying the suitability requirement in the form of FAQs to enhance Intermediaries' understanding and to assist them in meeting the suitability obligations under the Code of Conduct. The FAQs list the following specific matters that an intermediary in wealth management and financial planning business should have regard to when making a recommendation or solicitation. The Intermediary is required to:

(a) know their clients;

(b) understand the products they recommend to clients;

(c) provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom it is recommended;

(d) provide all relevant material information to clients and help them make informed investment decisions;

(e) employ competent staff and provide appropriate training; and

(f) document and retain the reasons for each product recommendation made to each client.

3.2.2 Licensed Corporations and Registered Institutions should also ensure that product due diligence is conducted on a continuous basis at appropriate intervals having regard to the nature, features and risks of investment products.

3.2.3 The suitability requirements in 5.2 of the Code of Conduct may be waived in respect of professional investors, including high net worth investors, when additional requirements are met (see section 4 below).

3.3 In addition to the requirements in 5.2, 5.3 of the Code of Conduct requires an Intermediary providing services to a client in derivative products (including futures contracts or options, or any leveraged transaction) to assure itself that the client understands the nature and risks of the products and have sufficient net worth to assume the risks and bear the potential losses of trading in the products. This requirement cannot be waived for clients who are professional investors.

4. **Professional Investors**

4.1 Some of the requirements including the requirement in 5.2 of the Code of Conduct may be relaxed where the client is a professional investor. For the purposes of the Code of Conduct, professional investors are :

4.1.1 First, market professionals who fall under paragraphs (a) to (i) of the definition of professional investor in Part 1 of Schedule 1 to the SFO. These include investment banks, brokers and managers of authorised funds; and

4.1.2 Secondly, persons belonging to a class which is prescribed under the PI Rules (this includes high net worth investors with minimum portfolio of HK$8 million) who have demonstrated that they have sufficient knowledge and expertise in the relevant products and markets.

4.2 In assessing whether a client who is a high net worth investor can be treated as a professional investor in order for the requirements in the Code of Conduct to be relaxed, the Intermediary must take additional steps first.

4.3 The Intermediary must assess and be satisfied that the client is knowledgeable and has sufficient experience in relevant products and markets. In making this assessment, the Intermediary should have regard to:

4.3.1 the type of products in which the client has traded;

4.3.2 the frequency and size of trades (the client would be expected to have traded not less than 40 transactions in a year);

4.3.3 the client's dealing experience (he would be expected to have been active in the relevant market for at least 2 years); and

4.3.4 whether the client is aware of the risks involved in trading in the relevant markets.

4.4 The Intermediary must provide a written explanation to the client explaining the risks and consequences of being treated as a professional investor. This should also inform the client that he has a right to withdraw from being treated as a professional investor.

4.5 If the client elects to be treated as a professional investor, the Intermediary needs to obtain a signed declaration from the client consenting to being treated as a professional investor.

4.6 The Intermediary needs to have procedures in place to carry out an annual confirmation exercise to ensure that the client continues to meet the minimum portfolio requirement.

Appendix 5

Key SFO provisions for enforcement of misselling and issuing of unauthorised documentation

1. **Key SFO provisions for enforcement**

1.1 We set out below the key statutory provisions which, *inter alia,* empower the SFC to police and enforce statutory provisions and regulations in respect of point of sale advice by way of criminal proceedings or civil action. In the proceedings outlined below, sentencing or the penalty is determined by the Court and will depend on a number of factors including the maximum penalties provided for under the relevant SFO provision and the mitigating factors put forward on behalf of the particular offender.

1.2 Section 103

1.2.1 General prohibition against the issue of advertisements, invitations or documents relating to investments, subject to a number of exemptions. For example, the prohibition does not apply to any issue made to professional investors.

1.2.2 Makes it a criminal offence to issue or have in your possession for the purposes of issuing (whether in Hong Kong or elsewhere) an advertisement, invitation or document which contains an invitation to the public to participate in an unauthorised investment scheme.

1.2.3 Maximum penalty (on conviction on indictment): a fine of HK $ 500,000 and an imprisonment for 3 years and, in the case of a continuing offence, a further fine of HK $ 20,000 for every day during which the offence continues.

1.3 Section 107

1.3.1 Criminal offence to induce others, by any fraudulent or reckless misrepresentation, to invest money.

1.3.2 Maximum penalty (on conviction on indictment): a fine of HK $ 1,000,000 and an imprisonment for 7 years.

1.4 Section 277

1.4.1 Civil market misconduct of disclosure of false or misleading information about securities or futures that is likely to induce transactions.

1.4.2 The Market Misconduct Tribunal ("MMT") can impose a range of civil sanctions:

(a) disgorgement order – payment of profits made or loss avoided from misconduct;

(b) disqualification order – disqualifying a person from being involved in corporate management for up to 5 years;

(c) cold shoulder order - prohibiting a person from trading SFC regulated products for up to 5 years;

(d) cease and desist order – ordering a person not to breach any of the market misconduct provisions again;

(e) disciplinary referral order - referring a person found to have engaged in market misconduct to that person's disciplinary body; and

(f) costs order – requiring payment of costs of the MMT inquiry and/or the SFC investigation.

1.5 Section 298

1.5.1 Criminalises the disclosure of false or misleading information about securities or futures that is likely to induce transactions.

1.5.2 Maximum penalty (on conviction on indictment): a fine of HK $ 10,000,000 and imprisonment for 10 years.

1.6 Section 300

1.6.1 Offence involving the use of fraudulent or deceptive devices, etc. in transactions in securities, futures contracts or leveraged foreign exchange trading.

1.6.2 Maximum penalty (on conviction on indictment): a fine of HK $ 10,000,000 and imprisonment for 10 years.

1.7 Section 384

1.7.1 Offence involving the provision of false or misleading information under any requirement of the SFO and Parts II and X of the CO.

1.7.2 Maximum penalty (on conviction on indictment): a fine of HK $ 1,000,000 and imprisonment for 2 years.

Appendix 6

Distributors of Minibonds series issued by Pacific International Finance Limited still held by investors when Lehman Holdings filed for bankruptcy

Banks (Registered Institutions)

ABN Amro Bank NV Hong Kong Branch;
Bank of China (Hong Kong) Limited;
Bank of Communications Co. Ltd. Hong Kong Branch;
Belgian Bank;
Chekiang First Bank Limited;
Chiyu Banking Corporation Limited;
Chong Hing Bank Limited;
CITIC Ka Wah Bank Limited;
Dah Sing Bank, Limited;
Fortis Bank Asia HK;
Fubon Bank (Hong Kong) Limited;
Industrial and Commercial Bank of China (Asia) Limited;
International Bank of Asia Limited;
MEVAS Bank Limited;
Nanyang Commercial Bank, Limited;
Public Bank (Hong Kong) Limited;
Shanghai Commercial Bank, Ltd.;
The Bank of East Asia Limited;
Wing Hang Bank, Ltd.; and
Wing Lung Bank Limited.

Brokers (Licensed Corporations)

Sun Hung Kai Investment Services Limited
Grand Cathay Securities (HK) Ltd.
KGI Asia Limited

Appendix 7

Alternative approach to investor protection

1. **UK's "Treating Customers Fairly" approach**

1.1 The UK's Financial Services Authority ("UK FSA") has approached the issue of customer protection from a different perspective looking at the desired outcomes. As part of the UK FSA's move to a principles-based approach to regulation it adopted an approach that is outcome focused based on principles rather than detailed rules prescribing how outcomes must be achieved. The UK FSA calls its approach Treating Customers Fairly ("TCF"). Through its TCF work the UK FSA aims to deliver improved outcomes for retail consumers.

1.2 The UK FSA believe this principles-based approach gives authorised firms greater flexibility to determine for themselves how to deliver fair treatment to their customers in a way that suits their business. The flexibility of the principles-based approach, rather than prescriptive rules and processes, should enable firms to compete and innovate more effectively in product design, in the quality of customer service, and in giving value for money.

1.3 Through TCF the UK FSA is seeking to bring about a real change in behaviour of firms towards their customers. It has defined six outcomes for consumers which summarises what it wants TCF to achieve. The TCF outcomes that reflect the product life cycle are:

Outcome 1: Consumers can be confident they are dealing with firms where the fair treatment of customers is central to the corporate culture.

Outcome 2: Products and services marketed and sold in the retail market are designed to meet the needs of identified consumer groups and are targeted accordingly.

Outcome 3: Consumers are provided with clear information and are kept appropriately informed before, during and after the point of sale.

Outcome 4: Where consumers receive advice, the advice is suitable and takes account of their circumstances.

Outcome 5: Consumers are provided with products that perform as firms have led them to expect, and the associated service is both of an acceptable standard and as they have been led to expect.

Outcome 6: Consumers do not face unreasonable barriers after a sale imposed by firms to change product, switch provider, submit a claim or make a complaint.

1.4 Whilst the UK FSA's expectations share many of the characteristics of the principles set out in the Code of Conduct, we believe that it would be appropriate to study how the UK regulators and the industry in the UK has sought to implement the UK FSA's vision to see what lessons exist for Hong Kong. December 2008 was set as the final deadline for TCF with firms expected to be able to demonstrate that they are consistently treating customers fairly. This requires having appropriate management information processes in place. The FSA expects to publish in September 2009 its assessment of how well the industry performed against the December 2008 deadline.

Appendix 7

1.5 In February 2008 the Monetary Authority of Singapore issued a consultation paper on "Proposed Guidelines On Fair Dealing – Board And Senior Management Responsibility For Delivering Fair Dealing Outcomes To Customers". This encapsulated many of the elements of the FSA's TCF in particular it asked if the five fair dealing outcomes express the key outcomes that the regulatory regime should achieve.