

## Press Releases

28 May 2010

### **SFC adopts measures to enhance investor protection**

The Securities and Futures Commission (SFC) today announces a package of measures to strengthen the regulatory regime governing the sale of investment products.

The latest regulatory initiatives, which result from a three-month public consultation, are directed at enhancing investor protection and addressing issues highlighted in the report submitted by the SFC to the Financial Secretary in December 2008 (Note 1).

The measures - outlined in a set of [consultation conclusions](#) - include a consolidated product handbook with revised product codes for unit trusts and mutual funds and for investment-linked assurance schemes as well as a new product code for unlisted structured investment products. There are also requirements for product key facts statements to summarise the key features and risks of investment products, issuers to provide a post-sale "cooling-off" or "unwind" right for certain unlisted structured investment products to give investors a window to exit these investments, and conduct requirements for intermediaries to enhance selling practices relating to the sale of investment products.

The majority of the proposals in the consultation paper published in September 2009 will be adopted, with some modifications and amendments to take into account responses received during the consultation process. Details of the submissions and the SFC's responses to the comments are contained in the conclusions.

"We have carefully analysed the comments received and adopted a balanced approach in arriving at the conclusions. We believe these investor protection enhancing measures are reasonable and in line with our regulatory objectives," said the SFC's Chief Executive Officer, Mr Martin Wheatley.

"The measures will strengthen investor protection and ensure that Hong Kong remains a well-regulated, vibrant financial market. We thank our stakeholders for their constructive feedback, which has enabled us to achieve a healthy balance between the need for market innovation and investor protection," Mr Wheatley added.

Over 100 submissions were received during the consultation period.

In finalising the proposals, the SFC held discussions with a diverse group of industry participants, including banks, brokers, fund managers, investment advisers, and professional firms as well as consumer groups and academics. A forum was organised

for some 240 industry participants to exchange views on two key proposals and to share the insights of experts from major overseas regulators into some of the implementation issues.

Some of the measures will take effect immediately after publication of the revised codes in the Government Gazette, while transitional arrangements will be implemented in respect of some requirements to enable the industry to make the necessary adjustments.

In introducing the enhanced regulatory regime, the SFC will work closely with the industry and may issue additional guidance where necessary. It will also launch a series of focused investor education programmes to inform investors of the details of the new measures.

End

Note:

On 25 September 2009, the SFC issued a "[Consultation Paper on Proposals to Enhance Protection for the Investing Public](#)" for a three-month consultation which ended on 31 December 2009. Please click [here](#) to view the report entitled "Issues Raised by the Lehmans Minibonds Crisis, Report to the Financial Secretary, December 2008".

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## Section 2 – Products

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

## Part I Executive summary

### Introduction

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

### Overview of submissions

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



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

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

### **Conclusions with respect to cross-product proposals**

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

### **Product Key Facts Statements (Product KFS)**

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



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

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

### **Advertising guidelines**

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

### **Ongoing disclosure**

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

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

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



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

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

### **The SIP Code**

#### Product Arranger

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

#### Market-making and indicative valuations

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

#### Definition of "structured investment products" in the SIP Code

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



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

#### Inter-relationship with the CO reform proposals

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

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

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



## **The UT Code**

### Annual reports – bilingual versions

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

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

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

## **The ILAS Code**

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

## **Transitional arrangements**

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



## Funds and ILAS

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

## Unlisted structured investment products

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

## Implementation details

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

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

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



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



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

### Part I Executive summary

1. Part III of the Consultation Paper sought public views on proposed measures to effectively enhance intermediary conduct and selling practices relating to the sale of investment products that are securities and futures (“investment products”) in Hong Kong.
2. The consultation period ended on 31 December 2009. Significant number of submissions<sup>1</sup> was received in response to the conduct proposals. The respondents include industry associations, professional bodies, brokers, fund managers, investment advisers, banks, insurance companies and individuals.
3. The respondents were supportive of the Commission’s objective to enhance the regulation of the sale of investment products. Taking into account the submissions received and comments raised in the various discussions with industry participants, the Commission has made some amendments to the original proposed revisions where appropriate.
4. The respondents’ major comments and the Commission’s conclusions on the specific proposals are summarised as follows: –

#### Scope of application

- (a) Many respondents indicated that some of the proposals in the consultation should only apply to unlisted investment products. However, other respondents indicated that they could not see any reason for the delineation and that the proposals should apply to all investment products.
- (b) The Commission considers that the proposals should generally apply to the selling activities of all investment products, although consideration should be given regarding the circumstances of the business activities or mode of operation of intermediaries.

#### Investor characterization

- (c) Respondents were generally supportive of the concept of characterizing clients based on their knowledge of derivatives, although some respondents commented that investors are already adequately profiled under the existing requirements.
- (d) The Commission will codify the current practice by requiring an intermediary to assess a client’s knowledge of derivatives and characterize the client (other than professional investors for the purpose of paragraph 15 of the Code of Conduct) based on his knowledge of derivatives.

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



- (e) In this regard, for a client without knowledge of derivatives who wishes to purchase a derivative product, and the intermediary has not solicited the client or made a recommendation to the client in relation to the proposed transaction:
  - (i) Where the product is traded on an exchange, the intermediary should explain the relevant risks associated with the product to the client.
  - (ii) Where the product is not traded on an exchange, the intermediary should warn the client about the transaction and provide appropriate advice to the client as to whether or not the transaction is suitable for the client in all the circumstances. Records of the warning and other communications with the client should be kept. If the transaction is assessed to be unsuitable for the client, the intermediary may only proceed to effect the transaction if to do so would be acting in the best interests of the client in accordance with the general principles of the Code of Conduct.

### **Professional investors**

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

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

- (g) Most respondents were generally supportive of the proposal for distributors to provide relevant disclosure regarding the benefits they receive from product issuers for distributing investment products. However, some respondents suggested specific disclosure as this provided more relevant information to investors, while others suggested generic disclosure as they were concerned that specific disclosure would reveal sensitive commercial information.
- (h) Taking into account the comments received, the Commission will require specific disclosure in terms of percentage ceiling for business models 1 (distributing third party investment products) and 3 (back-to-back transactions) and *generic disclosure* for business model 2 (distributing in-house products). The Commission takes the view that this strikes a reasonable balance between enhancing transparency and assisting investors in making informed decisions by identifying any potential conflicts of interests arising from the transactions.
- (i) For benefits which are not quantifiable prior to or at the point of sale, generic disclosure of the existence and nature of the benefits will be required.

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

- (j) As many respondents supported this initiative, the Commission will adopt the proposal on restricting intermediaries from offering gifts (except for discount of



fees and charges) for the purpose of promoting a specific investment product to investors.

#### **Sales Disclosure Document**

- (k) Many respondents were supportive of the proposal for the disclosure of sales related information although they suggested that a degree of flexibility should be allowed in the way such information is disclosed to investors.
- (l) Intermediaries will be required to disclose sales related information to investors (i.e. capacity in which a distributor is acting, affiliation with product issuer, monetary and non-monetary benefits received by distributor and discount of fees and charges) prior to or at the point of sale. The information may be disclosed under different formats by the intermediaries in accordance with their mode of operations.

#### **Audio recording**

- (m) The majority of the respondents did not support the proposal to make audio recording of the selling process mandatory, as the consensus was that the existing record keeping requirements are sufficient. In addition, other major jurisdictions do not generally mandate audio recording of the selling process.
- (n) The Commission takes the view that the current standards of record keeping are appropriate and does not propose to make audio recording of the client risk profiling process and the advisory or selling process for investment products mandatory.

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

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

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

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<sup>2</sup> This includes the sales commission retained by the distributor in relation to that transaction.