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Legal Update
Banking & Finance
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Enhanced Investor Protection Regarding Unlisted Structured Investment Products

Following public consultation, the Securities and Futures Commission published the *Consultation Conclusions on Proposals to Enhance Protection for the Investing Public* and the final form of the *SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products*. The Hong Kong Monetary Authority has issued its own circular on *Implementation of Pre-investment Cooling-off Period for Retail Customers*. This Legal Update focuses on the enhanced requirements applicable to unlisted structured investment products (SIP).

Introduction and effective dates

This Legal Email Update focuses on the enhanced requirements applicable to unlisted structured investment products (SIP).

On 28th May 2010, the Securities and Futures Commission (SFC) published the *Consultation Conclusions on Proposals to Enhance Protection for the Investing Public*. At the same time, the SFC published the final form of the *SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products* (SFC Handbook).

The enhanced requirements imposed by the SFC apply to investment products and conduct of intermediaries issuing or distributing these products. They cover the 3 key stages of an investment: pre-sale, sale and post-sale. Some of the requirements will take effect immediately after publication of the revised codes/product code in the Government Gazette (on 4th June 2010). The SFC has made transitional arrangements with respect to other areas.

The Hong Kong Monetary Authority (HKMA) has issued its own circular on *Implementation of Pre-investment Cooling-off Period for Retail Customers* on 20th May 2010. All authorised institutions (AI) are required to implement the arrangement no later than 1st January 2011.

Enhanced requirements applicable to SIP

Securities and Futures Commission (SFC)

SFC Handbook

- The SFC Handbook does not have the force of law. However, failure to comply may result, among other consequences, in the SFC deauthorising or restricting further offering of the SIP implicated by the non-compliance, and refusing to authorise new SIP to be issued, managed and/or originated by the same SIP provider.
- It comprises the overarching principles and 3 product codes regarding UT, ILAS and SIP respectively.

OVERARCHING PRINCIPLES

The SFC Handbook specifies a set of overarching principles which apply across different types of investment products governed by the SFC Handbook. These principles are intended:

1. to enhance product transparency and to set an overall disclosure standard for all offering documents in respect of different types of products being offered to the public in HK,
2. by augmenting and facilitating consistency in the interpretation of the specific, detailed requirements in the various product codes in the SFC Handbook.

The overarching principles are:

General principles

- Act honestly, fairly and professionally
- Disclosure should be complete, accurate and fair, legible and comprehensible to the investing public, not false or misleading or presented in a deceptive or unfair manner, and ongoing disclosure (if required) should be disseminated in a timely and efficient manner
- Properly protect assets held for investors' benefit
- Avoid conflicts of interest
- Comply with all applicable legal and regulatory requirements and respond to requests and enquiries from regulators in an open and co-operative manner
- Discharge functions with due skill, care and diligence
- Advertisements should be clear, fair and present a balanced picture with adequate and prominent risk disclosures, not false, biased, misleading or deceptive

Name of product

- Name should not be undesirable or misleading
- Name should be consistent with nature of product, should not give investors a sense of false assurance or security, nor impression that persons other than the product provider are responsible for the product, nor impression that the product provider is not responsible for the product
- Where the name carries the words "guaranteed", "principal guaranteed", "capital protected" or equivalents, it should accurately reflect the nature and extent of the guarantee or principal/capital protection having regard to the impression that the description might give to the investing public

Offering document

- Should contain information necessary for investors to be able to make an informed judgement of the investment
- Should comply with all applicable disclosure requirements under the applicable product code
- All key features and risks of the product should be highlighted for investors prominently in a succinct manner
- Regarding a product offered on a continuous basis, its offering document should be updated in compliance with the product code

Product Key Facts Statement (Product KFS)

- SFC will provide illustrative templates with respect to different types of products
- Generally no more than 4 pages in length
- Concise and easily understood by retail investors
- Easy to read and highly legible
- In a format that facilitates comparison with other products
- Unless otherwise specified in the applicable product code, forms part of the offering document of the product
- Carry prominent upfront warning statement on first page to warn investors that it is a part of the offering document (where applicable) and investors should not invest in the product based on the Product KFS alone
- Bilingual - English and Chinese

Language of offering document of product

- Bilingual - English and Chinese
- Existing requirements under applicable laws or

regulatory regime continue to apply as to whether both versions should be of equal standing

Advertisements relating to product

- Should comply with advertising guidelines in applicable product code
- Should not use visual images which divert or mislead investors' focus from the proper consideration of the product, stress benefits/ rewards without balancing by possible downside, carry slogan that is exaggerated, unwarranted or inconsistent with or unrelated to nature and risk and return profile of product
- A competent delegate (who should be duly authorised to issue the advertisement on behalf of the issuer of the advertisement) designated by senior management of the issuer should review the advertisement before it is issued to ensure that it complies with the applicable product code and advertising guidelines

Use of disclaimers

- Subject to applicable product code
- Should be reasonable

Avoidance of conflicts of interest

- Product providers should manage and minimise conflicts by implementing appropriate measures such that investors interests can be sufficiently protected, and conflicts (actual or potential) should be properly disclosed to investors
- If conflicts relating to a product cannot be properly managed, the product provider should consider whether it is still appropriate for that product to be generally offered to the public

Product providers' duty to notify SFC of breach of SFC Handbook

- Rrequired to notify the SFC of material breaches of the SFC Handbook, regardless of duration or cause of breach

Selection of distributors, counterparties and service providers

- Product providers should exercise reasonable care and diligence in selecting and appointing distributors, counterparties and service providers for their products

Ongoing disclosure

- Should comply with on-going disclosure requirements under the applicable product code to keep investors informed of matters affecting them or to disseminate product-related information on a regular basis
- Should monitor closely those matters required for notification

Investor education

- As a matter of best practice, product providers are encouraged to provide investor education regarding their products, especially where the products are novel in the HK market

Enquiries and complaints handling

- Should provide in the offering document information regarding how investors' enquiries and complaints will be handled

CODE ON UNLISTED STRUCTURED INVESTMENT PRODUCTS (SIP CODE)

The SIP caught by the SIP Code are those which, regardless of their legal form:

1. involve derivative arrangements;
2. are commonly regarded in the market as equity-linked, index-linked, commodity-linked or credit-linked investment products;
3. are or whose advertisements are subject to the SFC's authorization under Part IV of the Securities and Futures Ordinance (SFO), i.e. the current regime regulating offering of securities, collective investment schemes and regulated investment agreements.

The SFC emphasises that the types of SIP specified in the SIP Code are not intended to be exhaustive. The SFC may expand the product types or issue additional codes or guidelines in light of market development.

The ultimate goal of the SFC is to disapply the prospectus regime under the Companies Ordinance with respect to SIP in the form of debentures so that all SIP will be regulated under the SFO regime.

Some key provisions and requirements prescribed by the SIP Code include:

Anti-avoidance

- Issuers, guarantors, product arrangers and trustees/custodians should discharge the obligations and responsibilities imposed by the SIP Code, and they are not allowed to override or alter such obligations and responsibilities by commercial or other arrangements in the packaging and distribution of the relevant SIP

Eligibility of issuer and guarantor - some principal criteria

- A licensed bank regulated by the HKMA, or a corporation licensed by the SFC, or an overseas banking entity subject to equivalent regulatory oversight to that of HK and acceptable to the SFC, or an entity having a credit rating which is one of the top 3 investment grades awarded by at least one rating agency of international standing and reputation which is acceptable to the SFC
- Net asset value of at least HK$2 billion
- Law of place of its incorporation permits issuance and offering of the SIP to the investing public in HK or provide guarantee (as the case may be)
- Inability of issuer to meet certain eligibility criteria may be compensated by a guarantee of the issuer's obligations provided by a guarantor that meets the eligibility criteria applicable to guarantors (normally expected by the SFC to be in the same corporate group of the issuer), or by the issuer being a SPV subject to prescribed conditions plus having the SIP collateralised in compliance with the applicable requirements under the SIP Code

Some principal obligations of issuer

- Ensure issuer and SIP comply with applicable legal and regulatory requirements
- Responsible for contents of advertisements and other product documents\
- Ensure proceeds of SIP are applied in accordance with offering document
- Ensure timely dissemination to investors of information in compliance with applicable disclosure requirements
- Comply with its obligations under the terms of SIP
- Ensure sufficient monitoring of SIP to enable performance of post-sale obligations
- Provide information and undertakings to the SFC in such form as required by it from time to time
- An issuer that is a SPV or an issuer (or the guarantor) that is not a bank licensed by the HKMA or a corporation licensed by the SFC is required to appoint a product arranger

Product arranger

- Must be licensed or registered by the SFC for Type 1 regulated activity - dealing in securities
- Major obligation is to ensure issuer's compliance with applicable regulatory requirements at all times
- Must provide information and undertakings to the SFC in such form as required by it from time to time

Guaranteed or collateralised SIP

- The SIP Code prescribes requirements on guarantee/guarantor and assets used as collateral to increase/maximise protection to investors
- Terms of guarantee must inure for the benefit of the investors and expressly provide for the

guarantor to be unconditionally and irrevocably liable as primary obligor

- Assets held as collateral must be, among other things, liquid and tradable (with an active secondary market), have prescribed credit rating, and diversified (where appropriate), fully-funded, acquired at the best available price on arms length basis, and must not include (i) structured products primarily linked to embedded derivatives or synthetic instruments or (ii) securities issued by SPV or similar entities
- SIP issuer must ensure, among other things, that collateral are clearly identified, properly segregated and ring-fenced for the benefit of the investors of the relevant series/tranche from all other series/tranches, and that risks that would prejudice efficient and timely realisation of collateral for the benefit of investors (including conflict of laws or cross-border insolvency) are eliminated or mitigated
- SIP issuer should consider the structural needs in designing a SIP and is encouraged by the SFC to accord first priority to investors' claims to the proceeds of realisation of the collateral (and, where first priority is not accorded, to disclose that fact in the offering document)

Offering document

- As a general requirement, an SIP offering document must contain the information necessary for investors to be able to make an informed judgement of the investment
- Must contain a Product KFS which forms a part of the offering document
- Must be issued in both English and Chinese

Advertisements

- All advertisements must be authorised by the SFC prior to issue or publication
- Must comply with advertising guidelines set out in the SIP Code

Some principal post-authorisation requirements

- Make available material contracts and documents for investors inspection
- Provide market-making (unless the scheduled tenor of SIP is 6 months or less) at least bi-weekly on a committed basis and make indicative bid prices of SIP available to investors
- If the SIP or any party involved in the SIP fails to meet requirements under the SFC Handbook, issuer and product arranger must cease to advertise or offer the SIP to public in HK, notify the SFC immediately and take remedial action to rectify as soon as possible

Some principal ongoing disclosure obligations to investors and/or SFC - applicable as long as obligations to investors remain outstanding

- Annual report and audited financial statements of issuer and each guarantor and key product counterparty
- If issuer or guarantor ceases to meet core eligibility criteria
- Changes in financial condition or other circumstances expected to have material adverse effect on ability of issuer, guarantor or key product counterparty to fulfil its commitments
- Occurrence of event of default concerning collateral or deterioration of collateral
- Breach by trustee/custodian of its obligations under the SIP Code
- Termination or resignation of product arranger or trustee/custodian, their replacement and reasons for termination, resignation or replacement

Post-sale cooling-off or unwinding right of investor

- Investor is entitled to cancel order, sell back or otherwise unwind transaction, and receive refund (unless scheduled tenor of SIP is one year or less)
- Right is exercisable for at least 5 HK business days after investor places order
- Right should only be exercised (i) in respect

of the entire order (and not part of it), (ii) where the investor has not sold or transferred the investment, and (iii) when the SIP is still subsisting and not yet expired or terminated

- Any exercise of right by investor is irrevocable
- Refund amount equals principal amount of investment minus market value adjustment and reasonable, disclosed handling fee (which should not contain profit margin) plus refund of sales charges/commissions, and is capped at principal amount plus sales charges/commissions
- Refund must be made as promptly as practicable after exercise of right by investor

CONSEQUENTIAL AMENDMENTS TO CODE OF CONDUCT FOR PERSONS LICENSED BY OR REGISTERED WITH THE SECURITIES AND FUTURES COMMISSION

The SFC Code of Conduct is amended in line with the enhanced requirements. Some major amendments include:

- Licensed/registered persons are prohibited from offering any gift (other than a discount of fees or charges) in promoting a specific investment product to a client
- Additional investor characterisation requirement under KYC due diligence to identify clients (who are not professional investors as defined in the SFO) who have no knowledge of derivatives but wish to purchase a derivative product, and additional warning and risk disclosure requirements (the procedures regarding handling of professional investors are tightened correspondingly)
- Pre-sale disclosure of monetary and non-monetary benefits payable by product issuer to licensed/registered person for distributing the investment product, including disclosure of specific benefits on a transaction basis and general disclosure
- Disclosure of sales related information prior to or at the point of sale, including capacity of licensed/registered person, affiliation of licensed/registered person with product issuer, disclosure of monetary and non-monetary benefits, and generic terms and conditions under which client may receive discount of fees or charges
- Where a client exercises cooling-off or unwinding right, the licensed/registered person should promptly execute client's instruction and pass on to the client the full amount of refund received from product issue less a reasonable, disclosed administrative charge (which should not contain any profit margin).

Hong Kong Monetary Authority (HKMA)

Circular on Implementation of Pre-investment Cooling-off Period for Retail Customers

Whilst the cooling-off and unwinding right prescribed by the SFC is post-transaction, the cooling-off arrangement prescribed by the HKMA is pre-transaction.

Principal requirements prescribed by the HKMA in the Circular:

- After an AI has ensured that the relevant product is suitable for a customer and adequately disclosed material information of the product to the customer, the AI should allow the customer a Pre-Investment Cooling-off Period (PICOP) of at least 2 calendar days (of which the last day should be a business day) to understand the product, consider the appropriateness of the investment and, if necessary, consult with family members and friends
- Price and terms of the transaction should be fixed on the day (i.e. upon the end of the PICOP) when the customer gives specific confirmation to the AI to confirm placement of purchase/subscription order

- The AI must put in place arrangements and controls procedures and measures:
  - for the customer to give specific confirmation of order placement, supported by proper audit trail
  - to ensure that the PICOP requirements are properly implemented and explained to customers
  - to provide sufficient training to all relevant staff before implementation of the PICOP requirements and thereafter on an ongoing basis
  - to maintain adequate records and supporting documents on the actual operations of PICOP
  - to perform regular reviews (through an independent unit such as the compliance function) on the compliance with the PICOP requirements

Applicability of PICOP requirements

- Applicable to all derivative products that are not listed on an exchange in HK
- Applicable to retail customers which exclude corporations, sole proprietors, partnerships and private banking customers (unless the relevant investment services are provided to the private banking customers by retail branches of the AI); AI should classify an individual as a private banking customer only if he/she maintains a personalised relationship with the AI, or receives personalised banking services or a portfolio management service from the AI, and has assets under the AI's management of at least US$1 million
- Mandatory where customer is aged 65 or above EXCEPT the customer will be allowed to opt out from the PICOP arrangement if (i) the customer's asset concentration is below 20% and (ii) the customer is not a first-time buyer of the relevant type of product
- Not necessary where customer is aged under 65 BUT mandatory if (i) the customer's asset concentration is 20% or above and (ii) the customer is a first-time buyer of the relevant type of product
- "Asset concentration" means the percentage of the customer's total net worth (excluding real estate properties) to be invested in the relevant transaction, calculated using the nominal amount of that transaction, and the AI may rely on self-declaration by the customer in ascertaining asset concentration

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