Part III Intermediaries conduct

Consultation on the regulation of intermediary conduct and selling practices

Introduction

1. In this Part III of the consultation paper, the Commission seeks public views on proposed measures to effectively enhance intermediary conduct and selling practices relating to the sale of investment products in Hong Kong. To this end, the Commission has issued the FS Report in December 2008. Specific proposals were also made by the HKMA in another report to the Government (HKMA Report).

2. Some of the proposals set out in this Part III will entail a revision of certain provisions in the Code of Conduct and the Securities and Futures (Professional Investor) Rules (Professional Investor Rules). The proposed amendments are marked up against the current version of the relevant requirements in Appendix C to this consultation paper.

Background

3. The regulatory structure for the sale of investment products rests on two important pillars – disclosure of product information and suitability of the product for the investor. The first pillar requires product issuers to disclose sufficient product information in the product documentation to enable a reasonable person to make an informed decision. The second pillar requires intermediaries[18] that recommend a product to ensure the suitability of the product for the particular investor.

4. Under the Code of Conduct, intermediaries are required to comply with a series of general principles (GPs) which are supplemented by specific requirements. The general principles are set out below:

[18] For the purposes of this consultation paper, use of the word "intermediaries" refers to licensed and registered persons under the Code of Conduct.

(a) GP1. Honesty and fairness

In conducting its business activities, a licensed or registered person should act honestly, fairly, and in the best interests of its clients and the integrity of the market.

(b) GP2. Diligence

In conducting its business activities, a licensed or registered person should act with due skill, care and diligence, in the best interests of its clients and the integrity of the market.

(c) GP3. Capabilities

A licensed or registered person should have and employ effectively the resources and procedures which are needed for the proper performance of its business activities.

(d) GP4. Information about clients

A licensed or registered person should seek from its clients information about their financial situation, investment experience and investment objectives relevant to the services to be provided.

(e) GP5. Information for clients

A licensed or registered person should make adequate disclosure of relevant material information in its dealings with its clients.

(f) GP6. Conflicts of interest

A licensed or registered person should try to avoid conflicts of interest, and when they cannot be avoided, should ensure that its clients are fairly treated.

(g) GP7. Compliance

A licensed or registered person should comply with all regulatory requirements applicable to the conduct of its business activities so as to promote the best interests of clients and the integrity of the market.

(h) GP8. Client assets

A licensed or registered person should ensure that client assets are promptly and properly accounted for and adequately safeguarded.

(i) GP9. Responsibility of senior management

The senior management of a licensed or registered person should bear primary responsibility for ensuring the maintenance of appropriate standards of conduct and adherence to proper procedures by the firm. In determining where responsibility lies, and the degree of responsibility of a particular individual, regard shall be had to that individual's apparent or actual authority in relation to the particular business operations, and the factors referred to paragraph 1.3 of the Code of Conduct.

5. Paragraph 5.1 of the Code of Conduct requires intermediaries to take all reasonable steps to establish the true and full identity of each of its clients and their financial situation, investment experience and investment objectives.

6. Based on the information gathered in the "know your client" process conducted under paragraph 5.1, paragraph 5.2 of the Code of Conduct further sets out the key requirement for intermediaries to ensure suitability –

   Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, 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.

7. In addition, paragraph 5.3 of the Code of Conduct makes particular reference to derivative products –

   A licensed or registered person providing services to a client in *derivative products*, including futures contracts or options, or any leveraged transaction should assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

8. In May 2007, the Commission issued some Frequently Asked Questions (Suitability FAQs) to provide further guidance on the existing requirements of the Code of Conduct and the Management, Supervision and Internal Control Guidelines (Internal Control Guidelines) by clarifying the suitability obligations of intermediaries engaged in financial planning and wealth management business activities. In particular, intermediaries must know their clients, understand the investment products they recommend to clients and provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom the product is recommended.

9. The Commission recognizes that although the current regulatory framework has served Hong Kong well and provides a sound basis for guiding intermediaries' business conduct, issues such as those arising from the sale of structured products, especially those with embedded derivative elements, show that certain areas of intermediary regulation can be further strengthened. The Commission takes the view that new regulatory requirements could be usefully introduced and further guidance may be provided to enhance the overall regulatory framework, having taken into account international regulatory developments and market feedback.

10. Paragraph 35 of the FS Report proposed to further study and consult on establishing a new dispute resolution procedure or body. The Commission will not pursue the study of this issue given the Government's intention to consult the market in the near future on the formation of a financial services ombudsman that will cover the dispute resolution process.

11. Paragraph 27.3 of the FS Report recommended that issuers of investment products are to provide relevant information and that intermediaries should ensure that this information is brought to the attention of investors. Under GP5 of the Code of Conduct, an intermediary should make adequate disclosure of relevant material information in its

dealings with its clients. Intermediaries are reminded that they have an on-going obligation to pass on any relevant material information provided by issuers of investment products to their clients.

Summary of matters for consultation

12. In this Part III of the consultation paper, the Commission is consulting on the following proposals:

Investor characterization

This section seeks public views on whether intermediaries should, as part of the "know your client" procedures, obtain clients' information about their knowledge of derivatives and characterize those clients (other than professional investors) with such knowledge as "clients with derivative knowledge", to assist intermediaries in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable.

Professional investors

This section discusses how the "professional investors" regime could be further refined so as to enhance investor protection. The section suggests ways in which intermediaries may assess the "knowledge, expertise and investment experience" of a professional investor in a relevant market and/or product and discusses whether the minimum portfolio requirement should be adjusted from the existing level.

Pre-sale disclosure of monetary and non-monetary benefits

This section analyses various disclosure options to address potential intermediary conflicts of interest issues regarding monetary and non-monetary benefits received.

Use of gifts by distributors in promoting a specific investment product

This section discusses whether there should be restrictions on the use of gifts by product distributors in promoting a specific investment product to investors.

Sales Disclosure Document

This section discusses the manner in which intermediaries would disclose material information regarding their relationships and dealings with clients by preparing and delivering to clients Sales Disclosure Documents prior to or at the point of sale.

Audio recording

This section discusses whether audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current SFC record keeping requirements are already sufficient.

13. The above proposals will generally apply to securities and futures products (hereafter referred to as investment products). However, the Commission recognizes that some of the proposals may be more applicable to unlisted investment products because of the different operation modes, information disclosure framework etc. of such products. The

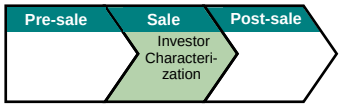
Commission thus invites market views on the scope and applicability of the proposals above.

Question (18)

Do you agree that some of the proposals in this part of the consultation paper should only apply to unlisted investment products? Please explain your views.

Transitional Period

14. The Commission will provide an appropriate transitional period for any of the proposals that are implemented under this Part III of this consultation paper.



Investor characterization

15. There is a general concern that the complex nature and features of some unlisted investment products makes it difficult for the average investor to fully appreciate the product's characteristics and the risks involved. The Lehman Minibonds is a good example. A SFC Investor Survey in December 2008 revealed that two-thirds of the investors surveyed knew very little about at least one of the products they had invested in, such as unlisted equity linked products[19].

16. Paragraph 34.3 of the FS Report recommended that:

"the SFC brings forward requirements for Intermediaries to adopt suitable criteria for characterizing investors with a view to assisting in ensuring that investment advice and products offered are suitable for the investors".

17. The Commission has also looked at how other jurisdictions address this issue. In Europe, the E.U. Markets in Financial Instruments Directive (MiFID) Article 19(5) provides that "Member States shall ensure that investment firms, when providing investment services other than investment advice or portfolio management, ask the client or potential client to provide information regarding his knowledge and experience in the investment field relevant to the specific type of product or service offered or demanded so as to enable the investment firm to assess whether the investment service or product envisaged is appropriate for the client".

18. In the US, an investor's experience and/or knowledge are also important factors that an intermediary has to consider. The Financial Industry Regulatory Authority (FINRA) member firms are required to consider limiting purchases of structured products to those clients that have accounts approved for options trading, given the similar risk profile of many structured products and options. In approving an account for options trading, a firm has to ascertain essential information about the client, including his investment experience and knowledge in options and other financial instruments. In addition, in determining customer suitability in connection with specific structured products, FINRA member firms are required to consider, among other factors, whether the client meets the options suitability requirements by having "such knowledge and experience in financial matters that he may reasonably be expected to be capable of evaluating the risks of the recommended transaction"[20].

19. In Hong Kong, the conduct of intermediaries in relation to the selling and advising of investment products is governed by the Code of Conduct and clarified by the Suitability FAQs. Intermediaries are required to conduct proper "know your client" procedures before providing services to clients. Specifically, intermediaries should seek from their clients information about their financial situation, investment experience / knowledge / objectives and risk tolerance etc. Furthermore, having regard to the information collected above, 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.

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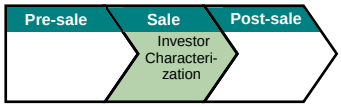
[19] Key Findings of Retail Investor Survey, December 2008
(Link: http://www.sfc.hk/sfc/html/EN/speeches/public/surveys/surveys.html)

[20] NASD Notice to Members 05-59 and FINRA Rule 2360(b)(19)(B) (previously being NASD Rule 2860(b)(19)(B) as quoted under NASD Notice to Members 05-59).



20. As the regulation of the conduct of intermediaries in Hong Kong is principle based, intermediaries would need to tailor their own selling or advisory procedures according to the risk level of the investment products and the investors' profiles. For products having features and risks which are not difficult for an average investor to understand, the suitability requirement can be achieved under simplified procedures. It is important to note that the suitability requirement is triggered when the intermediary makes a recommendation or solicitation.

Proposal

21. Major markets, including Hong Kong, consider investors' knowledge in investment products to be a crucial factor in determining whether an investment product is suitable for a client. The assessment of the client's investment knowledge is already part of the "know your client" procedures under the Code of Conduct. As unlisted investment products with embedded derivatives elements are generally difficult for investors to understand and are increasingly popular, the Commission sees merit in providing further guidance to intermediaries who provide services in relation to unlisted derivative products to clients.

22. Accordingly, the Commission would like to explicitly set out that before serving clients in relation to unlisted derivative products, intermediaries should seek from clients, as part of the "know your client" process, information in relation to clients' knowledge of derivatives. Intermediaries would then characterize those clients (other than professional investors) who have derivative knowledge as "clients with derivative knowledge".

23. If a client is not characterized as a "client with derivative knowledge", the intermediary should not promote any unlisted derivative products to such a client in all circumstances. An intermediary can promote unlisted derivative products to a "client with derivative knowledge" provided that it complies with paragraphs 5.2 and 5.3 of the Code of Conduct and that the recommendation is suitable for the client.

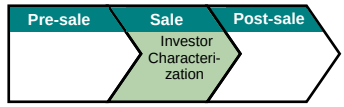
24. Where a client who does not have derivative knowledge wishes to purchase an unlisted derivative product on his own initiative, the intermediary should warn the client about the proposed transaction and provide appropriate advice to him, including assessment of suitability of the transaction. The suitability assessment should take into account, inter alia, the client's personal circumstances such as his total portfolio, asset concentration and exposure to a particular market or asset class. The warning and communications with the client should be recorded. If the product is assessed to be not suitable for the client, the intermediary should exercise caution in serving the client and should act in the best interest of the client pursuant to GP1 of the Code of Conduct.

25. Intermediaries are <u>not</u> required to seek information about a client's knowledge of derivatives if no services with respect to unlisted derivative products are envisaged to be provided to that client. If a client who has not been characterized as a "client with derivative knowledge" subsequently wishes to purchase unlisted derivative products, the intermediary should seek such information from the client.

26. Investors may be regarded as having knowledge of derivatives through:

    (a) Undergoing training or attending courses on derivative products;

    (b) Prior trading experience in derivative products; or



(c) Current or previous work experience related to derivative products.

The Commission seeks views on the contents of the training or courses and the extent of previous trading experience or work experience.

27. For the avoidance of doubt, intermediaries are still required to comply with the requirements under paragraphs 5.2 and 5.3 and other parts of the Code of Conduct when providing services to clients, where applicable.

28. See the draft amendments to the Code of Conduct in Appendix C to this consultation paper.

Question (19)

Do you think that intermediaries should, as part of their "know your client" procedures, seek clients' information about their knowledge of derivatives and characterize those clients (other those professional investors) with such knowledge as "clients with derivative knowledge" to assist intermediaries in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable ?

Please give your views on the contents of the proposed measures for intermediaries to assess whether investors have knowledge of derivatives.

Professional investors

29. The examination of the existing "professional investors" regime began in mid-2008 with the Commission agreeing to review the regime at a Legislative Council Panel on Financial Affairs meeting and it was decided that the professional investors review should form part of this consultation.

30. Paragraph 29.7 of the FS Report states that:

"We recommend that the SFC consults the market on whether it is appropriate:

(a) to raise the minimum asset portfolio requirement under the Professional Investor Rules; and

(b) to clarify and tighten the assessment criteria under the Code of Conduct"

31. The concept of "professional investors" was first introduced in the Code of Conduct in 2001, followed by the Professional Investor Rules being issued in 2003. The idea was that professional investors, by virtue of their experience and financial resources, would be in a better position to make informed decisions and protect their own interests. Certain investor protection requirements imposed upon intermediaries could therefore be dispensed with when providing investment services to these professional investors. A similar concept of "professional investors" is also found in other jurisdictions, such as the UK, the US, Australia and Singapore.

Definition of "professional investors"

32. Under the Code of Conduct, there are two types of professional investors – (i) **market professionals**[21] (e.g. banks and insurance companies); and (ii) **high net worth investors**[22]. To be treated as a professional investor, a high net worth investor must possess a minimum portfolio of HK$ 8 million, be knowledgeable and have sufficient expertise and investment experience in the relevant products and markets, and have signed a written declaration consenting to be treated as such.

33. If an investor is classified as a "professional investor", the legal restrictions on the issuance of advertisements in relation to investments[23], the making of unsolicited calls[24], and the communication of an offer in relation to securities[25] do not apply. Further, the offering of any shares in (or debentures of) a company to professional investors is not subject to the prospectus regime under the CO.

34. Notwithstanding the above statutory exemptions, intermediaries are still required to comply with the Code of Conduct when they serve professional investors. However, under paragraph 15.5 of the Code of Conduct, intermediaries are exempted from complying with certain requirements in the Code of Conduct such as paragraph 5.2 on suitability.

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[21] Being persons referred to in paragraph 15.2A of the Code of Conduct

[22] Being persons referred to in paragraph 15.2B of the Code of Conduct

[23] Section 103 of the SFO. This exemption also applies to issuers of securities, regulated investment agreements or collective investment schemes.

[24] Section 174 of the SFO

[25] Section 175 of the SFO

35. In the case of high net worth investors, the intermediary has to assess the knowledge, expertise and investment experience of the high net worth investor, and should have regard to factors such as the type of product previously traded, frequency and size of trades, the person's dealing experience and the person's awareness of the risks involved in trading in the relevant markets. The assessments are hereafter collectively referred to as the **"knowledge, expertise and investment experience assessment**".

Proposal

36. There has been an increase in the sale of investment products whose structures and features tend to be complex and the Commission is concerned that these products may not be easily understood by high net worth investors. The Commission is therefore reviewing the "professional investors" regime with the objective of ensuring that only those investors with sufficient knowledge, expertise and investment experience in the relevant financial products and having an investment portfolio of an appropriate size would be regarded as professional investors.

Reviewing the knowledge, expertise and investment experience assessment criteria under the Code of Conduct

37. Under the existing Code of Conduct, an intermediary could "treat" a high net worth investor as a professional investor for the purposes of the Code of Conduct (and thereby be exempted from certain conduct requirements) only if it is reasonably satisfied that the investor has sufficient knowledge, expertise and investment experience in the *relevant* products and markets (*emphasis added*). It has always been the intention of the Commission that, as stated in the existing Code of Conduct, intermediaries should consider the investor's knowledge, expertise and investment experience that is *relevant* to the product type and markets under consideration. To this end, products would be regarded as "relevant products" if they have similar nature, features and inherent risks.

38. In considering whether a high net worth investor has specific knowledge and expertise in trading in the relevant product, it is proposed that the intermediary should consider whether

(a) the person is currently working or has previously worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or

(b) the person has undergone training or studied courses which are related to the relevant product.

39. An independent and separate assessment should be undertaken by the intermediary prior to treating an existing high net worth investor as a professional investor in a different type of product or market.

40. In light of rapid market development and innovation, a high net worth investor may not have a sufficient level of knowledge and expertise as expected if he has ceased trading in that market or product for some time. To address this, the Commission considers that intermediaries should re-assess the knowledge, expertise and investment experience of those high net worth investors who have ceased trading for two years or more in the relevant market or product.

41. Moreover, it is the Commission's intention that the knowledge, expertise and investment experience assessment be conducted formally and in writing so that an intermediary will be able to demonstrate its compliance with the requirement. This requirement will also be expressly set out under the Code of Conduct.

42. There are other criteria that can be adopted by intermediaries to carry out the above assessment and the Commission invites market views on the appropriate criteria.

43. See the draft amendments to the Code of Conduct in Appendix C.

Question (20)

Should a high net worth investor be considered to have specific knowledge and expertise if:

(a) he is currently working, or has previously worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or

(b) he has undergone training or studied courses which are related to the relevant product?

Do you have any other suggestions?

Reviewing the minimum portfolio requirement under the Professional Investor Rules

44. The minimum portfolio requirement of HK$ 8 million for high net worth investors has remained the same since 2001. For reference, as at 2 April 2001[26], the Hang Seng Index closed at 12727.30 while it closed at 19724.19 on 31 August 2009. In 2007, the average net worth of wealthy individuals in Hong Kong ("individuals with a net worth of or exceeding USD 1 million") was USD 5.4 million[27] (around HK$ 42.1 million). The Per Capita Gross National Product also increased by approximately 21% from 2001 to 2007[28]. Therefore, a fresh review might be appropriate in light of the change in social and economic conditions.

45. Industry feedback indicates that many of Hong Kong clients treated as "professional investors" have portfolios far exceeding HK$ 8 million. In fact, the Commission initially proposed that the threshold be set at HK$ 16 million and finally agreed to revise the threshold downwards to HK$ 8 million after considering market feedback in 2001. In comparison with other jurisdictions, the existing minimum portfolio requirement in Hong Kong is lower than some jurisdictions: in Singapore for example, the minimum portfolio requirement is SGD 2 million (around HK$ 11 million) while it is AUD 2.5 million in Australia (around HK$ 16 million). However, the minimum portfolio requirement in Hong Kong is higher than that of the United Kingdom which is EUR500,000 (around HK$5.5 million).

[26] The revised Code of Conduct came into effect on 1 April 2001.

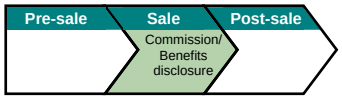
[27] Page 8 of the "Asia-Pacific Wealth Report 2008" published by Capgemini and Merrill Lynch.

[28] Figure calculated by reference to the per capita GNP figures in the "2008 Gross Domestic Product (Yearly)" and "2006 Gross Domestic Product (Yearly)" published by the Census and Statistics Department of Hong Kong.

46. While it may now be the appropriate time to re-consider the minimum HK$ 8 million portfolio requirement for a high net worth investor to be classified as a "professional investor" under the Professional Investor Rules, some of the feedback received during the soft consultation did not support raising the existing minimum portfolio requirement. Any excessive increase in the minimum portfolio requirement may have the following unintended and adverse consequences: (i) adversely affecting the private placement activities in Hong Kong; and (ii) hindering the market practice of the direct placement of a newly listed company's shares in an initial public offering to professional investors in Hong Kong.

Question (21)

What amount should the minimum portfolio requirement be set at? Please give your reasons.



Pre-sale disclosure of monetary and non-monetary benefits

47. Product issuers of investment products remunerate distributors in a variety of ways, the common ones being initial commission rebate[29], trailer fee/commission[30] and volume benefit[31]. To a lesser extent, some product issuers offer non-monetary benefits (e.g. sponsored overseas conferences) to distributors. It is noted that distributors may make trading profits from the transaction (for example by buying an investment product from a third party and re-selling it to an investor).

48. Some distributors may have incentive to promote investment products that bring higher monetary rewards or benefits to themselves and this creates potential conflicts of interest between them and their clients. In such circumstances, it would be helpful if an investor is aware of the rewards or benefits received by the distributor, among other factors, in order to make an informed investment decision.

49. Potential conflicts of interest also arise for some distributors whose related companies are product issuers, as these distributors may be inclined to promote in-house products to clients.

50. Such issues are generally addressed by existing requirements in the Code of Conduct which provide that an intermediary should

    (a) act in the best interests of its clients (GP 1);

    (b) try to avoid conflicts of interest, and when they cannot be avoided, should ensure that clients are fairly treated (GP 6); and

    (c) not advise or deal in relation to a transaction for which it has an actual or potential conflict of interest unless it has disclosed that material interest or conflict to the client and it has taken all reasonable steps to ensure fair treatment of the client (paragraph 10.1).

    Moreover, under paragraph 2.2 of the Code of Conduct, any mark-ups or fees affecting a client should be fair and reasonable in the circumstances and be characterized by good faith.

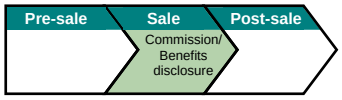
51. In order to further mitigate the abovementioned conflict of interest issues and enhance transparency, under paragraph 31.6 of the FS Report:

    "We recommended that the Commission reviews requirements for comprehensive disclosure to clients at the pre-sale stage of commissions, fees and other benefits the Intermediary receives from the sale of product that it recommends or is offering to clients."

[29] An initial commission rebate is a payment made by a product issuer to a distributor at the deal closing stage in recognition of the distributor placing an investor's investment with the product issuer.

[30] A trailer fee/commission is an ongoing payment made by a product issuer to a distributor as long as the client holds the investment with the product issuer.

[31] A volume benefit is an additional reward given by a product issuer to a distributor or the group of companies in which the distributor is a member based on the sales volume in a particular product or a range of products. Depending on the structure of the volume benefit, it may not be possible to attribute the volume benefit to any particular product.



52. Reference has been made to the disclosure of benefits requirements of the UK, the US, Australia and Singapore. Currently, all these jurisdictions have rules requiring pre-sale disclosure in varying degrees whereby regulated firms (or any of their related companies in the case of the UK and Australia) are required to disclose to investors the monetary and non-monetary benefits receivable by these firms in relation to the provision of services to investors. The extent of the required disclosure varies, as can be seen in Appendix D which sets out a broad comparison of the requirements in various jurisdictions. In this regard, the Commission notes that the UK has recently issued a consultation proposing to ban product providers from offering commission to secure sales from adviser firms[32]. The Commission will continue to closely monitor international developments.

Proposal

53. The Commission has identified various business models whereby an intermediary or its associates receive or will receive benefits from providing a service. Where the monetary benefits are quantifiable (e.g. initial commission rebate) prior to or at the point of sale, there are various disclosure options which are discussed below.

54. In relation to non-monetary benefits and some monetary benefits which are not quantifiable prior to or at the point of sale, a distributor would only be required to make generic disclosure of the existence and nature of each benefit.

55. All the proposed disclosures are to be made to investors, prior to or at the point of sale, in a document called a "Sales Disclosure Document", which is covered in the section on "Sales Disclosure Document" of this consultation paper.

56. For the avoidance of doubt, this disclosure only applies to the benefits receivable at the institutional level and therefore disclosure of the benefits receivable by the sales staff is not required. Furthermore, this disclosure would not apply to situations where the intermediaries are remunerated directly by the clients for executing trades.

Business model 1 – Where a distributor distributes a product and it or any of its associates explicitly receives monetary benefits from that product issuer (directly or indirectly)

The following three disclosure options are identified:

Option 1.1 – Specific disclosure of dollar amount or percentage

57. Under this option, a distributor would disclose the monetary benefits that are receivable by it and/or any of its associates in dollar amount or a precise percentage of the investment amount.

[32] FSA consultation on "Distribution of retail investments: Delivering the RDR" (June 2009)

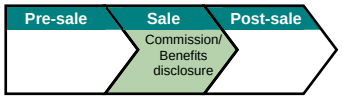


Illustration A1 - A distributor is engaged in distributing a product which requires an investor to pay 5% in subscription fees for an investment amount of HK$100. The product issuer splits the subscription fee 50:50 between itself and the distributor. Therefore, the commission rebate paid by the product issuer to the distributor is 2.5% (or HK$ 2.5). Option 1.1 would require the distributor to disclose to the investor the receipt of HK$ 2.5 or 2.5% of the investment amount.

58. During the soft consultation, some market practitioners expressed concern that this option would reveal sensitive commercial information but others were supportive on the premise that this disclosure option provides the most relevant and easily understandable information to investors.

Option 1.2 – Specific disclosure of percentage band or ceiling (i.e. "x% to y%" or "up to y%")

59. Under this option, a distributor would disclose the monetary benefits that are receivable by it and/or any of its associates in percentage band or ceiling of the investment amount. Some market practitioners consulted have specifically suggested the Commission to standardise the percentage bands.

Illustration A2 - Following on from Illustration A1, Option 1.2 requires the distributor to disclose the commission rebate in the form of (i) a percentage band (say, "2% to 3% of the investment amount") or (ii) percentage ceiling (say, "up to 3% of the investment amount").

60. This option should provide investors with some useful information regarding how the distributor is being rewarded without revealing the same level of sensitive commercial information as Option 1.1. However, the percentage band or percentage ceiling should not be too large or too high or otherwise the disclosure may not be meaningful.

Option 1.3 – Generic disclosure

61. Under this option, a distributor would simply make a generic disclosure of the existence and nature of each of the monetary benefits and where possible, the method of calculating each benefit.

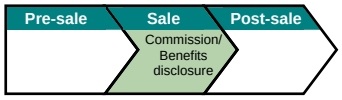
Question (22)

Where a distributor and/or any of its associates explicitly receives or will receive monetary benefits from a product issuer (directly or indirectly), which of the following three disclosure options would be more appropriate? Please explain your views.

Option 1.1 – Disclosure of dollar amount or percentage
Option 1.2 – Disclosure of percentage bands or ceiling (i.e. "x% to y%" or "up to y%)
Option 1.3 – Generic disclosure

Question (23)

Do you have any suggestions as to how the percentage bands referred to in Question 22 should be set (e.g. up to 1%, over 1% to 2%, etc)?



Business model 2 – Where a distributor does not explicitly receive any monetary benefits for distributing an investment product issued by itself or any of its associates

Option 2.1 – Specific disclosure

The distributor would have to determine the distribution reward in the following manner:

Determining benefits - where the distributor is able to ascertain the external distribution reward

62. A distributor of an in-house[33] product would ascertain how much an external distributing firm in Hong Kong is paid for distributing the same or similar product, and whether that external distributing firm is having more or less the same set of circumstances as the distributor such that this arms-length external distribution reward is a good approximation of what the distributor would reasonably expect to receive as its own product distribution reward.

63. The arms-length product distribution reward that an external distributing intermediary receives, with any reasonable adjustment necessary to reflect the distributor's own particular circumstances, would then be disclosed by the distributor to the investor in terms of precise dollar amount, percentage, percentage band or percentage ceiling together with a description of the methodology used.

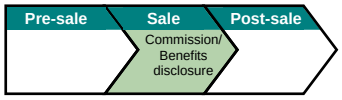
> Illustration B1 – A distributor is engaged in distributing an in-house product and the investment amount is HK$100. The product issuer pays an external distributing intermediary (in comparable circumstances as the distributor within the group) 2.5% of the investment amount for distributing the same product. Under Option 2.1, the distributor would be required to disclose (i) HK$ 2.5 or 2.5% of the investment amount; (ii) 2% to 3% of the investment amount; or (iii) up to 3% of the investment amount.

Determining benefits – where the distributor is unable to ascertain the external distribution reward

64. Where the external distribution reward cannot be ascertained, the distributor would have to estimate how much it should charge for the service it provides with a view to recovering its costs and making a profit. This approach is based on the premise that any distributor, when negotiating with a third party product issuer about the distribution reward, would seek to recover its costs and earn a target profit.

> Illustration B2 – A distributor is allocated an overhead expense of HK$870 for the year to be recovered from its service. Its senior management has a budgeted profit margin of 15% (or HK$130). The distributor should therefore seek a total product distribution reward of HK$1,000 (being HK$870 (cost) + HK$130 (profit). Total sales have been budgeted at HK$30,000. For a product with an investment amount of HK100, the product distribution reward should be [HK$100 ÷HK$30,000] x HK$1,000 = HK$3.3.

[33] An in-house product is a product issued by an intermediary or its associate



Under Option 2.1, the distributor would be required to disclose (i) HK$3.3 or 3.3% of the investment amount; (ii) 3% to 4% of the investment amount; or (iii) up to 4% of the investment amount.

65. The Commission recognizes that this approach will entail higher compliance costs and any internal allocation and budgeting is likely to be subjective. On that basis, it may be difficult for investors to compare products and distribution channels on a like-with-like basis.

Option 2.2 – Generic disclosure

66. In circumstances where the investment product is issued by an associate of the distributor, the distributor would make a generic disclosure stating that while it does not explicitly receive any benefits in distributing the investment product, the associate will benefit from the origination and distribution of the product. This disclosure obligation would also apply when the product issuer and distributor are the same company.

Question (24)

Where a distributor does not explicitly receive any benefits for distributing an investment product, which of the following disclosure options would be more appropriate? Please explain your views.

Option 2.1 – Specific disclosure of distribution reward
Option 2.2 – Generic disclosure

Business model 3 – Where a distributor makes a trading profit from a transaction

67. Where a distributor sources the product externally and re-sells the product to the investor (i.e. a back-to-back transaction) and makes a profit, the distributor should disclose to the investor the profit to be made. This trading profit, to some extent, is similar to the commission that may otherwise be generated from the same transaction and therefore should be disclosed under the same principle.

68. Although, conceptually, a distributor should also disclose the trading profit where it sources the investment product from its own inventory, there are market concerns that distributors may have acquired the investment product at a different time and price and/or have different cost allocation policies and procedures. Investors will therefore not be able to compare costs on a like-with-like basis and as such, disclosure of the trading profit should not be required in such circumstances.

The distributor should disclose to the investor the profit to be made in the back-to-back transaction using either of the disclosure options outlined below.

Option 3.1 – Specific disclosure of trading profit

69. Under this option, a distributor would have to disclose the profit from the transaction in a dollar amount, percentage, percentage band or percentage ceiling together with a description of the methodology used.

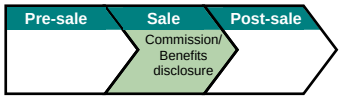


Illustration C1 – A distributor externally sources a product for a client at a price of HK$100 and the client agrees to purchase this at a price of HK$105. The distributor thus makes a profit of HK$5.

Option 3.1 requires the distributor to disclose to the investor (i) the profit of HK$5 or 5% (ii) 4% to 5% of the investor's investment amount, or (iii) up to 5% of the investor's investment amount.

70. Many of the market practitioners consulted claim that this option would reveal sensitive commercial information such as the distributor's bargaining power for securing the product from external sources. In addition, many risk or cost factors such as counterparty credit risk, financing cost etc. have not been reflected, so that the mere disclosure of trading profit may overstate the profit made by the intermediary in a back-to-back transaction.

Option 3.2 – Generic disclosure

71. Under this option, a distributor would disclose to a client that it is making a trading profit without disclosing further details. This option may provide a practical solution to address market concerns as explained in the above paragraph.

72. Consideration may also be given to the view that distributors should disclose trading profits only where the transaction results directly from recommendations or solicitations made to clients, as this would give rise to potential or perceived conflicts of interest.

Question (25)

Where a distributor makes a trading profit from a back-to-back transaction, which of the following disclosure options would be more appropriate? Please explain your views.

Option 3.1 – Disclosure of specific trading profit
Option 3.2 – Generic disclosure

73. The Commission aims to provide investors with additional information regarding the remuneration structure of distributors to help investors make informed investment decisions. The specific disclosure option for all three business models above would best meet this objective, although the Commission is mindful of the operational issues, costs and disclosure of sensitive commercial information that may arise with this disclosure option. The Commission, therefore, seeks market views as to how disclosure of remuneration should be made in these circumstances.

74. See the draft amendments to the Code of Conduct in Appendix C to this consultation paper.

Use of gifts by distributors in promoting a specific investment product

75. The HKMA noted that in the marketing of some Lehman retail investment products, "gifts" having monetary value such as supermarket gift coupons, audio-visual equipment and the like were offered to investors. The HKMA pointed out that consideration should be given to restrict the use of gifts as a marketing tool to promote financial products to investors.

76. In this consultation paper, the focus is on whether distributors should be subject to similar restrictions from offering certain types of gifts when marketing investment products to investors.

77. In Singapore, while the MAS does not restrict the offering of gifts to clients for conclusion of a sale, it considers it good practice for financial institutions to have proper systems and controls to ensure that the basis for any recommendation is not compromised as a result of offering gifts.

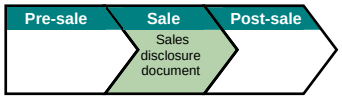
78. Such a restriction may help prevent investors, particularly unsophisticated investors, from being distracted by the gifts without paying sufficient attention to the features of the investment product.

79. Market practitioners who were soft consulted on this issue took the view that corporate gifts with low resale values should be allowed and added that discount of fees and charges for substantial purchases/transactions should also be allowed as it will reduce investors' initial investment outlay or offset future transaction costs or fees and thus benefit investors. Intermediaries should, however, refrain from pricing the discount of fees and charges into the products.

80. See the draft amendment to the Code of Conduct in Appendix C.

Question (26)

Do you consider it appropriate to restrict distributors from offering investors supermarket gift coupons, audio visual equipment and other kinds of gifts having monetary value (except discount of fees and charges) in promoting a specific investment product to investors?



Sales disclosure document

81. The HKMA recommended that consideration be given to require distributing institutions to produce Sales Key Facts Statements in uniform disclosure formats in respect of retail investment products. This consultation paper further discusses the pre-sale disclosure of monetary and non-monetary benefits to investors to enhance transparency.

82. Current regulations require a distributor to make adequate disclosure of relevant material information in its dealings with its clients. For example, where distributors only recommend investment products which are issued by their related companies, they should disclose this limited availability of products to each client.

83. In relation to this type of pre-sale disclosure, other jurisdictions such as the UK, the US, Australia and Singapore have rules in varying degrees requiring disclosure to investors in written form. The Commission therefore seeks views on whether a distributor distributing an investment product should disclose in writing certain information material to the sales process to an investor, in a Sales Disclosure Document, which would be delivered to the investor prior to or at the point of sale.

Proposal

84. Although the HKMA's proposal covers all retail investment products, in practice, investors in listed products are currently being provided with information regarding the nature of the services and basis of remuneration at the account opening stage and in the client agreement and the contract note for each transaction. Hence, it appears that the Sales Disclosure Document proposal would only apply to unlisted investment products. The Commission would like to seek views on this.

85. In circumstances where delivering a Sales Disclosure Document is not possible before a transaction is concluded (e.g. telesales for a time-critical investment), the distributor should make a verbal disclosure and deliver the Sales Disclosure Document to the investor as soon as practicable after the conclusion of the transaction.

86. Regarding the information content of the Sales Disclosure Document, the following information would be included at a minimum:

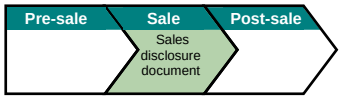
(a) The capacity (principal or agent) in which a distributor is acting;

(b) Affiliation of the distributor with the product issuer;

(c) Disclosure of monetary and non-monetary benefits (*For proposed disclosure options, please refer to the section on "Pre-sale disclosure of monetary and non-monetary benefits" of this consultation paper)*; and

(d) Terms and conditions in generic terms under which an investor may receive a discount of fees and charges from a distributor.

87. Some market practitioners indicated during soft consultations that if there is significant support for generic disclosure of the monetary and non-monetary benefits as set out in the relevant section in this paper, it may then be possible for the proposed disclosure in the Sales Disclosure Document to be made during the account opening stage.



Otherwise, such disclosure should be made during the selling process.

88. A Sales Disclosure Document should be in Chinese or English according to the language preference of an investor.

89. See the draft amendments to the Code of Conduct in Appendix C.

Question (27)

Do you have any comments on the proposed information content of the Sales Disclosure Document which includes (a) capacity (principal or agent); (b) affiliation with product issuer; (c) monetary and non-monetary benefits; and (d) discount of fees and charges available to investors?

Audio recording

90. The HKMA Report proposed, among others, a mandatory requirement for registered institutions to audio record their customer risk profiling process and investment selling process (including where there are risk mismatches between clients' risk profiles and product risk ratings). This audio recording requirement applies to the sales of investment products, and the audio records should be kept for seven years.

91. On 25 March 2009, the HKMA issued a circular to all authorized institutions requiring them to implement the above audio recording requirements effective from July 2009. Notwithstanding this, due to the unique operating mode of private banking business, certain flexibility may be allowed on the application of this requirement for the private banking sector.

92. In overseas jurisdictions such as the UK, the US, Australia and Singapore, audio recording of the risk profiling or sales process is required under specified circumstances. For example, in Singapore, audio recording is generally not mandatory but is required in carrying out treasury activities relating to investment products, such as interest rate swaps and forward rate notes. In the US, FINRA only requires those member firms that employ 5 or more staff who have previously been subject to disciplinary actions to implement audio recording. In Australia, audio recording is regarded as an alternative to recording of advice in writing.

93. The Securities and Futures (Keeping of Records) Rules set out a broad requirement in that intermediaries would need to retain such records that are sufficient to explain and reflect the financial position and operation of their business. In addition, the Code of Conduct requires an intermediary to use a telephone recording system to record order instructions received from clients over the telephone and maintain those records for 3 months. Furthermore, under the Internal Control Guidelines and Suitability FAQs, intermediaries are requested to document and record contemporaneously the information given to each client and the rationale for recommendations given to the client, including any material queries raised by the client and the responses given by the intermediary. A copy of the basis of the investment recommendations should also be provided by the intermediary to its client.

94. On one hand, a mandatory audio recording requirement would provide a useful audit trail, particularly when a post sale dispute arises. On the other hand, such a requirement would increase compliance costs for firms. Implementation of the audio recording requirement would generally entail the installation of a specialized recording and retrieval system and additional storage space for the recorded data. There might also be a need to change the business infrastructure to enable proper recording of conversations or discussions between clients and frontline staff.

95. In addition, experienced investors who had bought similar products before might consider this arrangement to be inconvenient and time-consuming. In this regard, consideration should be given as to how the benefits of a mandatory audio recording requirement are balanced against the additional costs to firms and inconvenience to investors.

96. We understand from discussion with a fellow regulator that given the different nature of operations of different types of intermediaries, mandatory audio recording may be more preferable for intermediaries with operations in which a wide range of investment products (from relatively simple to highly complex) are offered to a large and diverse

client base (particularly with high proportion of inexperienced customers who have little knowledge in investment products), as this could offer enhanced investor protection to the customers concerned. Audio recording would be a better measure to ensure uniformity, appropriateness and due compliance with regulatory standards in this kind of operational environment.

97. In view of the HKMA's current requirements, public views are sought as to whether the audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current SFC record keeping requirements are sufficient.

Question (28)

Do you think audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current record keeping requirements are sufficient? If audio recording is made mandatory, how long do you think these audio records should be kept for? Please explain your views.

List of consultation questions in Part III

Question (18) Do you agree that some of the proposals in this part of the consultation paper should only apply to unlisted investment products? Please explain your views.

Question (19) Do you think that intermediaries should, as part of their "know your client" procedures, seek clients' information about their knowledge of derivatives and characterize those clients (other those professional investors) with such knowledge as "clients with derivative knowledge" to assist intermediaries in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable?

Please give your views on the contents of the proposed measures for intermediaries to assess whether investors have knowledge of derivatives.

Question (20) Should a high net worth investor be considered to have specific knowledge and expertise if:

(a) he is currently working, or has previously worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or

(b) he has undergone training or studied courses which are related to the relevant product?

Do you have any other suggestions?

Question (21) What amount should the minimum portfolio requirement be set at? Please give your reasons.

Question (22) Where a distributor and/or any of its associates explicitly receives or will receive monetary benefits from a product issuer (directly or indirectly), which of the following three disclosure options would be more appropriate? Please explain your views.

Option 1.1 – Disclosure of dollar amount or percentage
Option 1.2 – Disclosure of percentage bands or ceiling (i.e. "x% to y%" or "up to y%)
Option 1.3 – Generic disclosure

Question (23) Do you have any suggestions as to how the percentage bands referred to in Question 22 should be set (e.g. up to 1%, over 1% to 2%, etc)?

Question (24) Where a distributor does not explicitly receive any monetary benefits for distributing an investment product, which of the following disclosure options would be more appropriate? Please explain your views.

Option 2.1 – Specific disclosure of distribution reward
Option 2.2 – Generic disclosure

Question (25) Where a distributor makes a trading profit from a back-to-back transaction, which of the following disclosure options would be more appropriate? Please explain your views.

Option 3.1 – Disclosure of specific trading profit
Option 3.2 – Generic disclosure

Question (26) Do you consider it appropriate to restrict distributors from offering investors supermarket gift coupons, audio visual equipment and other kinds of gifts having monetary value (except discount of fees and charges) in promoting a specific investment product to investors?

Question (27) Do you have any comments on the proposed information content of the Sales Disclosure Document which includes (a) capacity (principal or agent); (b) affiliation with product issuer; (c) monetary and non-monetary benefits; and (d) discount of fees and charges available to investors?

Question (28) Do you think audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current record keeping requirements are sufficient? If audio recording is made mandatory, how long do you think these audio records should be kept for? Please explain your views.