MESSAGE

To: consult/SFC@SFC CEOO Ext :
cc:

From: HKIFA <hkifa@hkifa.org.hk>
Date: 31/12/2009 11:57 AM

Subject: HKIFA submission on SFC's Consultation Paper on Proposals to Enhance Protection for the Investing Public

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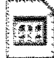
Dear Sir/madam

Attached please find a copy of the HKIFA submission on SFC's Consultation Paper on Proposals to Enhance Protection for the Investing Public sent to the SFC for your information.

The hardcopy has been sent to you as well.

Thanks and regards,
Eric So
Manager
Hong Kong Investment Funds Association

Appendix 1 - HKIFA Submission_SFC consultation paper 2009 _30Dec09_.pdf



Appendix 2 - Members' feedback re SFC consultation paper 2009 _30Dec09_.pdf

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Hong Kong Investment Funds Association
1505 Tak Shing House, 20 Des Voeux Road Central, Hong Kong
Tel: (852) 2537 9912 Fax: (852) 2877 8827, 2877 2368
Website: http://www.hkifa.org.hk E-mail: hkifa@hkifa.org.hk

December 30, 2009

Securities and Futures Commission
8th Floor, Chater House
8 Connaught Road Central
Hong Kong

Attention: Consultation on proposals to enhance protection for the investing public

Dear Sir/Madam

Re: SFC's Consultation on proposals to enhance protection for the investing public

On behalf of the Hong Kong Investment Funds Association ("HKIFA"), I would like to express our support to the SFC for this major exercise to further bolster the regulatory framework, with the ultimate goal to enhance protection for the investing public in Hong Kong. In general, we believe that most of the initiatives proposed not only ensure that Hong Kong adopts international best practices, but also accord fund managers sufficient flexibility to be able to utilize the state-of-art international investment practices.

With this background, we have prepared two papers, which lay out our views/comments as to what we think are the optimal ways to achieve the outcomes: Appendix 1 provides consensual comments consolidated from the industry and states the stance of the HKIFA on key issues; while Appendix 2 includes a list of questions raised by our members on the various proposals for clarification purposes.

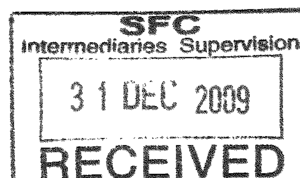
Our starting premise is to look at how we could ensure that investor interests are being looked after and most importantly, to strike an appropriate balance between investor protection and industry development, which ultimately will be in the interests of investors.

We believe that a robust and pragmatic regulatory framework is vital to ensuring the vibrancy and competitiveness of Hong Kong as an asset management centre. We are committed to working closely with the SFC to achieve this outcome.

If you wish to discuss this further, please do not hesitate to contact me on 2537 9912.

Yours sincerely,

Desmond Ng
Chairman



Hong Kong Investment Funds Association

Appendix 1

SFC's Consultation Paper on Proposals to Enhance Protection for the Investing Public ("CP") – Submission by HKIFA

(A) Overarching Principles Section of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products ("Handbook")

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

(1) Products Advisory Committee

We welcome the initiative to further streamline the authorization process by converting the Products Advisory Committee into one that is purely advisory in nature and will cover all functionally substitutable products. But we believe it is important that there is full transparency about the committee representation, its selection criteria and tenure, its "terms of reference", its process, the outcome of its deliberations and how it will interact with the respective department(s) of the SFC. Also, as this would replace the existing Unit Trust Committee, this effectively means taking away a "product approval" vehicle and vest greater power with the respective SFC department(s) – the question is whether there will be some check and balance mechanisms? Also, will there be a process to provide room for "innovation", e.g. to approve "new products" on an exceptional basis?

(2) Selection of distributors

We note the proposed new paragraph 5.3 of the Overarching Principles Section imposes an obligation on Product Providers to exercise due care in the selection of distributors "having regard to whether such distributor is suitably qualified and competent to discharge its obligations properly". If this provision is intended to impose an obligation which goes beyond checking that a distributor has the necessary licence and is provided with adequate information regarding the relevant product, we do not believe it is appropriate for generic products. A distributor has to demonstrate that it is fit and proper in order to obtain a licence. This process includes an examination of the experience, qualifications and competence of the licensee. The SFC has the power to conduct inspections to satisfy itself that licensed persons remain fit and proper.

We believe that this should at best be appropriate for structured products, ILAS schemes, and certain specialised schemes such as hedge funds, that training be provided to distributors with regard to the specific features and risks of the product to enhance the distributor's understanding of the product.

(3) Other important principles

While we recognize that additional disclosure will be required for all funds (whether UCITS or non-UCITS), we exhort the SFC to continue to allow UCITS funds to be managed in accordance with UCITS regulations to foster industry development.

Also, we believe that the SFC and other relevant authorities should continue to embrace the concept that investors have an inherent responsibility to understand what they are investing in. We believe it is important that the SFC continues to work with the relevant industry participants to manage investors' expectations, i.e. the events in the fourth quarter of 2008 are exceptional cases rather than the norm and investors cannot expect compensation every time an investment does not work out.

Last but not least, there are concerns that there are some potential discrepancies between the ones prescribed by the SFC and the ones mandated by the Hong Kong Monetary Authority. It would be useful if relevant authorities can form a working group inviting representatives from the industry associations (including manufacturers as well as distributors) to work out the specifics so as to ensure that the rules released are workable and implemented in a mutually acceptable timeframe.

(B) Revised Code on Unit Trusts and Mutual Funds ("UT Code")

(1) Approach of Chapter 8.8 - structured funds

Question (11): In relation to proposals regarding investment activities set out in Proposal 1 (structured funds), Proposal 2 (funds that invest in financial derivative instruments – "FDI") and Proposal 3 (investments in other schemes), other than the proposed general requirements, what other requirements do you think should be included? Please explain your views.

While we applaud the initiative to add a new chapter to provide clarity on structured funds, we believe that the draft as it stands needs a lot of fine-tuning so as to provide clarity to the industry re the definition of "structured funds", the application of Chapter 8.8 and how it cross-references with other chapters.

In fact, based on the definition specified in the draft (see below paragraph), we have tried to apply Chapter 8.8 to different scenarios. We wish to seek SFC's confirmation as to whether our understanding is correct or not. We believe that through these examples, the industry can have a better understanding of how the SFC interprets this chapter.

"Funds which state at the outset that the funds will invest substantially all of their assets in a portfolio of derivatives or even a single derivative instrument which will not be actively managed (i.e. the derivatives are purchased upfront and will stay largely unchanged over the life of the fund except as necessary to meet redemption requests) and will expose the funds to significant counterparty risks."

- We presume that Chapter 8.8 will not apply to active UCITS III funds such as fixed income funds which commonly make substantial use of derivatives as part of an active investment strategy.
- As a general principle, all UCITS III funds can invest up to 100% in FDIs but may not actually do so. Our interpretation is that UCITS III funds with flexibility to invest up to 100% in FDI will not automatically be regarded as "structured funds" for the purposes of Chapter 8.8. It is only when funds (UCITS III or not) which fall in the following categories will be grouped under this category – is our understanding correct?
  - A guaranteed fund, under which 90% of the capital is guaranteed by a guarantor. The investment objective is to give an investment exposure to an index through a swap with a counterparty pursuant to which an investor may participate in a leveraged exposure to the index growth of up to a capped return. If substantially all the assets of the fund are invested in the swap, we expect that such a fund would fall within Chapters 8.5 and 8.8 and Chapter 7 would not apply.
  - A fund whose investment objective is to track the performance of an index comprising stocks from an emerging market. If the fund cannot invest directly in the constituent stocks and needs to achieve the investment objective through participation instruments issued by a 3rd party issuer, we would expect the fund to fall within Chapter 8.9 (if it is not a UCITS). But Chapter 8.6(b)(iii) states that an index fund may seek to track an index by "synthetic replication through the use of financial derivative instruments to replicate the index performance". So if Chapter

8.6 applies, will Chapter 8.9 (if non-UCITS) and Chapter 8.8 (if UCITS) also be applied?
- Similar to the above example, except that the fund achieves its investment objective through a collateralised swap with a counterparty. We would expect the fund to fall within Chapter 8.8.
- A guaranteed fund which invests most of its assets in zero coupon bonds and the balance in derivatives to gain exposure - we would expect the fund to fall within Chapter 8.5 and Chapter 7 or Chapter 8.9, but not Chapter 8.8.

- We also note that the revised Code proposes to grandfather existing SFC-authorized guaranteed funds that are no longer open for new subscriptions, as any change to the structure of these funds could adversely affect the availability or terms of the guarantees currently supporting these funds. Does it imply that the Chapter 8.8 requirements will apply to new guaranteed funds going-forward if the structure of the guaranteed fund falls within the definition of "Structured Funds"? If that is the case, why would "collateral" still be necessary when the fund already provides a hard guarantee?

(2) Bilingual annual reports

Question (12): In relation to the disclosure and reporting requirements set out in Proposal 4 (bilingual annual reports) and Proposal 5 (Product KFS), do you agree with the proposals? Please explain your views

We note from the proposal in paragraphs 161 and 188 of the CP that the publication of a Chinese language annual report is voluntary for SFC-authorized schemes that are RJSs, provided that distributors of such schemes marketed to the public in Hong Kong would take steps to make investors aware that the annual reports would only be available in English. We support this pragmatic proposal and hope that Chapter 11.6 of the UT Code would be updated to reflect such proposal.

However, we believe that there should be a level playing field between RJS and non-RJS funds. And thus, this optional arrangement should be made available for non-RJS funds as well. We believe that this is a commercial decision and should be best left with the product manufacturers - this is a part of the service offering and the manufacturer should be in the best position to determine whether it needs to provide a Chinese report, based on their assessment of the needs of the target client segments as well as the competitive landscape.

Besides, to avoid double regulation, it seems appropriate to further clarify that Chapter 11.6 requirements do not apply to collective investment schemes that fall under the MPF regime as there are separate accounting, auditing and reporting requirements for MPF products.

However, if the SFC maintains that it is a must for non-RJS funds to provide Chinese annual reports, there should be a relaxation in the time limit of four months after the date of which the financial statements relates to allow time for translation and printing. We believe that at the earliest, the Chinese statements can only be distributed a few weeks after that for the English version. Also, we believe that only a summary Chinese translation should suffice. HKIFA would be ready to come up with a proposed template for the Chinese summary.

(3) Key Fact Statement ("KFS")

Question (12): In relation to the disclosure and reporting requirements set out in Proposal 4 (bilingual annual reports) and Proposal 5 (Product KFS), do you agree with the proposals? Please explain your views

HKIFA supports the proposal of KFS and believes that it is an important tool to empower potential investors.

We also believe that to achieve the outcome of producing upfront a document that is user-friendly, the document should be short, concise and succinct. However, the proposal as outlined in the CP may not necessarily achieve this outcome and we believe that improvement can be made.

(a) ***Allow the KFS to be distributed at the point of sale as a separate document***

Under the SFC's proposal, the KFS will form part of the offering document ("OD"). We would like to exhort SFC to consider adopting the following approach -

Allow the flexibility of treating the KFS as separate from the offering documents. At the point of sale, manufacturers/distributors will be required to:

- Provide the KFS to potential investors and remind them that they have to read through the KFS and understand all details;
- Remind potential investors not to make their investment decision based on this document alone, and are strongly recommended to read in conjunction with the OD prior to investing; and
- Clearly explain to potential investors that the OD is readily available (provide a hard copy on the spot and electronic or other formats, such as website, information for further reference).

At the point of sale, the potential investors will be asked to confirm that they are aware of this arrangement. Also, if the investors, having been offered the OD, do not wish to retain it, they can sign to confirm to this effect.

We believe that this is the most investor-friendly option, and will be the optimal solution to remove a key psychological barrier – too much information overfed upfront to investors. To better ascertain the needs of investors, we strongly encourage the SFC to conduct a customer survey to test out this approach vs. the ones outlined in the CP.

Having said that, we understand there are concerns that providers/distributors can disclaim their liabilities if the KFS does not form part of the OD. However, we believe that this concern is probably unfounded: we do not believe that a provider can contract out its liabilities, and in any event, the KFS will not contain any disclaimers; issuing the KFS would carry the same liabilities as any other materials provided to clients.

In addition, in order to eliminate any concern the SFC may have on the KFS in regard to the contents, we propose the SFC to specify in the Code that the KFS is required to be reviewed and approved by the SFC prior to its issuance, i.e., pre-vetting. The SFC can apply the same principles in the Advertising Guidelines ("AG") to conduct the pre-vetting. Of course, the SFC may consider allowing certain information can be exempted from the pre-vetting requirement, such as performance.

Also, one should be mindful of the unique characteristics of the Hong Kong fund market. Over 95% of authorized funds are offshore funds. If the KFS forms part of the OD, this would have issues for offshore funds since the KFS has to be submitted to the respective home regulators for approval and to ensure fair treatment of all investors.

(b) ***KID should be deemed as acceptable for KFS purposes***

Question (14):
What are your views about the idea of UCITS schemes which have issued KIDs under their own E.U. regulator's regime using those KIDs in place of the Product KFS? The issue here is how we should balance the importance of developing broadly standardized Product KFS across all products sold to the Hong Kong public so that it is easy for Hong Kong investors to understand and compare different products, and the commercial needs of individual fund houses to reduce costs and lessen administrative burdens. Also, if a large number of SFC-authorized funds adopt KIDs instead of Product KFS, it may defeat the purpose of comparability under the Product KFS proposal. The SFC would like to hear your views.

We believe that KID, which will be adopted in Europe, should be deemed as acceptable for KFS purposes. Based on a study of the two pieces of documents, we note that their contents are virtually the same, except for the risk ratings and the performance table. In view of this, we believe that by and large, KID can already fulfill the purpose of KFS.

Taking into account the fact that most offshore funds are UCITS products (according to the list of investment products last updated by SFC on 8 October 2009, out of the 2,094 authorized unit trusts and mutual funds, 1,504 are UCITS III funds.) and that extensive surveys, tests and debates that have been carried out in Europe in the past few years on this initiative, we are of the view that KID already provides a well-tested and sound model for Hong Kong to adopt. It is most cost-effective, and ultimately in the interests of investors. Should the SFC believe that additional information would be required to cater for the specific needs of Hong Kong investors, a covering note for Hong Kong can be added.

Furthermore, as the KID is in the process of finalization, we suggest that the SFC engages the CSER and the key home regulators (e.g. from Ireland, Luxembourg and the UK) to provide input so as to help shape the final output. Hopefully, through this process, we can have a common model that can be used in Europe and Hong Kong.

(c) ***Miscellaneous issues***

In addition, there are a number of operational issues that members have queries with regards to KFS that they wish the SFC to clarify, e.g. does the KFS require SFC's prior approval? If yes, is it only required on the first issue and subsequent material changes only? How about the filing requirements?

Whether other requirements (i.e. other than those relating to performance information) under the Advertising Guidelines or otherwise applicable to fund-specific marketing materials (e.g. those included in the SFC's circulars) need to be met?

(4) Recognized jurisdiction schemes ("RJS")

Question (13):
Do you have any comments on the revisions to the UT Code generally? Please explain your views.

The term "RJS" is mentioned in various chapters in the revised UT Code (such as in Chapter 1, 7, 8 and Appendix E & I). However, as the term has been defined differently in different places under the current UT Code, we believe that this should be rectified in the revised Code. For example, RJS in the context of UCITS III funds only includes Luxembourg, Ireland and UK (per the SFC Interim Measures for UCITS), whereas in Appendix A1 the list of RJS includes more countries. This gives rise to compliance problems, e.g. under the proposed Code, a

chapter 7 fund can invest up to 30% in another CIS provided that such CIS is a RJS or SFC authorized. Which "RJS" jurisdictions does SFC intend to cover in this context?

The issue of regulatory change affecting RJS has been highlighted by the introduction of UCITS III, which causes problems for the industry generally, in particular for funds of funds investing in RJS schemes which were not authorised; upon transition to UCITS III the position was initially taken that such underlying schemes ceased to be RJS and became subject to an aggregate 10% limit which could have required major restructuring of fund of fund portfolios.

To facilitate compliance, we would like to request the SFC to align the definition under the revised Code. For consistency purposes, we believe that a pragmatic approach is to define RJS to include all funds authorised for sale to the public by the regulators of the following jurisdictions:

Jurisdiction	**Regulator**
France	France Autorite des marches financiers ("AMF")
Germany	Bundesanstalt fur Finanzdienstleistungsaufsicht ("BAFin") (German Financial Supervisory Authority)
Guernsey	Guernsey Financial Services Commission
Ireland	The Financial Regulator
Isle of Man	Financial Supervision Commission
Jersey	Jersey Financial Services Commission
Luxembourg	The Commission de Surveillance de Secteur Financier ("CSSF")
United Kingdom	Financial Services Authority ("FSA")
United States of America	Securities and Exchange Commission ("SEC")

More specifically, we believe that the definition of RJS should pertain to the relevant authorities in the respective jurisdictions and products authorised for sale to the public under the laws of that jurisdiction from time to time, instead of a particular piece of legislation or a specific part of the legislation.

This is also relevant for the purposes of the Financial Resources Rules, which permit investments in RJS to be included as an asset of a licensed entity in calculating its financial resources.

In addition, to provide certainty to the industry, we would exhort SFC to provide guidance on which requirements/provisions of the Code must be complied with and/or which are deemed to be in compliance notwithstanding the differences between the Code and the requirements to which the RJS is subject in its domicile; and/or situations where scheme documentation of the RJS may not necessarily explicitly reflect the requirements/provisions. It would be helpful if a checklist can be developed – with one showing the provisions to be complied with; and another one showing the provisions which are deemed to be in compliance. HKIFA would be pleased to offer assistance on this.

Furthermore, if there is a change in the SFC's requirements, it would be important that investment managers be given sufficient notice and time in advance to enable them to, based on the clients' needs, determine whether to de-authorize or to comply with the revised requirements. We believe that this is extremely important because in the past, there were a number of instances where the lack of advanced notice on changes had given rise to dispute regarding non-compliance.

(5) Cross-referencing between the different chapters under the revised UT Code

Question (13): Do you have any comments on the revisions to the UT Code generally? Please explain your views.

We would exhort the SFC to provide guidance regarding the key tests/factors that the SFC takes into consideration when it determines whether a particular chapter applies to a fund. The reasons for raising this is that many members have expressed that there is a lack of certainty as to how the revised Code will apply, especially when a product has features that may cut across different chapters. A common example cited is guaranteed funds - if a fund is authorized as a structured fund and it has a guarantee feature, we presume it has to comply with Chapter 8.5 as well? It should also be made clear that structured funds that provide the performance of a strategy as reflected in an index are not subject to the "Acceptable Indices" requirements in Chapter 8.6 and would only need to comply with the disclosure requirements in Chapter 8.6 (if appropriate).

Also, in some areas, the revised Code has provided express provisions on how to cross-reference and spell out the other applicable chapters or sections. However, in other instances, this has not been the case. For example, Chapters 8.3 (a), 8.5 (a) and 8.6 (h) expressly state that the specialized scheme should also comply with the "core requirements" of Chapter 7, while the other sub-chapters under Chapter 8 do not have this explicit requirement. Does it mean that other specialized schemes without an explicit reference to Chapter 7 do not have to comply with the "core requirements"? Furthermore, what is the meaning of "core requirements"? It would be helpful if the SFC can provide more guidance on the applicability of Chapter 7 provisions on specialized schemes. Moreover, as a general policy, it would be helpful if the SFC can specify its policy on cross-referencing so that the industry can have a better understanding of when investment managers can rely on express statements and when they are expected to comply even there are no explicit provisions.

To facilitate compliance, we propose the SFC to draw up a checklist (say issued through FAQ) on the chapters that each type of fund needs to comply with or seek waivers/exemptions. HKIFA would be pleased to help prepare a draft list.

(6) Implementation period

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

As most of these changes would have implications to all the parties within the value chain – from manufactures to distributors, from back office to front office and even for regulators and the clients, there should be sufficient lead time to allow for smooth implementation. We hope that the SFC can give sufficient time to the industry for preparation as well as an ample period for a smooth roll out of the new requirement. We propose a transition period of 12 months. Some members even suggest that the Long Stop Date should be set by the end of 12 to 18 months from the Effective Date, as opposed to 9 to 12 months as proposed by the SFC in the CP.

With respect to KFS, we suggest it be implemented when KID is introduced for UCITS schemes. Besides, it would be advisable to factor in additional time for investor education. Because ultimately, what is most important is to ensure that there is sufficient time to allow the potential

and existing investors to understand what all these changes entail and how these changes affect their investments and their rights as well as obligations.

(C) Intermediaries conduct

(1) <u>Definition of "unlisted derivatives" for the purposes of segmentation of client base</u>

<u>Question (19):</u>
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.

According to the SFC's proposal, a licensed or registered person should, as part of the know your client procedures, seek each client's knowledge of derivatives and characterize those with such knowledge as "clients with derivative knowledge."

In regard to the definition of "unlisted derivatives" (Part III Page 67-71 of the SFC consultation paper), we believe that all SFC authorized funds (no matter whether the funds use FDIs for hedging, efficient portfolio management or investment purposes) should <u>NOT</u> fall within this definition.

The key reasons are:

- The purpose of investing in a fund is to enable investors to rely on the expertise of the investment manager to manage their assets. In fact, more often than not, it's exactly because fund investors do not have the necessary expertise or knowledge in the underlying instruments or do not have the channel (or a cost-effective channel) to gain exposure to the said instruments or markets that they go through funds. Thus, we do not expect fund investors to have the requisite knowledge of the underlying investment instruments, including derivatives.
- What is most important is that the investment managers have a sound investment management framework and approach (subject to the rules prescribed by the SFC and the home regulators, if applicable) and have a robust risk management control system. In fact, all UCITS funds have to comply with a series of directives issued by CESR and the respective regulators, ranging from risk principles to risk management. In addition, the trustees, which act as the fiduciary of the investors, discharge their responsibilities diligently to monitor the investment activities. As the SFC Code already has detailed provisions for these (on top of the restrictions imposed by the home regulators, if applicable), we believe that these should be more than sufficient to safeguard investor interests. Furthermore, the gist of the problem is to ensure that the distributors have conducted suitability test, and ensure that the products are suitable for the investors. Since the proposed Code has introduced a raft of measures to strengthen the conduct area, we believe that there is already sufficient safeguard to ensure suitability.
- If funds were to be included in the definition of "unlisted derivatives", we are very concerned that this would mean that the framework does not take into account the development of the global investment scene – derivatives have become an integral part of the investment management function - and it is highly likely that many local investors would be denied access to a wide array of products, thus greatly reducing the choices available to the local investing community.

In summary, we believe that it would provide clarity if 'products which can only be promoted to "clients with derivative knowledge"' is defined solely to cover "structured products" which fall under the proposed Structured Products Code. This definition will also ensure a coherent regulatory framework covering "structured products" from both the product and conduct perspectives.

(2) Disclosure of monetary and non-monetary benefits

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 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

In general, we believe the focus should not be on the monetary benefits but on whether a product is suitable for an investor. In disclosing remuneration, there can be a raft of variables (e.g. intra group distribution, spreads in the structured products) which make the information non-comparable across different companies and products would not be of great value to clients. This will be even more so with non-monetary benefits. Further, such overwhelming disclosure of all monetary and non-monetary benefits will become redundant and futile information for the investors, as they will be overwhelmed with the sheer volume of data and more importantly unable to distinguish the relevant information pertinent for their investment decision.

To strike a balance, we suggest it is more appropriate to require intermediaries to first provide the generic disclosure to clients. Upon specific requests from clients, intermediaries should then be required to disclose the ceiling/the distribution reward/trading profit.

In principle, disclosure of benefits to investors to avoid the more obvious conflict of interest scenario is a sensible initiative. As part of a commercial transaction, what cannot be ignored is the differentiated services that each service provider offers. In a highly personalized business where services offered is not a commodity and often hard to quantify, investors must be given the right information and the right amount of this information. The need to do away with hidden benefits is possibly more critical that to highlight the cost investors are known to be paying.

(3) Sales Disclosure Document

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?

Given the new knowledge and expertise requirements to be introduced under Chapter 15.3, we suggest the SFC to consider including Chapter 8.3A as one of the requirements to be waived for professional investors under Chapter 15.5.

From an implementation perspective, we suggest that the SFC provides flexibility to the industry to disclose the different information in different documents such as account opening form rather than in yet another new document for investors. This allows a more seamless implementation and avoids the need for investors to receive yet another document.

(D) Post-sale arrangements

(1) Cooling-off period

Question (29):
Do you believe that a cooling-off period would generally be beneficial for investors, or do you believe that costs associated with its implementation would outweigh the benefits for investors?

We support the SFC's proposal that this mechanism should only be applicable to products where there is no ready (and realistic) secondary market and which have a relatively long lock-up period or heavy early redemption penalties, such as ILAS and structured products. It is reasonable and meaningful for illiquid purchases.

We also agree that products such as authorized funds, which generally have daily liquidity and a ready mechanism for exit, should not be subject to this requirement. Fund investors can easily redeem their units and liquidate their holdings from the management company at NAV. This is also in keeping with international practice. For most funds, a cooling-off period can have the unintended and adverse consequences of promoting short-term and unnecessary trading among investors: it would encourage short-term trading behaviour which would be inconsistent with the long term nature of fund investing. It also gives investors a "subsidised chance" to bet on the market direction. If the market goes up, the investor would not use the cooling-off right (because no upward market value adjustment) but if the market goes down, the speculative investor can redeem, free of any initial/redemption charge. Admittedly, there may be a downward market value adjustment but their exposure to loss is reduced because of the waiver of the initial/redemption charge. Such short-term trading activities would be detrimental to the interests of long-term investors due to the operational, administrative, transitional and other costs involved.

We see huge implications no matter how cooling-off period were to be implemented in the context of authorized funds:

For instance, if a distributor were to put on hold the subscription orders – i.e. delaying the orders to be placed, there would be issues in:

- How to ensure fair trading for all investors, especially as non-HK investors do not have the option to enjoy such cooling-off period?
- There will be interest payments involved as investors would be placing subscription money with the fund houses as deposits. The operational procedures involved with such payment

would create extra administrative costs which would need to be borne by the fund. This would then again raise the issue on fair treatment to non-HK investors as they have to bear part of the costs involved in associate with the cooling-off period which they are not able to enjoy;
- Such introduction would encourage frequent trading and may, to a certain extent, create arbitrage opportunities to investors.

Placing the orders on the subscription day and reversing the trade should the investors decide not to proceed with the investment during the cooling-off period. This would substantially increase the cost to the fund and thus ultimately hurt the interest of investors. Thus, no matter how this mechanism were to be implemented for funds, there would be huge implications that would hurt the interests of investors.

Investors requesting the unwind of the trade should pay for any administrative charges or hedge unwind costs. The costs should not be borne by the fund.

In fact, what we consider important is investor education, i.e. they should be educated that they should assess whether the investment is suitable for them before committing.

(E) Other questions re Intermediaries conduct

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?

We support the proposal which further clarifies whether certain requirements mentioned in Chapter 15.5 of the Code of Conduct should be waived from the investor protection perspective. However, we would appreciate the SFC to clarify on whether the proposed knowledge and expertise requirements are intended to apply separately to the term "professional investor" as defined in the SFO and the rules thereunder. As there are no separate proposals to incorporate the knowledge and expertise requirements into statutory definition of "professional investor", we believe that it is not the intention of the SFC to restrict the scope of the existing exemptions under the SFO for professional investors (such as those set out under sections 103(3)(k), 174(2)(a) and 175(5)(d)).

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

We generally believe that any increase in the minimum portfolio requirement may have the unintended and adverse consequences as outlined in the CP i.e. (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. A more appropriate approach would be to implement the investor characterization proposal for structured products.

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?

We do not support the use of gifts to promote products. But we believe that greater flexibility

should be allowed because after all marketing requires creativity. The use of gifts and special offers are useful to differentiate between different groups of clients. Gifts are also used for brand promotion, relationship building and are common in all retail markets (financial or otherwise). What is more appropriate is to set out certain principles against using gifts as the key focus of promoting products; but not to introduce an outright ban.

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.

We do not have strong objection to audio recording, but believe that there should be certain flexibility, e.g. with the explicit written consent of investors to waive this requirement; or allow intermediaries to provide alternatives which can achieve the same outcome, e.g. if the intermediaries have a Client Relationship Management system with adequate documentation. Also, the retention period of tapes should not be more than 3 years.

Question (31):
Please provide your views on whether, and in what circumstances, you think a window could or should be provided to investors after the date the trade in the relevant product is executed during which an issuer should be required to buy back the product at an investor's request.

We believe that this issue should be addressed by the proposed resolution arrangement involving the financial services ombudsman.

Question (32):
On the basis that a cooling-off period is incorporated in an investment product and a client has exercised his right under the mechanism, do you consider that a distributor should promptly pass on to the client the full amount of refund (including the sales commission) received from the product issuer less a reasonable administrative charge? Please explain your views.

Fund distributors have put in efforts and resources in conducting the sales of the products. They are involved in a legitimate business activity. In the absence of mis-selling, they ought to be remunerated accordingly.

(End)

Questions on the SFC's Consultation Paper on Proposals to Enhance Protection for the Investing Public ("CP") - collected by the HKIFA from its members for discussion purposes

**Please note these questions do not represent the views of the HKIFA nor any HKIFA member other than the member who submitted the particular question on a no-name basis.*

A. Part II of the CP - Products

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

Questions on the Overarching Principles Section of the proposed SFC Handbook:

Section	Questions
Section I – Chapter 3.5	• Chapter 3.5 states "where assets are specifically required by the applicable product code to be held for the benefit of investors, all such assets shall be properly protected." Can SFC clarify what is meant by "all such assets shall be protected"? We believe that a pragmatic and realistic approach in interpreting this is to take into account market practice: For example, certain assets may be held via sub-custodians or through banks and in such cases, the sub-custodian or bank would not provide any ownership rights to such assets. Instead, they would only owe a debt to the account holder.
Section I - Chapter 4.1(c)	• It seems that there are two reporting thresholds under the Product Handbook and the existing Code of Conduct? Under the Product Handbook, it is proposed that the Product Provider shall inform SFC promptly should there be any breach. Under 12.5(a) of the existing Code of Conduct, a licensed or registered person is required to report to SFC any *material* breach, infringement of or non-compliance with any applicable statutory and regulatory requirements. For consistency purposes, we believe a single threshold should be adopted for the reporting requirements, i.e. to report when there are material breaches. The "materiality" test has been adopted by SFC for a long time as reflected in the previous version of the Code of Conduct (e.g. the version dated April 2001). It is also an established practice in the industry. It seems appropriate for the proposed Product Handbook to follow the existing Code of Conduct on the reporting threshold.
Section I – Chapter 5.3	• Can SFC confirm that once product providers have performed the checks (e.g. licenses, size of the distributors sales force, previous experience and/or whether any regulatory investigations in Hong Kong), they have discharged their obligations? • Some members point out that issuers should not need to provide the SFC with the results of their due diligence. Some opine that no on-going monitoring can or will be conducted since this is too onerous. The industry does not have the resources to conduct on-going monitoring. • Some members propose that SFC can apply more "fit and proper" requirements to intermediaries engaged in the sale of private

	placement products as these products may possess inherent risks with different disclosure requirements that are not overseen by the regulators.
Section I - Chapter 6.11	• Chapter 6.11 states that "Advertisements shall not carry any slogan that is exaggerated or unwarranted or slogan that is inconsistent with or unrelated to the nature and risk and return profile of the product." Can SFC provide any examples to enable the industry to understand more about SFC's expectations?
Section I - Chapter 6.12	• Regarding the use of disclaimers, does SFC only intend to cover disclaimers in the offering documents and product specific advertisements? Can SFC clarify what is meant by "any disclaimer used shall be reasonable"? Can examples be provided? Members expect that providers should still be entitled to disclaim information provided by third parties. For example 8.6 (Index Funds) requires disclosure on the underlying index. This can only be obtained from the index sponsor. The provider has no means of independently verifying the information and the index sponsor has a wide range of disclaimers on its liability which makes it extremely difficult for the fund and its directors to make any claims against the index sponsor. Members also note that the information on such index set out in the offering documents and marketing materials would be the same form of information which is made available to the public by the index sponsor. Therefore, disclaiming liability for information provided by index sponsors and other third parties is reasonable.
Section I - Chapter 7.2	• The issuer of adverts should be the responsibility of a corporate (either the fund house or distributor). Why does SFC wish to specify how the issuer fulfills this responsibility (by designating a person to review the advertisements or not)? The responsible officers of a licensed corporate are already subject to individual liabilities under the existing regime. • Can SFC clarify whether it only intends to allow licensed responsible officers or licensed representatives (and not compliance officers) to be the delegates for reviewing product advertisements by requiring such delegates to be duly authorized to issue such advertisements? Under Part V of the Securities and Futures Ordinance ("SFO"), the issuance of product advertisements would likely fall within one of the regulated activities. However, according to the licensing-related FAQ posted by SFC on 11 May 2009, SFC will normally not license back office staff, including compliance officers and in-house legal counsels. In light of the foregoing, can SFC clarify whether compliance officers would be accepted as the delegates as part of the due review process for advertisements?
Section I - Chapter 7.4	• In practice, fund managers do not have direct contractual relationship with the retail investors. In view of this, is it more realistic to have the obligation of handling enquiries and complaints be imposed on the fund distributors instead of the fund managers?

B. Part II Section 2 of the CP – Key proposals in the revised Code on Unit Trusts and Mutual Funds ("UT Code")

Question (11):

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

Questions on Question 11 and Proposal 1, 2 & 3:

Proposal 1: (Structured funds)	• Can SFC confirm that existing funds would be "grandfathered" and would not be subject to these new requirements? Alternatively, if existing funds will be subject to these new requirements, adequate time should be provided to allow these funds to accommodate such changes. • Can SFC provide more guidance as to whether Chapter 8.8 is intended to cover funds which state at the outset that the funds will invest substantially in a portfolio of derivatives or even a single derivative instrument which will not be actively managed (i.e. the derivatives are purchased upfront and will stay unchanged over the life of the fund) and will expose the funds to significant counterparty risks? Can SFC, as a general principle, elaborate on what constitutes "investing substantially in financial derivative instruments" e.g. in percentage terms (e.g. 5%, 10%?)? • For a CIS which seeks to achieve its investment objective primarily through investing substantially in FDIs (for example swap or market access products or repo agreements or similar arrangements), once it is classified as a structured fund, collateral has to be provided to limit the exposure of the scheme to the counterparty risk of the issuer of FDI when it is more than 10% (page 42, point 135 (c)). How does SFC define "primarily"? How is the "10%" being defined? Under the CSSF circular 07/308, the counterparty risk is sum of ["current replacement cost" and the "potential future credit risk"] multiplied by a weighting factor of 20% (taking the example of credit institutions as counterparties). Is SFC applying the same calculation method as CSSF's, or does SFC simply consider the "current replacement cost" as counterparty risk? The potential difference may cause different requirement of collateral placement. • Can the SFC clarify what does "market access products" cover? Does it include P-notes, ADR/GDR? Would the depository of ADR/GDR be considered as the issuer? Likewise, would the relevant exchange be considered as the issuer of futures contracts and other similar products? • It is not clear whether a fund needs to comply with both Chapter 8.8 and other chapters under Chapter 8 of the UT Code. For example, the chapter for guaranteed fund is largely unchanged, but a new chapter of structured fund is added, which is used to cover funds that "seek to achieve its investment objective primarily through investing substantially in financial derivative instruments". Taking some guaranteed funds launched in the past as examples, sometimes the option element was 3%, but it could be 10 or 15% as well, depending on the structure. Does this mean that a guaranteed fund needs to satisfy both Chapter 8.5 and 8.8? • Can SFC clarify for a UCITS fund falling under the definition of "structured fund", whether the UCITS III Interim Measures (issued

	in March 2005) and the Streamlined Measures for Processing UCITS III schemes with special features (issued in March 2007) will continue to apply besides Chapter 8.8? • For Chapter 8.8, please clarify which provisions of other chapters apply to UCITS schemes? For example, can a UCITS scheme just comply with the accounts requirements of the lead regulator and not Appendix E? Are the additional audit requirements for Luxembourg funds still applicable? • While Chapter 8.9 is intended to regulate non-UCITS funds, is Chapter 8.8 intended to cover both UCITS and non-UCITS "structured funds"? Chapter 8.8 (a) states that "the management company of a structured fund and the issuer of financial derivative instruments shall be independent of each other." What is the definition of "independent"? Can the two entities be members of the same group? Would a bank entity in HK or another bank in the same group which is the issuer of the FDI be considered as independent from the management company of the same financial group? What are the criteria for the SFC to assess whether these entities are independent? It is often the case that both parties – management company and the issuer – may be affiliated companies. We believe that to be practical, different legal entities within the same corporate group should be permitted as long as dealings are conducted on an arm's length basis and "functional independence" is in place. E.g. there is an independent board of directors and/or there are separate legal entities. Reporting lines probably should not be one of the criteria to establish independence since this is an unclear concept. • For Chapter 8.8 (a) (2), can SFC confirm whether indices reflecting an investment strategy would continue to satisfy these new index requirements? • For Chapter 8.8 (b), can SFC clarify whether it expects the directors of the fund be independent from the derivative counterparty of the fund only or whether "independent" means a wider scope? We understand from a SFC seminar that "independent directors" mean independent directors from the FDI counterparties. It will be useful if SFC can spell this out explicitly or else people may interpret that for a fund that is a mutual fund company, the majority of that board of that fund must be directors independent from the fund manager. • Chapter 8.8 (c) states that valuation is conducted independently - independent from whom? The manager or the issuer? In general, the valuation of OTC FDI is undertaken by the trustee or the valuation agent. The current practice is to take the issuers' quote. Whilst this is of course independent from the manager, it is not independent from the issuer. Usually, it is the manager who conducts checking of such valuation but not the valuation agents because they may not have the resources nor the skill set to conduct such valuation checking at all. Also, in respect to 8.8(c), FDIs are usually valued by an in-house valuation team of the FDI issuer (with its own term of reference) separate from the front office team. It maybe in practice impossible for an external party to provide valuation (e.g. in the case of proprietary strategy based products, non-vanilla products). With respect to UCITS funds, the administrator of the UCITS will conduct the valuation of OTC FDI. The current practice is to consider the swap counterparty's quote at which the swap counterparty is ready to reduce or increase the size of the FDI. It is the administrator who conducts a verification of such quote and the administrator can obtain the assistance of the manager to conduct such verification. We expect that this will

	satisfy Chapter 8.8 (c) and would be grateful for SFC's confirmation on this. • Also for Chapter 8.8 (c), should either one or both of the calculation agent/fund administrator have the mark-to-market capability? In general, the calculation agent is engaged by the derivative issuer rather than the fund manager. Fund administrator usually does not have the valuation capability, in particular on derivatives with relatively sophisticated payoff structures. Can SFC confirm the requirements with respect to the fund administrator? For example, what is meant by "a regular basis"? Is it sufficient that this is weekly or must it be daily? • Chapter 8.8 (d) requires collateral to be provided to limit the exposure of the scheme to the counterparty risk of the issuer of financial derivative instruments to no more than 10% of the net asset value of the scheme. This is workable but from a structuring perspective, it is more complicated and expensive. Can the SFC clarify whether the 10% limit is calculated on a per fund basis or per issuer of FDI? • The Note to Chapter 8.8 (d) is a double-edge sword as usually (unless one is only buying options) the collateral arrangement is bilateral, i.e. the counterparty would expect the same legal status for collateral given by the fund - can the fund legally do so? Such collaterals (given to the counterparty) would not be part of the fund's asset under the market standard title transfer collateral arrangements – would the SFC still treat them as part of the fund assets for regulatory purposes? Who has the legal title of the collateral? If the counterparty goes under bankruptcy, the fund may not be able to get its collateral back. Can SFC confirm that the generic market standard opinions would be acceptable (e.g. opinions given by ISDA's lawyers to all ISDA members)? Legal opinions are written at a particular point in time, e.g. at the launch of the product. It will not be practical for product providers to monitor the trust/bankruptcy law of one or more jurisdictions and keep refreshing the legal opinion (which will also be costly to do). The whole point of the risk section of the offer document is to disclose the key risks of the scheme, including country risks (e.g. risk of change in laws and regulations of a particular country) and other risk factors (e.g. risk of trustees'/custodians' bankruptcy resulting in a delay in the return of the funds' assets). The legal advice relating to trust/bankruptcy law should already be embedded in the key risks section of the offer document. Therefore we wish to understand why is there a need to require stand-alone legal opinion? • For 8.8 (e), would the existing practice of allowing portfolio of HK listed stocks be permitted under the new Code? • For 8.8 (e) (i), how is "short settlement cycles" defined? • For Chapter 8.8 (e) (ii), for a fund with weekly dealing/valuation, daily mark-to-market on collateral may not truly reflect the collateral value as % of the exposure. • For Chapter 8.8 (e) (iii), how is "high credit quality" and "high price volatility" defined? • For Chapter 8.8 (e) (iv), the diversification requirement is not clear even with the illustration. For example, a fund is holding 10% GE bond, it has a swap worth 25% of fund NAV with a counterparty which therefore exceed the 10% counterparty limit and the

	counterparty cannot post GE bond as collateral because the 10% is already used by the fund. Is this interpretation correct? But it should be noted that diversification would add to the costs of holding collateral - this would be unduly onerous on UCITS funds which are already subject to collateral diversification requirements in accordance with UCITS Regulations. Furthermore, the UCITS collateral diversification requirements are different from the SFC's Chapter 7 and this would place UCITS funds under two conflicting collateral diversification regimes. • The requirement of Chapter 8.8 (e) (v) is not possible in reality because all financial assets are correlated in some sense. How is correlation defined (e.g. the issuer of the FDI is likely to be a bank, so the issuer of the collateral cannot be a financial institution)? • Re Chapter 8.8 (e) (vi), what constitutes "proper collateral management"? Is the collateral management expected on the manager side or the custodian side (or both)? Can SFC provide guidance on "contingency plan" arrangements? What would the management company be obliged to do? • For Chapter 8.8 (g), percentage breakdowns by asset class and nature and credit rating might not be helpful for investors and would be unnecessarily burdensome. Since collateral will be reviewed daily and disclosure is provided quarterly, such information would become outdated very quickly. It would be more helpful if the prospectus stated the eligible collateral with any credit rating requirements. Will SFC consider alternative methods of publication, e.g. fund fact sheets?
Proposal 2: (Funds that invest in FDI)	• There are concerns re whether the rules and guidelines in Chapter 8.9 provide sufficient guidance and clarity on what is permissible or not and the manner in which risks should be measured and monitored. By way of example, CESR has issued a number of guidelines on eligible assets and on risk management for UCITS. Would SFC develop more robust requirements on this before allowing non-UCITS funds greater flexibility to invest in FDIs on an extensive basis? Besides, it is not clear whether any fund that invests in FDIs need to comply with Chapter 8.9. • Can the SFC clarify whether 1-to-1 P-notes, warrants and other similar instruments which do not have a leverage effect would be considered as "financial derivative instruments"? • The SFC specifies that FDI acquired for hedging purposes will not be counted towards the 100% limit. Is it necessary to spell this out because we assume that any funds falling within Chapter 8.9 should be using FDI for investment purposes and they should not be allowed to net off the holdings held for hedging purposes only? • Chapter 8.9 (a) requires the scheme's global exposure relating to these financial derivative instruments does not exceed 100% of the total net asset value of the scheme. However, UCITS permits up to 200% exposure and therefore, 130/30 funds can be issued under existing UCITS provisions. Will the SFC permit 130/30 funds and other funds which have a 200% exposure? • For Chapter 8.9 (c), is there a checklist/requirement for the risk management procedures that is expected from the management company of a Chapter 8.9 fund? Will the SFC adopt the same requirements of RMP as those for UCITS III funds?

	• Point 146 on page 44 of the CP states that "SFC-licensed management companies must maintain effective risk management systems which are appropriate for and commensurate with the scheme's business strategies, investment activities and risk profile. In the case of non-UCITS schemes managed by overseas managers licensed by regulators based in jurisdictions with regulatory framework comparable to Hong Kong, the overseas managers are subject to the on-going supervision of the overseas regulators." Does the above mean that non-HK based managers are not required to put in place any risk management procedures for the purpose of managing Chapter 8.9 fund? If so, will SFC consider imposing the same requirement on non-HK based fund managers to avoid creating any unlevel playing field? • For Chapter 8.9 (e), will SFC expect any information/documents from the management company to demonstrate that representatives and agents appointed by the management company possess sufficient know-how, expertise and experience in dealing with the underlying investments of the scheme? • For Chapter 8.9 (f) (ii), in order to comply with the requirement that the management company and swap counterparty are independent, the swap counterparty may need to be an affiliate of a substantial financial institution. However, the swap counterparty may be a substantial financial institution itself. Can SFC confirm if this is still acceptable? • Typically, over-the-counter FDIs will not permit to be liquidated during a market disruption event. Therefore, can the requirement under 8.9 (f) (iii) not be applicable to UCITS funds? Or should the whole of 8.9 not apply to UCITS funds? • Chapter 8.9 may be unduly restrictive in respect to permitted underlying and flexibility should be built in so as to permit reference assets as long as they are adequately disclosed. (e.g. there is no reason why listed derivative contract referencing commodities should be excluded). This would limit investor choice. • To ensure the proper operation of UCITS, it is essential that UCITS are not subject to 8.9. To avoid any confusion, members recommend that 8.9 (j) and (k) are either moved to a separate 8.10 or form part of 8.8.
Proposal 3: (Investments in other schemes)	• We support the proposal which further enhances investment flexibility while not compromising investor protection (given the 10% restriction on exposure to non-recognized jurisdiction schemes and non-authorized schemes). It also allows greater flexibility in product design. • Can SFC confirm that in terms of the investment restrictions, there is no need to "see-through" and aggregate the holdings via underlying funds?

	• For Chapter 7.11 and note to 7.17, please clarify the application of the Chapter 7 investment restrictions on underlying schemes? Will listed REITS and other forms of listed closed ended investment companies (such as UK investment trusts) treated as listed securities, and not be subject to the limits on investment in collective investment schemes, save as to provisions to minimise double charging of fees payable to the manager or its associates? • For Chapter 7.12, which jurisdictions will be considered as RJS funds for the purpose of Chapter 7.12 - Ireland, Luxembourg and UK only? (as per the UCITS III Interim Measures) or the full list as in Appendix A1? Also, there is no upper limit of the aggregate investments in underlying schemes by a Hybrid structure specified. Does it mean that investments in other schemes by a Chapter 7 fund can be up to 99%? • Chapter 7.14/7.15 limit fees payable when investing in associated funds do not apply to investments in unauthorised/non-recognised jurisdiction schemes; neither does 7.16 (d) (which applies to feeder funds). Is this the intention? • Can SFC clarify the applicability of Chapter 7.19 in investments in other schemes? This provision does not address the potential conflicts of interest issue which it intends to address in direct investments in stocks.

<u>Question (12)</u>:
In relation to the disclosure and reporting requirements set out in Proposal 4 (bilingual annual reports) and Proposal 5 (Product KFS), do you agree with the proposals? Please explain your views.

Questions on the proposed illustrated templates for Product Key Facts Statements (Appendix B)

Appendix B (Proposed illustrated templates for KFS	• Under "Quick facts": - Should "Dividend" be dividend history or dividend policy? - The KFS will be issued by the fund manager. However, for the minimum investment amount, different distributors may set different minimum investment amount, thus it may not be possible to specify the same. • Under "What is this product?", fund houses are required to state, for RJSs, that "The fund is subject to regulatory requirements which may not be entirely equivalent to those applicable to retail funds domiciled in Hong Kong. Ask your intermediary for more information, if in doubt." Members doubt if intermediaries are in a position to answer questions relating to the differences in the regulatory requirements between Hong Kong domiciled funds and RJSs. Before anyone can provide such information, a full research has to be done to compare the regimes adopted in HK vis-à-vis RJSs. Secondly, over 90% of the public funds authorised in HK are domiciled outside HK. These overseas domiciled funds are reviewed by the SFC and approved by the SFC on the basis that the funds can comply with both the structural and disclosures requirement imposed by the SFC for the purpose of protecting the retail investors. We believe that this statement is confusing to investors and add no value from an investor protection angle. This requirement is onerous and will definitely create burden to the industry and we recommend the SFC to remove this requirement.

- For “Investment mix”, Pie Chart may not be available for new funds.
- Under “What are the key risks?”:
  - Will SFC propose to have the contents of the risk disclosure box in the existing offering document of a fund included in this section?
  - There should be a standardized template for all types of funds and highlight all key risks in the "What are the key risks" box.
- Under “What are the fees and charges?”,
  - Can the custodian fee and administration fee be put together with valuation fee and shown as a single “Trustee Fee”?
  - For ETF, as SEHK’s charges for trading ETF are pretty transparent, we suggest to confine this section to charges imposed by the fund manager.
- The section “When will you lose your money?” only appears in the KFS template for guaranteed funds/funds with structured pay-outs but not the other types of funds. However, guaranteed funds are generally considered to be lower risk vis-à-vis other types of funds such as equity funds/structured funds. As long as the counterparty risk of guaranteed fund is clearly disclosed in a prominent manner in the KFS, we recommend that the SFC should consider taking out the requirement from the KFS template for guaranteed funds.
- For guaranteed funds, having a box that specifically says "When will you lose your money" is confusing if this is meant to only refer to counterparty risks which other funds are also subject to.
- The scenario analysis required for guaranteed funds and structured payout funds would normally be a simplified one so that investors can easily understand the scenarios and therefore such scenarios would be subject to extensive assumptions and qualifications. The suggested page number limit would make it extremely difficult to list those assumptions and qualifications. Failing to provide such assumptions and qualifications may result in such scenarios being potentially misleading.
- For guaranteed funds, scenario analysis with aim to show how the formula works can be misconstrued by investors as performance indication.
- It is more prudent and realistic to provide backtest with real historical data covering a long enough duration including best/worst/base case markets (vs. assumptions as per scenario analysis) subject to guidelines to give investors a fair way to compare the risks and returns of similar products. Backtest has long been allowed in Europe under MiFID and is consistent with the view to align disclosure requirements (KID) as per offshore funds of which 95% of SFC-authorised funds are.
- Regarding “Scenario analysis”, as far as guaranteed funds are concerned, can SFC clarify what is the meaning of “Worst case scenario”, “Base case scenario” and “Best case scenario”?

	- "Worst case scenario" – Does it mean the guarantor is in default, collateral (if any) has no value and the underlying investments drop to no value and investors can get back nothing? - "Base case scenario" - Does it refer to the scenario where investors can only get back the guaranteed amount but no upside at all? - "Best case scenario" – Theoretically upside potential is unlimited. Can SFC give more guidance as to what is considered to be "Best case scenario"? - Apart from the illustration of the three possible scenarios, the SFC expects "details be disclosed in the offering document" – Can the SFC clarify what kind of details should be disclosed in the offering document given the three possible scenarios have been included in the KFS? ● Under "How has the fund performed?": - Are fund houses at liberty to choose to show fund performance either by calendar year or by financial year? - The part of the end note which reads "but do not include the effect of any subscription fee you might have to pay" appears to be irrelevant because it is unequivocal that "subscription fee" is charged upfront and will logically not be counted towards the fund's performance. Please consider deleting this sentence given that it is redundant. - There is an end note which reads "if a fund uses a benchmark as a basis, the benchmark should be mentioned". Does this mean that the benchmark needs to be disclosed only if the fund is an "index fund" or if the benchmark is clearly disclosed in the investment objective of the fund? Or does it mean that disclosure is required whenever the fund has a benchmark, although it may only be for internal reference purpose? - Is it true that fund houses can only mention the benchmark in the KFS and cannot compare the funds' performance with the benchmark? If yes, what is the point of merely mentioning the benchmark? - Whether all requirements relating to presentation of performance information in the Advertising Guidelines have to be complied with (i.e. not just the requirement to update the KFS every 6 months as mentioned in paragraph 171, page 49 of the CP)? - A bar chart may not be available for new funds.

	• Under "Additional information", it may not be useful to state the fund manager's cut-off time as the distributors may have different/an earlier cut-off time. • Regarding "Intermediaries' information", since each product might be distributed on a number of distributor platforms, the list of intermediaries (which can be a long list) and their respective contact information may change from time to time and it is not practical and burdensome from an administrative view point to disclose such information in the KFS. From the perspective of distributors, it is beyond their control if this section is not updated by the fund manager on a timely basis. It is suggested, for practical reasons, not to include the intermediaries' information. We believe the alternative approach as stated in the illustrative template is more practical, i.e. provide a place(s) of where investors could obtain information about the intermediaries, e.g. direct investors to either the website (if any) or obtain the information from the fund house/HK Representative. • Alignment between Investment-Linked Assurance Scheme ("ILAS") and funds - fee disclosure requirements and performance representation for ILAS and unit trusts should be the same. Allowing ILAS to publish "with profits" features and bonuses that are not guaranteed and entirely discretionary is inconsistent with the UT Code. Funds are not allowed to publish forecast performance. - For fees and total expense ratio, it is not clear whether showing the policy's related fees and total expense ratio only are sufficient. Should ILAS's KFS be shown together with the underlying fund's KFS if appropriate (i.e. in case where a policy is purely a wrapper and the client is in fact investing in the fund only without other more substantial benefits than the 101% life insurance) to give investors the full picture? Some members suggest more transparency on various layers of fees at policy and fund level to facilitate easy comparison of similar funds with and without wrappers. - Proper disclosure for "with-profits" plan should include the following to ensure clients are not given a "promised return" with no basis: ➢ How will this be achieved? No guarantees; and that the firm has full flexibility in changing terms.

Question (13):
Do you have any comments on the revisions to the UT Code generally? Please explain your views.

Questions on the revised UT Code as set out in Appendix A Section II of the CP:

Part	Chapter	Page	Comments
Explanatory Notes (a)			• Can SFC confirm that communications of changes to the UT Code will cover any change made to: (1) the Appendices A1, A2 and B which are not set out within the body of UT Code but are to appear on the SFC website; (2) Appendix F which is a stand-alone document. Concern here is that provisions on the website may

			change without industry notification (e.g. an SFC alert email) as we have experienced with FAQs. We support SFC's move towards more web-based information but can there be a commitment to strengthening external communications?
I. General matters	1.2 (RJS)	1	• Can SFC accept all UCITS jurisdictions as recognized jurisdictions schemes? UCITS funds from Malta would be subject to the same UCITS requirements as Luxembourg and Irish UCITS funds but are not currently recognized jurisdiction schemes.
	1.3 (Documents to be supplied)	2	• Can SFC set out details of any other certification/confirmations and undertakings required and which party can give these? The FAQs on Authorisation have recently been amended to address this but further guidance would be welcome.
	1.5 -1.7 (Nomination of an individual as approved person)		• Can SFC clarify the role of the Approved Person? Is this just a liaising role or otherwise?
	3.2 (Interpretation)	6	• To ensure consistency with UCITS, can SFC not treat Repo transactions as FDIs as indicated by paragraph 133 on page 41?
	3.7 (Interpretation)	6	• Will exchange products like HSI futures (which is a derivative by its definition) be included as "financial derivative instruments"? The risk consideration of exchange products is quite different from derivatives issued by other financial institutions.
II: Authorisation Requirements	4.5 (General obligations of trustee/custodian)	9	• Where only a custodian is appointed, the board of directors plays the supervisory role of a trustee and the custodian would not normally perform this role. Can the UT Code reflect this?
	4.5 (a)	9	• It is common for custody agreement to limit the liability of the custodian for sub-custodians outside the custodian's group where selected by the manager, or non group sub-custodians in certain markets (generally emerging markets). Can the Code be amended to make it clear that such limitations are effective in the absence of an express waiver? Can the Code make it clear that custodians are not responsible for losses arising as a result of the insolvency of sub-custodians outside the custodian's group?
	4.5 (c)	9	• In practice, the custodian may not agree to have such term in the custodian agreement as the calculation of the NAV is undertaken by the administrator. Can the UT Code reflect market practice in recognising the differing functions of the Board, the administrator and custodian?

	4.5 (f)	9	• Most Recognised Jurisdiction Schemes' accounts do not contain a custodian report.
	4.5 (g)	10	• It is relatively uncommon to issue certificates and this provision creates confusion: units/shares can be created and issued prior to receipt of subscription monies. A standard trust deed provides that if cleared funds are not received within a specified number of days prior to or following the Dealing Day as at which the relevant units were issued, the manager may cancel such units.
	4.6 (Retirement of trustee/custodian)	10	• In practice, a custodian is likely to require termination of the fund if a replacement custodian approved by SFC cannot be found within a relatively short period.
	5.1	11	• Please clarify whether both the manager and any delegate with investment discretion must meet the qualifying criteria. Is the position different for hedge funds? In particular, is it necessary for both entities to be regulated in an AIR?
	5.5 (b) (Criteria for Acceptability of Management Company)	12	• For a fund manager licensed in an AIR, would it be possible for SFC to rely on the home regulator to have verified the track record of the two key personnel? This would help to promote a level playing field with current proposals for the treatment of structured products.
	5.5 (b) (Note)		• As long as the top level manager bears responsibility for the delegate, we are supportive of this proposal.
	5.10	13	• The obligation of the manager should be to manage the scheme in the "best interests" of the holders, rather than the "exclusive interest" of the holder as the manager should have regard also to the interests of others (such as creditors of the fund).
	6.2 (English and Chinese Offering Document)	15	• For translation certificates, would SFC move to a system of recognising certificates of approved translators?
	6.8 (Changes to scheme documentation)	16	• Please clarify how this applies to UCITS schemes (in particular those which do not provide for meetings)?
	6.15 (Dealing) and 11.8 (Maintenance of a website)	17 & 61	• Members generally support the proposals covering: (a) connected party transactions; (b) criteria for appointment of Hong Kong representative; (c) performance fees; (d) maximum interval for payment of redemption amounts; (e) sub-managers of multi-manager schemes; (f) distribution of financial reports; and (g) maintenance of a website.
	6.18 (Fees)	19	• We are pleased that the SFC has reconsidered the basis for calculation of performance fees in line with

			international market practice. • Please consider whether a general requirement for fairness and full disclosure could be introduced for performance fees? • Please confirm that the intention of the new note is to provide an exception from the high on high principle, so that if the benchmark is exceeded, a fee can be paid although the NAV per share is below the previous high? • It can be made clear that a fee can be charged on redemption notwithstanding it covers a period of less than a year and notwithstanding the fund is below its previous high provided the redemption value is higher than the redeeming holder's purchase price (or benchmark).
	6.19 (a) (Fees)	19	• Please clarify that a distribution fee can be paid as is common for UCITS schemes, e.g. to a shareholder servicing agent provided it is paid out of the management fee or disclosed as an addition to the management fee.
	7 Investment: core requirements	20	• Please confirm that the restrictions under Chapter 7 do not apply to Chapter 8.8 UCITS schemes.
	7 (Spread of investment)	20	• Whilst funds are subject to the 10% diversification rule, this is not the case with unlisted structured products. As such, we would suggest either apply the same diversification requirements on collaterals for unlisted structured products or apply the "investor characterization rule" in the selling of such products if the diversification rule does not apply.
	7.3 (Spread)	20	• Would SFC change the wording to "neither listed, quoted nor dealt in on a market" to cover the OTC markets?
	7.8 (Writing of options)	20	• Please clarify whether the writing of put options is allowed. If so, would the holding of the relevant amount of cash, monetary instruments or other cash equivalent instruments be adequate to satisfy the cover requirements?
	7.10 (Futures and commodities)	21	• Is it possible to elaborate on the calculation of futures exposure?
	7.25 (Applicability of restrictions to umbrella funds)	24	• As SFC requires confirmation of no cross-liabilities between sub-funds of an umbrella fund, is this provision necessary? (Or is the requirement only applicable to guaranteed funds?) Should sub-funds not be treated the same as other funds managed by the same manager?

	8. Specialized schemes	25	• For UCITS schemes, can SFC confirm that it will accept the home regulator's classification of the fund for the purposes of determining under which provision of Chapter 8 the scheme would be authorised in Hong Kong?
	8.1 (b) (UPMF-Investment and borrowing limits)	25	• If REITS, investment trusts and ETFs are to be treated as CIS for the purpose of Chapter 7, please confirm whether REITs, investment trusts and ETFs are CISs for the purposes of UPMFs.
	8.1 (c)	25	• Can this provision be disapplied for UCITS schemes?
	8.1 (g)	25	• Can this provision be disapplied for UCITS schemes?
	8.2 (Money market/cash management funds)	26	• Would SFC consider conforming these provisions to UCITS restrictions? • Can it be made clear that bonds with regular interest reset dates are treated as having a remaining maturity equal to the period to the next reset date?
	8.2 (f) (Investment limitations)	26	• Can SFC confirm that this provision can be disapplied for UCIT schemes as in practice the average portfolio maturity and remaining maturity of an instrument for UCITS funds differ from this requirement?
	8.5 (b) Guaranteed fund - Guarantor	31	• Currently, the UT Code does not allow a fund guarantor to be a corporation whereas for unlisted structured products, a corporation incorporated in Hong Kong or recognised by the SFC is allowed. We would propose that such corporations be allowed as guarantor of guaranteed funds.
	8.7 Hedge Funds	42, 43	• The US$50,000 minimum subscription amount for single strategy schemes does not encourage promoters to seek authorisation in light of the private placement exemptions. • The restriction on charging assets to the prime broker (8.7(b)(ii)) to the amount of indebtedness to the prime broker does not provide the prime broker with sufficient margin for security. • There is increasing use of managed accounts for funds of hedge funds, and this should be permitted.
	9.4 (a) (Criteria for appointment)	55	• 9.4 (a) requires "The HK Representative must be licensed or registered under the SFO". In the current UT Code, if a HK Representative assumes functions (including distribution function) which amount to dealing in securities, the HK Representative must be licensed or registered under the SFO. What is the SFC's rationale for proposing to require all HK Representative, regardless of whether it

			will carry out any "dealing in securities", be licensed or registered with the SFC? • There may be some fund groups which are only "testing" the market in Asia and it would be costly to require the establishment of a HK licensed representative company solely to sell authorized funds locally. Can SFC allow greater flexibility if the management group could appoint say, an affiliate of the trustee/custodian in HK or other parties on an arm's length basis to act as HK representative as long as there is a robust contractual requirement for the HK representative to have the power to represent the fund and the management company?
	9.9 (Jurisdiction)	55	• Please clarify that this is limited to unit trust deed, articles of association of a corporate fund or any other agreement under which Hong Kong investors may have rights (which would not include agreements such as management, custodian, administration agreements).
	10.13 (Transactions with connected persons)	58	• We welcome this more principles based approach instead of fixing a dollar value without regard to the quality and risks of using a connected party. • Are these provisions to apply to UCITS schemes, which have their own requirements on connected party transactions? • It may be difficult to prove that fees paid is at a "prevailing market rate" and in any case, such details would be disclosed as required under 10.13 (f).
	11.1B (Ongoing disclosures)	59	• For multi-manager products, can SFC consider the Luxembourg and Irish approach of allowing changes to managers within the same group without offering document updates or notices so long as information available and certain conditions met?
	11.1B Note (Ongoing disclosures)	60	• Members believe that the "on going disclosure" requirements on the management company to inform holders "as soon as reasonably" practicable of material adverse changes in the financial conditions or business of the key counterparties to the scheme may be difficult to comply with. This is especially so for GP2. • What constitutes "material adverse change in the financial conditions or business of the key counterparties to a scheme"? Can SFC clarify the notion of "material adverse change"?
	11.6 (Reporting to holder)	61	• Should Chapter 11.6 make clear that the requirement to translate financial reports into Chinese is voluntary with respect to offshore funds?

	11.8 (Maintenance of a website)	61	• We support the proposal of maintaining a website for publication of the materials in question. But would SFC require the website to be maintained in both English and Chinese? How will this apply to UCITS schemes?
	11.14 (Advertising materials)	62	• Can SFC explain the rationale of the 3 year retention period for the final proof of advertisement and supporting materials for substantiation of information presented thereon?
Appendix C	C25 (General information)	69	• The directors of the management company would be unable to accept full responsibility for information provided by third parties. Index funds will need to disclose information on the underlying index. Such information is obtained from the index sponsor (e.g. Hang Seng Indices), which would refuse to provide assurances to the fund and the management company that the information provided is accurate. It would not be equitable to expect that the directors of the management company accept full responsibility for information received from third party providers. It would be equitable if the directors would be liable for ensuring that the information is **materially** accurate and confirm that there are no material omissions. • Further, the investment manager is responsible for ensuring that the fund is managed in accordance with its investment objective and policy with a view to maximizing the return of investors. However, members respectfully submit that the management company and its directors should not be responsible for the statements in the offering documents of the fund which are reviewed and approved of by the fund company. There is a clear and necessary distinction between the responsibilities of the fund company and the management company which are clearly set out in the Investment Management Agreement and this is essential since: - The fund company and the investment manager must be independent of each other. The investment management company and its directors should not influence the fund company and its directors on the level of disclosure. The fund company has its own legal advisors and should make its decision on whether such disclosure is appropriate based upon its own legal advice without being subject to views of the investment manager. - The market standard position would be that the investment manager is an independent contractor which the fund and its directors may decide to remove or replace the investment manager at any time. To place an obligation on the fund company to ensure that it obtains a responsibility statement from the investment manager's directors would fetter its discretion to replace or remove the investment manager. That is, before the fund company can remove the current investment manager it will need to find a replacement investment manager whose directors are willing to provide such a responsibility statement in the offering documents.

			This would be extremely difficult to achieve since the replacement investment manager was not involved in the drafting of the offering documents. Consequently, after the introduction of these proposals, the fund company may be very hesitant to replace the investment manager due to the difficulties that this will create. - On the basis of specifying clearly the investment manager's responsibilities, the investment manager is able to provide a competitive and low investment management fee. A change in this position may result in significantly higher investment management fees. • We propose to revise the sentence, to read as "…for the material accuracy of the information contained in the offering document at the date of publication and confirm…"
	C26	69	• Can SFC confirm whether this is any minimum required information to be maintained on a scheme's website?
Appendix D	Contents of the constitutive documents	71	• Can SFC confirm that Appendix D does not apply to UCITS schemes?
Appendix E	Contents of financial reports	75	• Can SFC consider if UCITS schemes can comply only with the requirements of the home regulator and if there is any need to continue with the special audit procedures for Luxembourg schemes?
Appendix I	17(Dissemination of trading information by ETFs)	98	• How often should the exposure to each counterparty and the value, nature and composition of collateral received (as a percentage of the ETF's NAV) be published?
Appendix I	22(Dissemination of information by ETFs)	99	• Is the disclosure of estimated total expense ratio mandatory? It appears to be an optional disclosure in the KFS.

(End)