Client Alert.

July 20, 2010

Hong Kong SFC's New Regime on Unlisted Structured Investment Products

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Hong Kong's Securities and Futures Commission (the "**SFC**") has published rule changes on unlisted structured investment products. This follows a three month public consultation triggered by the global financial crisis, and in particular by the collapse of Lehman Brothers in 2008. The Hong Kong Monetary Authority ("**HKMA**") has also conducted a study and introduced rule changes for the banking institutions regulated by it.

The SFC has published its *Consultation Conclusions on Proposals to Enhance Protection for the Investing Public* and the final form of its *Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products*. In addition, the HKMA has issued its own circular on *Implementation of Pre-investment Cooling-off Period for Retail Customers*.

The implementation of the new regimes will include a "mystery shopper" scheme, under which the SFC and HKMA will deploy senior citizens and pregnant women to act as "investors" to monitor compliance with the new rules.

SFC'S CHANGES

The SFC's consultation proposals covered investment products and conduct of intermediaries, and spanned the pre-sale, sale, and post-sale phases. The major changes now introduced by the SFC are:

- a consolidated SFC Handbook comprising revised product codes for unit trusts, mutual funds, investment-linked assurance schemes, and unlisted structured investment products
- a product key facts statement is now required, summarizing the key features and risks of the investment product
- a post-sale "cooling-off" or "unwind" period for certain unlisted structured investment products with a scheduled tenor of more than one year in respect of which authorization is sought under the SFO
- new requirements on intermediaries' conduct and selling practices relating to the sale of investment products.

Introduction of a consolidated SFC Handbook

The Handbook is a consolidation of the two existing codes on Unit Trusts and Mutual Funds (UT) and Investment-Linked Assurance Schemes (ILAS) and a new Code on Unlisted Structured Investment Products (the "**SIP Code**", formerly known as the Code on Unlisted Structured Products).

The Handbook, effective June 25, 2010, contains a set of overarching principles that will apply across the different types of product governed by it. These are intended to enhance product transparency and to set an overall disclosure standard for all offering documents in respect of different investment products being offered to the public in Hong Kong.

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The Handbook also contains new advertising guidelines for unlisted structured investment products and sets out further guidance to issuers of advertisements in respect of all products covered by the Handbook.

Requirement for product key facts statements ("Product KFS")

Product KFS are intended to serve as concise product summaries, written in plain language, which will help investors understand the key features and risks of the relevant investment product. It is expected that Product KFS should generally be not more than four pages long, and be presented in a format that facilitates comparison with other products.

The basic requirement will be that the Product KFS should be stipulated to form part of the offering document for investment products covered by the Handbook.

The SFC will be prepared to grant an exception in cases where funds adopt uniform global offering documents for distribution in all jurisdictions where their funds are marketed. While the fund issuer in such a case may elect not to stipulate that the fund's Product KFS forms part of the fund's global offering document, the issuer would remain subject to applicable laws in Hong Kong imposing civil and/or criminal liability in respect of misrepresentations in the Product KFS.

Post-sale 'cooling-off' or 'unwind' period

This requirement will apply to unlisted structured investment products with a scheduled tenor of more than one year.

An investor must be given the right to change his/her mind during a 'cooling-off' or 'unwind' period of at least five business days in Hong Kong after the investor places an order for a structured investment product. The investor will be able to exercise the right in respect of the whole of the order, but not part of it, and such exercise is irrevocable.

Investors are entitled to a refund of, or payment equivalent to, (i) the principal invested less (if applicable) a market value adjustment (including break costs attributable to the unwind or cancellation) and any handling fee, and (ii) a refund of sales charges/commissions, except where the structured investment product has been terminated or has been sold or transferred by the investor prior to exercise of the right. The handling fee must not contain any profit margin for the issuer or the intermediary.

The amount required to be paid or refunded will be capped at the principal amount invested (not including sales charges/commissions). The refund or payment amount must be provided to investors as promptly as practicable after exercise of the right by the investor.

New requirements on intermediaries' conduct and selling practices

The new requirements mainly cover:

- *investor characterization* - as a codification of market practice, an intermediary is required to assess each client's knowledge of derivatives and characterize the client (other than professional investors) based on his knowledge of derivatives
- *pre-sale disclosure of monetary and non-monetary benefits* - specific disclosure on the monetary benefits received by the distributor or its associates as follows:

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- in the form of a percentage ceiling, where a distributor distributes a product and it or an associate explicitly receives monetary benefits from that product's issuer (directly or indirectly), or where a distributor makes a trading profit from a back-to-back transaction
- in the form of a generic disclosure, where a distributor does not explicitly receive any monetary benefits for distributing an in-house investment product issued by itself or any of its associates, but it or an associate will benefit from the origination and distribution of the product

- *use of gifts by distributors in promoting a specific investment product* - intermediaries will not be allowed to offer gifts (except for discount of fees and charges) for the purpose of promoting a specific investment product to investors
- *disclosure of sales related information to investors prior to or at the point of sale* - capacity in which a distributor is acting, affiliation with product issuer, monetary and non-monetary benefits received by distributor and discount of fees and charges
- *Product Arranger* - a Hong Kong regulated Product Arranger will be required for unlisted structured investment products issued by special purpose vehicles and also for unlisted structured investment products where neither the issuer nor the guarantor (if applicable) is Hong Kong regulated
- *indicative valuations* - the requirement for daily indicative valuations has been removed and market-making will be required on a committed basis and for indicative bids to be made on a bi-weekly basis for all unlisted structured products with scheduled tenors of more than six months

HKMA'S CHANGES: CIRCULAR ON IMPLEMENTATION OF PRE-INVESTMENT COOLING-OFF PERIOD ("PICOP") FOR RETAIL CUSTOMERS

Whilst the cooling-off and unwinding right prescribed by the SFC for its licensees applies post-sale, the cooling-off arrangement prescribed by the HKMA for authorised institutions regulated by it ("**AIs**", i.e. banks, restricted license banks and deposit-taking companies) applies pre-investment.

Under the new arrangement, an AI not only needs to continue to ensure that financial products introduced to its customers are suitable for them and material information in relation to the product (including the nature, risks, indicative price(s), and other terms) is adequately disclosed, it should also allow both elderly and inexperienced customers at least two days to consider their contemplated investment, including whether the investment is appropriate taking into account the nature and risks of the product, their financial ability to assume the risks, and the need to consult third parties.

The price(s) and terms of the transaction will only be fixed on the day when a customer confirms with the AI the placement of a purchase or a subscription order after the PICOP expires.

The PICOP arrangement is mandatory where a customer is aged 65 or above, but the customer will be allowed to opt out from the PICOP arrangement if (i) the customer's asset concentration is below 20% and (ii) the customer is not a first-time buyer of the relevant type of product. For customers aged under 65, PICOP arrangements are only mandatory if (i) the customer's asset concentration is 20% or above and (ii) the customer is a first-time buyer of the relevant type of product.

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"Asset concentration" refers to the percentage of a customer's total net worth (excluding real estate properties) to be invested in the relevant transaction, calculated using the nominal amount of that transaction, and an AI may rely on a self-declaration by the customer in ascertaining asset concentration.

PICOP arrangements should be implemented by all AIs on or before January 1, 2011.

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