1. Background and outline of new regulations

The SFC released the results of the consultation paper on proposals to enhance protection for the investing public on Friday, May 28th, 2010. Key areas of reform that will impact the financial planning industry include:
(a) A series of investment product reforms. The most important of these product reforms for financial planners relates to the introduction of the Product Key Facts Statements (Product KFS), which is a product disclosure document outlining key product features and risks.
(b) Revisions to the Code of Conduct that covers a range of new initiatives in relation to intermediary conduct and selling practices. The implementation of commission disclosure is included in this list of initiatives.
(c) Introduction of post-sale cooling-off rights for consumers applicable to unlisted structured investment products with a tenor that is greater than 12 months.

It is important to note that these changes with respect to intermediary conduct and selling practices are generally applicable to the sales activities of all investment products and not limited to the sales process for unlisted investment products only.

<table>
<thead>
<tr>
<th>Proposed in consultation paper and PROPOSED FOR IMPLEMENTATION in consultation conclusion</th>
<th>Proposed in consultation paper BUT NO CHANGE TO BE IMPLEMENTED according to the consultation conclusion</th>
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</thead>
<tbody>
<tr>
<td>√</td>
<td>Product Key Facts Statements</td>
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<td>Pre-Sale Disclosure of Monetary and Non-Monetary Benefits</td>
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<td>Investor Characterization for Selling of Unlisted Derivative Products</td>
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<td>√</td>
<td>Post-Sale Cooling-Off Rights for Consumers in Unlisted Structured Investment Products</td>
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2. How are these new regulations likely to impact your financial planning advice process and compliance requirements?

These new regulatory initiatives are likely to impact your business and the management of relationships with your clients at a variety of stages of the financial advisory process, specifically at the pre-sale, point of sale and post-sale stages. Additional compliance documentation may also be required to illustrate your firm’s application of these new requirements in your current work practice.

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

Whilst a series of product-related reforms were announced in this consultation conclusion, the most significant product initiative for financial planners relates to the introduction of the **Product KFS**, which you will be required to give to your clients and discuss with them prior to their purchase of a product. All product providers will be required to make these documents
available to consumers. These documents will be produced in short form (no more than 4 pages), and are required to be written in consumer friendly and easy to understand language. This document will contain information regarding key product features and risk information, and will be presented in a way that will allow your clients to compare information about investment products. The Product KFS is deemed to form part of the offering document.

**Investor Characterization**

Prior to conducting any sales of unlisted derivatives products, financial planners will be required to undergo a specific **investors characterization process** as part of the pre-sale “know your client” procedures. Financial planners will be required to obtain additional specific information about an individual’s prior knowledge of derivative products and classify those investors according to their knowledge of derivatives.

The September 2009 consultation paper outlined that investors may be regarded as having knowledge of derivatives through: (a) undergoing training or attending courses on derivative products, (b) prior trading experience with derivative products, or (c) current or previous work experience related to derivative products. This final conclusion however noted that the proposed criteria “for assessing whether or not a client has knowledge of derivatives should be viewed as examples only and will not be included in the Code of Conduct. The Commission will issue guidance on this separately.”

Record keeping of documentation in relation to a client’s knowledge of derivative products will however be required.

Financial planners will hereafter not be able to promote products with derivatives component to clients who are classified as not having the knowledge of derivatives. If these clients request to purchase a product with derivatives component and which is listed on the exchange, financial planners will then be required to explain the risks associated with the product. Where the product is unlisted, the financial planner should warn the client about the transaction and provide appropriate advice to the client as to whether or not the transaction is suitable for the client in all circumstances. If the transaction is assessed to be unsuitable for the client, the financial planner may only proceed with the transaction “if doing so would be acting in the best interests of the client in accordance with the general principles of the Code of Conduct”.

For compliance purposes, you should keep all documentation and communication that records your warning of the risks of this investment with those clients classified as “without derivatives knowledge” but who wish to purchase a product with derivatives component on a self directed basis.

**Pre-sale Disclosure of Monetary and Non-Monetary Benefits**

Much of the regulatory reform in this area is focused on new disclosure requirements you will need to make to your clients in relation to monetary and non-monetary benefits you may receive when your client invests money in a product you have recommended. To ensure your clients are aware of any potential conflict of interest issues that may arise from your relationship with product providers, all intermediaries will now be required to disclose monetary and non-monetary benefits to clients prior to undertaking any financial transactions with them. For benefits that are not quantifiable prior to or at the point of sale, generic disclosure of the existence and nature of the benefits will be required.

The format of disclosure and degree of disclosure required to be communicated to your client will vary depending upon the business model in which your business operates.

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1 SFC Consultation conclusion, p.73
2 SFC Consultation conclusion, p.69
### Business Model Summary

<table>
<thead>
<tr>
<th>Business Model</th>
<th>Business Model 1</th>
<th>Business Model 2</th>
<th>Business Model 3</th>
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</thead>
<tbody>
<tr>
<td>Nature</td>
<td>Distributing 3rd party investment products</td>
<td>Distributing in-house products</td>
<td>Back-to-back transactions where a distributor is making a trading profit</td>
</tr>
<tr>
<td>Minimum disclosure requirement</td>
<td>Commission payments to be disclosed as a % ceiling of the investment amount</td>
<td>Generic disclosure statement. Required to disclose that the distributor or any of its associates will benefit from the origination and distribution of the in-house product</td>
<td>Trading profit from back-to-back transactions is deemed to be similar to commission rebates in Business Model 1. As such, the profit shall be disclosed in the form of a % ceiling of the investment amount</td>
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</table>

The SFC did not prescribe the preferred format for the way in which this information should be disclosed to your clients. The guiding principle is that disclosure should be prominent and presented in a clear and concise manner that will be easy for the average investor to understand. Content for inclusion in sales disclosure documents is outlined as “sales related information to investors (including the capacity in which the distributor is acting, affiliation with product issuers, monetary and non-monetary benefits received by distributor, and discount of fees and charges) prior to the point of sale.”

#### Use of gifts in promotional offerings

Use of gifts in the promotion of investment product offerings will no longer be allowed. Marketing campaigns offering investors gifts for the sale of a specific investment product will be banned. It should be noted, however, that gifts for brand promotion, relationship building or other purposes not directly related to the promotion of a specific investment product will not be banned. The SFC will focus on the purpose of the gift rather than the direct monetary value of it.

#### Post-sale Cooling-Off Rights

The SFC now requires product issuers to provide a “cooling-off” or “unwind” right to all classes of investors for unlisted structured investment products with a tenor of more than 1 year. The “cooling-off” or “unwind” right must comprise a period of at least 5 business days in Hong Kong after the investor places an order for the relevant structured product during which the investor has the right to change his/her mind. It is important to note that “cooling-off” will not be required for authorized funds as these products have existing redemption facilities in place. Cooling-off provisions are already in place for ILAS products as well.

When providing advice on unlisted structured investment products with a tenor of more than 1 year, it is important to clearly outline to your client the product “cooling-off” feature. Under the new provisions, “investors will be entitled to a refund of, or payment equivalent to, the principal invested less (if applicable) a market value adjustment (including break costs attributable to the unwind or cancellation) and any handling fee, and a refund of sales charges/commissions.”

It is very important that you communicate to the client that a cancellation of an investment product under cooling-off provisions, may in certain market conditions, result in a reduction in value of the product. It is important that your client is aware that they may not receive their full dollar value of the investment upon activating the “cooling-off” provisions. If the client decides to return the product under these new cooling-off provisions, the commission paid to you for the sale of the product will be returned. Financial planners will not receive commission payments if the client activates their “cooling-off” rights.

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3 SFC consultation conclusion, p.70
4 SFC consultation conclusion, p.43
3. How long will you have to implement these changes?

The requirement restricting the use of gifts will be implemented within 3 months upon the publication of the amendments to the Code of Conduct in the Government Gazette. Except for the commission refund obligations under the new cooling-off provisions (which will be effective when the Code on Unlisted Structured Investment Products takes effect) all other requirements will be effective within 12 months following the gazettal of the amendments to the Code of Conduct.

4. What will IFHK be doing to help you prepare for these changes?

IFHK understand that the changes outlined in this consultation conclusion are likely to impose significant impact to your current business practice. More detailed information seminars and training programs will be hosted to assist members to prepare for these changes. Details of upcoming programmes will be announced in due course.