

# Selling of Investment Products: New Requirements in HONG KONG

*New conduct of business requirements applicable to the sale of investment products which were announced in June 4 2010 will come into effect on June 4 2011. These requirements will tighten obligations on licensed and registered persons to assess the suitability of derivative products for clients and will expand disclosure requirements with a view to addressing misalignments in economic interests of distributors of investment products and their client. In this article, we review the new requirements and consider their effects on licensed and registered persons.*

Since the global financial crisis, particularly the Lehman mini-bond debacle in Hong Kong, the Securities and Futures Commission (“SFC”) has made a concerted effort to reinforce the obligation of licensed and registered persons to ensure that investment products are suitable for their clients and to supplement disclosure obligations to ensure that clients of distributors of investment products understand the risks of their investment decisions.

The Report to the Financial Secretary on Issues Raised by the Minibonds Crisis, issued in December, 2008, proposed a number of regulatory changes, many of which have already been adopted. Three of these proposed changes, which are set out in the revised Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code”), will come into effect on June 4, 2011. Consistent with the broader regulatory efforts, these changes will (i) tighten obligations on licensed and registered persons to assess the suitability of derivative products for clients, (ii) raise the threshold requirements for a client to qualify as a professional investor under the Code, thereby expanding the range of persons to which suitability obligations will

May, 2011

For more information

Timothy Loh,  
Principal  
tloh@timothyloh.com  
Hong Kong: +852 2899.0179

Founded in 2004, TIMOTHY LOH, SOLICITORS has attained international recognition as a leading law firm. We have particular strengths in handling regulatory enforcement actions, complex tax, corporate and regulatory issues affecting the finance industry and mergers and acquisitions involving private equity or financial institutions. We are recommended by the International Financial Law Review 1000 as a leading law firm in banking and by the Legal 500 as a leading law firm in regulatory matters.

*New paragraph 5.1A of the Code focuses on suitability obligations in relation to the sale of derivatives. It will require a licensed or registered person, as part of its know your client procedure, to (i) assess a client's knowledge of derivatives, and (ii) characterize the client based on his knowledge of derivatives.*

apply and (iii) expand disclosure requirements with a view to addressing misalignments in economic interests of distributors of investment products and their clients.

## SUITABILITY

New paragraph 5.1A of the Code focuses on suitability obligations in relation to the sale of derivatives. It will require a licensed or registered person, as part of its know your client procedure, to (i) assess a client's knowledge of derivatives, and (ii) characterize the client based on his knowledge of derivatives. This requirement will not apply however, where the client is a professional investor.

The Code does not specify how clients should be characterized.

### Sales to Clients with No Derivatives Knowledge

At the same time, new paragraph 5.1A of the Code will establish new requirements applicable to the sale of derivatives on an unsolicited and non-recommended basis to clients who have no knowledge of derivatives. In these circumstances:

- *Exchange traded derivatives.* A licensed or registered person must explain the relevant risks associated with the derivative product to the client.
- *Over-the-counter derivatives.* A licensed or registered person must warn the client about the transaction, provide appropriate advice as to whether or not the transaction is suitable for the client in all the circumstances, and record the warning and other communications with the client.

New paragraph 5.1A does not prohibit a licensed or registered person from selling a derivative to a client who has no knowledge of derivatives on an unsolicited

and non-recommended basis where the licensed or registered person regards the derivative as unsuitable for the client but does require the licensed or registered person in this case to proceed only if to do so would be in the best interests of the client.

Without these new requirements, the Code would only impose suitability obligations on a licensed and registered person where the licensed or registered person solicits a client for the purpose of selling a product or recommends a product to a client.

### Professional Investors

Where the client is a professional investor, the new suitability requirements will not apply. The standard for determining whether a client is a "professional", however, has been raised under the Code. Revised paragraph 15.3 of the Code will require a licensed or registered person to assess the knowledge, expertise and investment experience of a client before characterizing a client as a professional investor. In this regard, the licensed or registered person should consider (i) the type of products in which the client has traded, (ii) the frequency and size of trades of the client, (iii) the client's dealing experience, (iv) the client's knowledge and expertise in the relevant products, and (v) the client's awareness of the risks involved in trading in the relevant products and market.

At the same time, new paragraph 15.3A of the Code will require a licensed or registered person to undertake a separate assessment for each different product type or market prior to treating a person as a professional investor for that product type or market.

If a professional investor has ceased to trade in the relevant product or market for more than 2 years, a licensed or registered person will be required to undertake a new assessment in accordance with the above-mentioned

*Where the client is a professional investor, the new suitability requirements will not apply. The standard for determining whether a client is a “professional”... has been raised... [T]he Code will require a licensed or registered person to assess... knowledge, expertise and investment experience... before characterizing a client as a professional...*

requirements before treating the same as a professional investor under new paragraph 15.3B of the Code.

### Scope of Term “Derivatives”

The scope of the term “derivatives” is unclear. Neither the Code nor the Securities and Futures Ordinance (“SFO”) define the term. While in its Circular to Licensed Corporations on the Code of Conduct Requirements with respect to Derivative Products the SFC suggests that derivative products in Hong Kong generally include derivative warrants, callable bull/bear contracts, and those exchange-traded funds that invest in derivative instruments designed to replicate the performance of an index, there does not appear to be any consideration as to the different types of derivatives. Thus, for example, it may be that a person with knowledge of equity derivatives would be regarded as having knowledge of derivatives for the purpose of investing in credit derivatives.

### Threshold for “Knowledge”

Equally, it is unclear what constitutes the threshold of “knowledge” for the purpose of triggering the requirements for warning and risk disclosure. The Code itself gives no express indication of what is meant. In its Guidance to Licensed Corporations and Registered Institutions in relation to Investor Characterization and Professional Investors Requirements, (“**Guidance Note**”) the SFC suggest that criteria for assessing if a client can be regarded as having knowledge of derivatives include:

- *Training.* The client having undergone training or attended courses offered by academic institutions or financial institutions on derivative product.
- *Experience.* The client having current or previous work experience related to derivative products or the client having prior trading experience in derivative products.

The Guidance Note goes on to provide that a client will be considered to have knowledge of derivatives if he has executed at least five transactions in any derivative product within the past three years.

### Sales Where Derivative is Unsuitable

While paragraph 5.1A of the Code allows licensed and registered persons to effect an unsuitable transaction for the client, it is not clear when such a transaction would be “in the best interests of the client in accordance with the general principles of the Code”.

The SFC had only pointed out that it does not consider certain pre-set steps, including (i) reminding the client of the risk mismatch of the product, (ii) documenting the reasons of any product recommendation, (iii) documenting the reasons of the client’s choice of the product, and (iv) obtaining the client’s acknowledgement and confirmation of the risk mismatch, to be acting in the best interests of the client. No example is given to illustrate situations where the effect of an unsuitable transaction for the client will be acceptable to the SFC. If an intermediary wishes to effect an unsuitable transaction for a client, he must be prepared to justify his action despite the unsuitability.

### “Execution Only” Transactions

It is also uncertain how paragraph 5.1A of the Code affects “execution only” transactions-- unsolicited and non-recommended transactions under specific client instructions. For example, a client without derivative knowledge may place an order for a derivative product by fax and then expect the order to be executed by a licensed or registered person without further communication. Under such circumstances, it is unclear whether a licensed or registered person may proceed with the transaction or whether a licensed or registered person must withhold execution until he has explained

or warned the client of the relevant risks associated with the derivative product.

## DISCLOSURES

Particularly where a distributor of an investment product earns a reward for a sale from the product issuer, there may be a misalignment of economic interests between the distributor and the investor. In this case, the distributor's economic interest lies in concluding the sale to earn the reward. It does not lie, at least in the short-term, in ensuring that the investor's interests are best served.

Regulatory suitability obligations, such as those described above, are intended to control the misalignment. New disclosure requirements are intended to enable the investor to understand the misalignment and hence, understand that advice they receive may not be impartial.

### Monetary and non-monetary benefits

New paragraph 8.3 of the Code requires pre-sale disclosure of any monetary and non-monetary benefits.

- *Explicit remuneration arrangements.* A licensed or registered person should disclose any monetary benefits receivable by them or their associates, expressed as a percentage ceiling (or the dollar equivalent) of the investment amount.
- *Non-explicit remuneration arrangements.* A licensed or registered person should disclose that they or their associates will benefit from the origination and distribution of the investment product.
- *Trading profits made from a back-to-back transaction.* A licensed or registered person should disclose the profit to be made, expressed as a percentage ceiling (or the dollar equivalent) of the investment amount.

- *Non-quantifiable monetary benefits or non-monetary benefits.* A licensed or registered person is required to disclose the existence and nature of such monetary benefits.

### Sales-related Information

Separately, new paragraph 8.3A requires a licensed or registered person to disclose to the client the following information prior to or at the point of sale:

- the capacity (principal or agent) in which a licensed or registered person is acting and the licensed or registered person's affiliation with the product issuer;
- any monetary and non-monetary benefits receivable by the licensed or registered person and their associates; and
- the terms and conditions in generic terms under which a client may receive a discount of fees and charges from a licensed or registered person.

The disclosures made must be (i) in writing, (ii) in Chinese or English according to the client's preference, and (iii) present in a prominent, clear and concise manner which is easy for the average clients to comprehend. Where the delivery of information in written form is not possible prior to or at the point of sale, a licensed or registered person is required to make a verbal disclosure first and then follow up with a written disclosure as soon as practicable.

A licensed or registered person is required to ensure that adequate measures are in place to ensure that the above-mentioned information is provided to the client prior to or at the point of sale. The only exception to this new SFC requirement is where the client concerned is a professional investor.

You can add or remove your name from the distribution list for articles from this firm or obtain a reprint of this firm's articles by sending an email to [publications@timothyloh.com](mailto:publications@timothyloh.com).

Copyright © 2011. Timothy Loh. All rights reserved. Version as per January, 2011.

This article provides general guidance only and should not be relied upon as legal advice. You should seek legal advice specific to your individual circumstances. Timothy Loh disclaims any liability to any person relying upon this article as legal advice.