

Enhanced Requirements on Complex Products – Are you ready?

Background

The effective date of the enhanced requirements that shall apply in the provision of services on complex products, while deferred from the previous proposed date of April 2019, is now around the corner.

From 6 July 2019, the Guidelines on Online Distribution and Advisory Platforms (“Guidelines on Online Platforms”) issued by the Securities & Futures Commission (“SFC”) would become effective, within which outlines the SFC’s further guidance on the expected conduct requirements on intermediaries offering investment products on online platforms, and where the SFC introduced specific requirements with respect to investment products that are “complex products”.

Correspondingly, a new paragraph 5.5 in the SFC Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code of Conduct”) shall apply to all intermediaries (*online or offline*) in providing services in complex products. Paragraph 5.5 of the Code of Conduct will also take effect on 6 July 2019.

Complex Products

“Complex product” is defined to refer to an investment product whose terms, features and risks are not reasonably likely to be understood by a retail investor because of its complex structure. Intermediaries are expected to exercise due skill, care and diligence in determining whether a product is a complex product. We would add that it is not necessarily required that the client in question is a retail investor in order for the enhanced requirements to apply, but rather an expectation to consider from the perspective of a retail, “person on the street”, investor whether reasonably likely to understand the terms, features and risks of the product.

According to the Guidelines on Online Platform and the Code of Conduct, the following are factors to determine whether an investment product is complex or not:

- (i) whether the investment product is a derivative product;
- (ii) whether a secondary market is available for the investment product at publicly available prices;
- (iii) whether there is adequate and transparent information about the investment product available to retail investors;
- (iv) where there is a risk of losing more than the amount invested;
- (v) whether any features or terms of the investment product could fundamentally alter the nature or risk of the investment or pay-out profile or include multiple variables or complicated formulas to determine the return (for example, a right of the product issuer to convert the instrument into a different investment); and
- (vi) whether any features or terms of the investment product might render the investment illiquid and/or difficult to value.

Intermediaries are required to consider the structure and strategy of the fund, and the nature of the underlying investments, with reference to the product disclosure documents.

To provide the industry with further guidance, the SFC has set out certain factors to be taken into account whether an investment product is complex or not, as well as publishing [\(non-exhaustive\) examples of complex products](#) on the SFC's website. The SFC also published a list of non-complex products on its website, which includes shares traded on the Hong Kong Stock Exchange (HKEX), non-complex bonds, non-derivative funds authorised by the SFC, SFC-authorised non-derivative exchange traded funds traded on HKEX, SFC-authorised real estate investment trusts traded on HKEX, and any other investment products as the SFC may specify from time to time.

For SFC-authorised funds, therefore, a key to ascertaining whether a fund is a complex or non-complex product is to ascertain whether or not the fund is a derivative fund. A non-derivative fund (with net derivative exposure of up to 50% of its net asset value, as determined in accordance with relevant requirements of the SFC under the Code of Unit Trusts and Mutual Funds) is considered a non-complex product.

Similar considerations may be adopted for a fund which is not authorized by the SFC (i.e. a fund for private placements), which may be categorized as a complex product if it is a derivative fund, with the purpose and use of derivatives assessed by reference to the SFC's corresponding requirements for authorised funds. Further, even if it is not a derivative fund, a private fund is still likely to be considered a complex product since it may be unlikely to be able to satisfy factor (ii) - whether a secondary market is available for the non-public fund at publicly available prices; factor (iii) - whether there is adequate and transparent information about the investment product available to retail investors; and factor (vi) - whether any features or terms of the non-public fund might render the investment illiquid and/or difficult to value. In addition, it should be further considered whether the fund not authorised by the SFC is authorised for offer to retail investors by an overseas regulator or regulated or traded on an exchange in a [specified jurisdiction](#).

The SFC has provided a [flowchart](#) on its website to assist intermediaries in determining whether a fund not authorised by the SFC is a complex product, and the applicable requirements.

Enhanced Requirements for Complex Products

Effective from July 2019, SFC licensed or registered intermediaries providing services in a complex product would be required to ensure that the transaction in the complex product is suitable for the client in question in all the circumstances, that sufficient information on the key nature, features and risks of the complex product is provided to the client so as to enable the client to understand the complex product before making an investment decision, and that warning statements in relation to the distribution of the complex product are provided to the client in a clear and prominent manner (prior to and reasonably proximate to the point of sale or advice).

The enhanced requirements on "complex products" should be considered in the context of the general suitability requirement which already applies and are expected of intermediaries under paragraph 5.2 of the Code of Conduct. Further to the general suitability requirement, a licensed or registered person is required to ensure the suitability of its recommendation or solicitation of investment products to clients, having regard to information about the client which is known or should be aware through the exercise of due diligence. The SFC recently clarified that the

enhanced requirements for complex products do not apply where an intermediary is already complying with paragraph 5.2 of the Code of Conduct to ensure suitability of the product for the client. Besides, compliance with paragraph 5.2 of the Code of Conduct as well as the enhanced requirements on complex products is exempted when dealing with "corporate professional investors" (subject to compliance with paragraphs 15.3A and 15.3B of the Code of Conduct) and "institutional professional investors" with such meanings given according to the Securities & Futures Ordinance and the Code of Conduct.

General Requirements re Derivative Products

An exception to the enhanced requirements on complex products is where the complex product is a derivative product traded on an exchange in Hong Kong or in a [specified jurisdiction](#) (or could reasonably be treated as such).

However, intermediaries would still be required to comply with relevant requirements under the Code of Conduct with respect to derivative products generally. Under the existing Code of Conduct, SFC licensed or registered persons are required to assess client's derivatives knowledge, and if a client is assessed to be without derivatives knowledge, even if the intermediary has not solicited the client or made a recommendation to the client on the product, the intermediary is expected to (i) explain to the client the relevant risks associated with a product where the product is a derivatives product traded on an exchange; or (ii) where the product is a derivatives product that is not traded on an exchange, to warn the client about the transaction and, having regard to the information about the client which the intermediary is or should be aware through the exercise of due diligence, including taking into account that the client is without derivatives knowledge, provide appropriate advice to the client as to whether or not the transaction is suitable for the client in all the circumstances. The Code of Conduct further stipulates that if the transaction is assessed to be unsuitable for the client, the intermediary may only proceed with effecting the transaction for the client if to do so would be acting in the best interests of the client in accordance with the general principles of the Code of Conduct. This is already a highly stringent standard.

Further, when providing services in derivative products, intermediaries are generally required to be satisfied that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products, through the exercise of due diligence on the client (such as on the investment knowledge and experience of the client, the client's derivatives knowledge, financial position and financial needs).

Latest guidance issued

On 13 June 2019, the SFC issued a circular providing further guidance on the regulatory requirements for complex products. Among other clarifications, the most notable guidance provided by the SFC with this circular is in respect of any intermediary who merely acts as an execution broker and provides order execution or transaction services to a client in circumstances where an investment manager or investment adviser licensed by the SFC or regulated by an overseas banking or securities regulator provide discretionary portfolio management services or investment advisory services to the same client.

The intermediary will need to agree in writing with the investment advisor or investment manager that:

- the investment advisor or investment manager is responsible for complying with the applicable requirements of the overseas jurisdiction where it is regulated before transmitting the client's order to be executed;
- where the investment advisor or investment manager is licensed by or registered with the SFC, the investment advisor or investment manager is responsible for ensuring the suitability of a transaction in a complex product for the client and providing sufficient product information and warning statements in respect of the complex product to the client before transmitting the client's order for execution; and
- the execution broker is not responsible for ensuring suitability of the order received from the investment advisor or the investment manager or providing product information and warning statements to the client.

There is also a requirement that the client in question be informed in writing on the aforesaid arrangement which may apply to the overall relationship or arrangement with the client (and not limited to or required to be repeated for each transaction).

Another clarification which intermediaries may find helpful from the SFC is that although the requirements apply on each transaction, intermediaries may develop appropriate procedures for providing disclosure to the clients on repeat transactions or products of the same category.

Required Actions

Intermediaries should be reviewing its readiness to comply with the enhanced requirements on complex products which shall be effective July 2019. Given the requirements, the following broad lines of review and preparation may be undertaken:

- whether services are provided not involving solicitation or recommendation of investment products whereby there is already compliance with the general suitability requirement under paragraph 5.2 of the Code of Conduct;
- where there are or may be services not involving solicitation or recommendation of investment products:
 - whether the services relate to products or instruments that fall within the categories of "non-complex products" only (by reference to the list published on SFC website and relevant factors); OR
 - whether the products or instruments offered by the intermediary in its services or available on its online platform may be or are complex products which would require specific actions to comply with the enhanced requirements;
 - with respect to providing services on or making available products which may be complex products, to review its product due diligence process and know-your-client process in order to comply with the requirement for assessing whether a transaction in a complex product is suitable for a client in all the circumstances;
 - with respect to product due diligence process to assess whether or not a product is a complex product, to enhance disclosures requirements on the key nature, features or risks of a complex product to enable the clients to understand the complex

product to enable clients to understand the complex product, and which should be provided before the client makes an investment decision, and with prominent and clear warning statements to warn clients on a complex product;

- where the intermediary is an execution broker (not involving solicitation or recommendation), it may wish to consider reviewing its existing client relationships to enter into specific written agreements with the investment advisor or investment manager of the clients (as may be applicable) on the responsibility of the investment advisory or investment manager, as the case may be, on ensuring suitability and providing required information or warning statements on “complex products”.

Minimum Information on Complex Products and Warning Statements

Although the SFC has provided on its website examples of expected minimum information on complex products and warning statements, it would no doubt be necessary to prepare specific disclosures or statements on the key nature, features or risks of a complex product.

In this regard, for fund managers offering or seeking to offer or distribute their funds in Hong Kong, especially funds likely to be considered complex products, they may wish to take the additional steps of preparing specific disclosures or statements that may be provided to intermediaries and their clients in an easily comprehensible manner on the product nature, terms, features or risks of their fund products, to meet the enhanced disclosure requirements and risk warnings on complex products.

Fund managers would want to be doing their best to support its fund distributors and intermediaries in conducting the required legal and regulatory review of the relevant fund products in the determination of whether or not a fund product is a complex product, and the specific product nature, features, terms and risks that would need to be disclosed to investors under the enhanced requirements for complex products, and also for consistency across different distributors or distribution platforms in the classification and in the related disclosures and warning statements.

Contact Details

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