



Hong Kong

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HONG KONG SFC ISSUES NEW GUIDANCE ON SELLING COMPLEX PRODUCTS

The Securities and Futures Commission¹ (**SFC**) issued a Circular² on 13 June 2019 informing SFC-licensed and -registered intermediaries of new Frequently Asked Questions³ (**FAQS**) setting out further guidance on the regulatory requirements for sales of complex products.

What is a 'complex product'?

Complex products are defined in Paragraph 6.1 of the SFC's proposed Guidelines on Online Distribution and Advisory Platforms⁴ (**Guidelines**) as investment products whose terms, features and risks are not reasonably likely to be understood by retail investors because of their complex structure. According to the SFC's Circular⁵ of 19 March 2019, these Guidelines are due to take effect on 6 July 2019.

Factors to be taken into account in determining whether a product is a complex product are set out in Paragraph 6.1 of the Guidelines and in Paragraph 5.5 of the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures

Commission⁶ (**Code of Conduct**), which will also take effect on 6 July 2019. The factors to be considered include whether:

- i) the investment product is a derivative product;
- ii) a secondary market is available for the investment product at publicly available prices;
- iii) adequate and transparent information about the investment product is available to retail investors;
- iv) there is a risk of losing more than the amount invested;
- v) 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; and
- vi) any features or terms of the investment product might render it illiquid and/or difficult to value.

1 <https://www.sfc.hk/web/EN/index.html>

2 <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=19EC42>

3 <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/openAppendix?refNo=19EC42&appendix=0>

4 <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guidelines-on-online-distribution-and-advisory-platforms/guidelines-on-online-distribution-and-advisory-platforms.pdf>

5 <https://sc.sfc.hk/gb/www.sfc.hk/edistributionWeb/gateway/EN/circular/suitability/doc?refNo=19EC13>

6 <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission/code-of-conduct-for-persons-licensed-by-or-registered-with-the-securities-and-futures-commission.pdf>

The SFC has provided a non-exhaustive list of examples of 'non-complex' and 'complex' products.⁷ In the SFC's Circular of 13 June 2019, it notes that security tokens have been added to the list of complex products, and that if a particular product is not specifically mentioned in the non-exhaustive list, platform operators should consider whether a product is 'of the same type' as one of the listed examples.

What provisions apply to complex products?

The requirements applicable to sales of complex products, whether online or offline, under the Guidelines on Online Distribution and Advisory Platforms⁸ are as follows.

1. Suitability Requirement

Paragraph 6.3 of the Guidelines and Paragraph 5.5(a)(i) of the Code of Conduct require a licensed intermediary to ensure that any transaction in a complex product is suitable for the client in all the circumstances. This obligation must be discharged according to the standard set out in Paragraph 5.2 of the Code of Conduct, i.e. the intermediary's recommendation or solicitation with respect to a complex product must be suitable for the particular client, having regard to the information about the client of which the licensed person is or should be aware through the exercise of due diligence. Paragraph 6.4 of the Guidelines also notes that platform operators should refer to the SFC's guidance on the Suitability Requirement as provided from time to time in the SFC's circulars and FAQs.

2. Minimum information and warning statements

Paragraphs 6.7 of the Guidelines and 5.5(a)(ii) of the Code of Conduct require online platforms to provide sufficient information on the key nature, features and risks of complex products to enable clients to make an informed investment decision with respect to the product in question. Paragraphs 6.8 of the Guidelines and 5.5(a)(iii) of the Code of Conduct require clear and prominent warning statements to be provided.

3. Exchange-traded derivatives

The requirements relating to suitability, provision of information and warning statements do not apply to complex products which are derivative products traded on a Hong Kong or Specified

⁷ <https://www.sfc.hk/web/EN/rules-and-standards/suitability-requirement/non-complex-and-complex-products/>

⁸ <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guidelines-on-online-distribution-and-advisory-platforms/guidelines-on-online-distribution-and-advisory-platforms.pdf>

Jurisdiction exchange, if no solicitation or recommendation has been made (Paragraphs 6.5 of the Guidelines and 5.5(b) of the Code of Conduct). The licensed persons must however comply with the Code of Conduct's Paragraph 5.1 ('Know your client: investor characterization') and 5.3 ('Know your client: derivative products').

4. Exemptions for Institutional Professional Investors and Corporate Professional Investors

Platform operators who deal with Institutional Professional Investors are automatically exempt from the above requirements of Paragraphs 6.3 (suitability of transaction), 6.7 (minimum information) and 6.8 (warning statements) (Paragraph 6.9 of the Guidelines).

Similarly, licensed persons dealing with Corporate Professional Investors are exempt from the requirements of Paragraphs 6.3, 6.7 and 6.8, provided that they have complied with the requirements and procedures of Paragraphs 15.3A and 15.3B of the Code of Conduct (Paragraph 6.10 of the Guidelines).

Platform operators dealing with Individual Professional Investors must comply with the requirements of Paragraphs 6.3, 6.7 and 6.8.

5. Overseas products

The note to Paragraph 6.2 of the Guidelines provides that in determining whether an investment product should be treated as a complex or non-complex product, platform operators should have regard to whether the product is regulated in, or traded on an exchange in a jurisdiction which is on the SFC's list of specified jurisdictions.⁹ Platform operators are expected to exercise extra caution with respect to products which are regulated in, or traded on an exchange in, a jurisdiction which is not a specified jurisdiction. The SFC's Circular of 13 June 2019 notes that the Netherlands has been added to the list of specified jurisdictions for non-exchange traded unauthorised funds.

Newly added FAQs regarding online and offline sale of complex products

According to the SFC Circular of 13 June 2019, the objective of the newly added FAQs is to:

⁹ <https://www.sfc.hk/web/EN/rules-and-standards/suitability-requirement/non-exhaustive-list-of-examples-of-non-complex-and-complex-products/list-of-specified-jurisdictions.html>

- i) clarify that Paragraph 5.5 of the Code of Conduct applies exclusively to the unsolicited purchase of complex products (Question 35);
- ii) clarify that providing a loan for a client to purchase a non-complex product does not result in the product being converted into a complex product (Question 36);
- iii) provide guidance on the application of Paragraph 5.5 of the Code of Conduct where a transaction involves multiple contractual relationships – namely, an execution broker executing orders made by an investment adviser or asset manager on the client's behalf (Question 37); and
- iv) clarify the SFC's expectation with respect to the required disclosure of product information for solicited or recommended repeat purchases of products, and the application of Paragraph 5.5 of the Code of Conduct to such purchases, whether of the same kind or of the same category (Question 38).

1. Question 35: Unsolicited purchase of complex products

An intermediary must ensure the suitability of a complex product for the particular client in accordance with Paragraph 5.2 of the Code of Conduct where it:

- i) solicits the sale of or recommends a complex product; or
- ii) provides discretionary account services involving the making of a recommendation on a complex product.

This requirement attaches to advice provided in relation to both complex and non-complex products. However, the SFC has clarified that an intermediary which complies with Paragraph 5.2, is not additionally required to comply with the requirements of Paragraph 5.5 of the Code of Conduct. All applicable regulatory requirements, including the SFC's FAQs on Compliance with Suitability Obligations by Licensed or Registered Persons,¹⁰ must however be complied with.

¹⁰ <https://www.sfc.hk/web/EN/faqs/intermediaries/supervision/suitability-obligations-of-investment-advisers/compliance-with-suitability-obligations.html>

Conversely, the SFC clarified that where an intermediary executes a complex product transaction on behalf of a client without making any prior solicitation or recommendation (so that the client purchases on an unsolicited basis), the intermediary must comply with the requirements of Paragraph 5.5 of the Code of Conduct.

2. Question 36: Provision of loans for purchasing non-complex products

The FAQs reiterate that in determining whether a product is a complex or non-complex product, intermediaries should consider the factors set out in Paragraph 6.1 of the Guidelines (and reflected in the note to Paragraph 5.5 of the Code of Conduct) and consult the non-exhaustive list of examples of 'complex' and 'non-complex' products provided on the SFC's webpage.

FAQ 36 clarifies that if an intermediary provides a loan to a client to purchase a non-complex product (e.g. HKEx-listed shares), the provision of the loan does not convert the non-complex product into a complex product, since the loan does not change the terms, features and risks of the investment product itself. An intermediary providing a loan to facilitate a client's purchase of a non-complex product, or a leveraged transaction on a non-complex product, is not therefore required to comply with the requirements of Chapter 6 of the Guidelines and Paragraph 5.5 of the Code of Conduct.

Nonetheless, the intermediary must still comply with all other applicable legal and regulatory requirements, such as the requirement under Paragraph 5.3 of the Code of Conduct to ensure that the client understands the nature of the product and the risks involved, and is financially capable of assuming such risks and bearing the potential losses of trading in the product.

With regard to securities margin financing activities, the SFC also reiterated that licenced corporations must comply with the requirements set out in Schedule 5 of the Code of Conduct as well as the Guidelines for Securities Margin Financing Activities.¹¹

¹¹ <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/guidelines/guidelines-for-securities-margin-financing-activities/guidelines-for-securities-margin-financing-activities.pdf>

3. Question 37: Complex product transactions involving multiple contractual relationships

This question considered two specific scenarios where a client has contractual relationships with two separate parties – namely:

- i) one party acting as either an investment adviser providing investment advice or an asset manager managing a discretionary portfolio on behalf of a client; and
- ii) the other party acting as an execution broker providing execution services to the client by executing orders placed by the investment adviser or asset manager on the client's behalf.

The two scenarios considered are:

- i) where the two parties, the investment adviser or asset manager and the execution broker are:
 - a) two separate branches of the same financial institution or two separate legal entities within the same financial group; and
 - b) the two parties are based in different jurisdictions (e.g. the investment adviser or asset manager is based in Singapore while the execution broker is based in Hong Kong); and
- ii) the investment adviser or asset manager and the execution broker are different legal entities with no group relationship, and either all the parties, or only the execution broker, are Hong Kong-based.

The SFC's guidance is that the execution broker in these scenarios is not required to comply with the requirements applicable to complex products under Chapter 6 of the Guidelines and Paragraph 5.5 of the Code of Conduct when executing a transaction in a complex product on behalf of a client, provided that:

- i) the investment adviser or asset manager is licensed or registered by the SFC (or is regulated by the banking or securities regulator in the overseas jurisdiction where the investment advisory or discretionary portfolio management services are provided);

- ii) the execution broker only provides order execution and custody services to the client and has no day-to-day contact or direct communication with the client (e.g. the execution broker does not advise on the client's trades, manage the client's investment portfolio, handle the client's enquiries regarding complex products or the client's requests to trade complex products);

- iii) the execution broker has agreed in writing with the investment adviser or asset manager that:

- a) where the investment adviser or asset manager is regulated overseas, they are responsible for complying with the requirements that apply in that jurisdiction prior to transmitting the client's order for execution;

- b) where the investment adviser or asset manager is licensed by or registered with the SFC, they are responsible for complying with the requirements as to the suitability of a transaction in a complex product for a particular client and the provision of adequate product information and clear warning statements, before transmitting the client's order for execution;

- c) the execution broker is not responsible for ensuring compliance with the requirements referred to in paragraph (b) above; and

- iv) the execution broker has ensured that the client has been informed in writing of the arrangement set out in paragraphs (ii) and (iii) above.

Once the client has been notified of the arrangement as required under paragraph (iv) above, there is no need to repeat the arrangement and notification for each subsequent transaction that is executed for that client. However, if the arrangement is changed, the execution broker must ensure that the client is promptly provided with a written update.

The SFC's guidance however applies only to the two specific scenarios considered, it does not apply where a client consults the execution broker directly (i.e. on an unsolicited basis) and requests the purchase of a complex product. If the execution broker executes the transaction, it must comply with the requirements of Chapter 6 of the Guidelines and Paragraph 5.5 of the Code of Conduct.

The SFC notes that determining whether an execution broker is required to comply with the requirements of the Guidelines and the Code of Conduct is a 'question of fact' and must be evaluated in light of the circumstances of the case in question. The SFC further stresses that the arrangements outlined above must not be used to avoid compliance with the relevant requirements, and that it will not hesitate to take regulatory action in the case of any attempted circumvention of the regulations against any licensed or registered person who fails to act with honesty and integrity in the best interests of its clients.

4. Question 38: Solicited or recommended repeat purchases of complex products

As noted above, intermediaries must comply with the applicable requirements for solicited or recommended purchases of complex products, which include providing the client with sufficient information about the product, explaining to the client the nature of and potential risks associated with that product, disclosing product information and providing relevant warning statements in relation to the product. The question raised is whether a licensed or registered intermediary is permitted to adopt a risk-based approach when:

- i) disclosing product information (including providing explanations of investment products and the nature and extent of the risks associated with them) for solicited or recommended repeat purchases of the same investment product or investment products of the same product category; or
- ii) disclosing product information and giving warning statements for a transaction made by a client in complying with Paragraph 5.5 of the Code of Conduct if it is a repeat purchase of the same complex product or a complex product of the same product category.

The answer notes that the explanations and disclosures given should be made 'on a transaction-by-transaction basis', given that the purpose of the disclosure is to ensure that the client has the requisite understanding of the product he/she wishes to purchase. As such, the SFC clarifies that a risk-based approach can be adopted taking into account factors such as the client's trading pattern, level of sophistication and investment experience and the complexity and risk of the particular product.

The SFC further clarifies that an intermediary can design its own procedures for risk disclosure for repeat purchases if it can reasonably satisfy itself that the client sufficiently understands the product (taking into account the adequacy and validity of its previous disclosure). The SFC also stressed the importance of keeping good records of disclosure so that the intermediary can show, if required, that proper disclosure has been made to the client on prior transactions.

With regard to complex products of the same product category, the SFC cautioned that care should be taken when designing disclosure procedures given that factors such as the structure, risks, terms and conditions of products considered to be 'of the same category' can vary, notwithstanding that they fall into the same category.

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