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A legal update from Dechert's Financial Services Group

Hong Kong's Securities and Futures Commission and the Minibond Fallout

Introduction

Hong Kong's Securities and Futures Commission ("SFC") recently issued practical guidance to issuers of SFC-authorized collective investment schemes (i.e., retail mutual funds) regarding the SFC's expectations of disclosure standards in fund marketing materials and offering documents.

As part of its initial response to the outcry over investor losses from failed investments in retail structured products (generically referred to as "minibonds") triggered by the collapse of Lehman Brothers, the SFC issued a circular on October 3, 2008[1] (the "October 3 Circular") requiring all issuers of retail investment products to review their risk disclosure and product descriptions in existing fund offering and promotional documentation, and to consider their adequacy in light of the market turmoil. Marketing materials issued "must be clear, fair and present a balanced picture with adequate and prominent risk disclosure in compliance with all applicable regulations." The circular requires "investment product issuers [to] ensure that, in their marketing materials, there are upfront, prominent and adequate warnings of all the risks associated with their products, including any new risks that may have emerged in the prevailing market circumstances, before these marketing materials are issued or [where they] remain in issue."

Martin Wheatley, the SFC's CEO, commented in a press release accompanying the circular that "Recent events show that investors need to be presented with a clearer picture of product risks—they need to understand better how products will operate in extreme market conditions or in the face of bankruptcy."

In a letter dated December 5, 2008 (the "December 5 Letter") sent to issuers of SFC-authorized products, the SFC provided the first set of guidelines on the interpretation of the October 3 Circular. The December 5 Letter applies equally to marketing materials and offering documents. Its stated purpose is to "give further guidance" regarding the "SFC's expectations on the disclosure in marketing materials and offering documents, in light of, and in response to the new circumstances and concerns in the market." Besides retail mutual funds, the guidance in the December 5 Letter also applies to investment-linked assurance schemes (primarily life insurance policies with benefits linked to the performance of the policyholder's selected investment options) and products offered under Mandatory Provident Fund schemes (mandatory fully-funded and privately managed retirement savings schemes applicable to most employees in Hong Kong).

The December 5 Letter is of significance not only to the local fund industry, but also to European and other offshore asset managers considering tapping the growing pools of wealth

1 *Available at* www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H522.

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in the major Asian wealth management centres of Hong Kong and Singapore.

Background

The media reported that a significant number of retail investors (including elderly pensioners) in Hong Kong, Taiwan, and Singapore had lost large sums of money in complex structured products (mostly credit-linked notes with exposure to collateralized-debt obligations ("CDOs")). Many of these investors had been attracted to the products because they offered an enhanced yield above that provided by capital-guaranteed bank deposits.

Many investors have taken to the streets in Hong Kong and Taiwan in mass protests to demand their money back. There have been allegations of fraud, at worst, and misselling by banks and brokers, at best, over the sale of the structured products. There have been similar scenes in normally strait-laced Singapore, which has very strict laws against public assembly. Lawsuits have been initiated or are being contemplated by disgruntled investors.

Against this backdrop, there has been increasing political heat on governments and regulators to take decisive action. Hong Kong's Legislative Council has invoked rarely used special powers to commence a quasi-judicial independent inquiry into the minibond saga. Other retail investment products (such as UCITS funds) have now been tainted with the same brush in the minibond saga.[2] Mutual fund net subscriptions are sharply down, and retail fund authorization by the SFC has slowed to a crawl, as regulators study the implications of recent market events and develop a response.

The SFC's Expectations

From the perspectives of retail mutual fund issuers and distributors, the SFC's guidance in the following areas (cited verbatim below in quotation marks, where applicable, from the December 5 Letter) is of particular significance:

"All principal risks should be prominently disclosed." Disclosure statements should be "visually reader-friendly" and "densely packing complex and diverse information into a lumpy paragraph would not be visually reader-friendly." Disclosures should be in plain language so that investors can understand them. The use of "technical jargon or complex sentences" would not be plain language.

This drive toward plain language must be viewed in the context of the minibond saga. While it is generally not in dispute that the offering documents of the affected securities (many of which are now worthless) carried clear warnings about the lack of principal protection, many investors have claimed that the risks associated with the products they had invested in had not been properly or adequately explained to them. Complaints to the regulators have alleged that retail investors could not possibly have understood the dense legalese and fine print in the offering documents. It would appear now that the SFC's expectation is that risk disclosures must be presented in such an obvious manner that "mom and pop" investors (an expression used by the SFC's CEO Martin Wheatley for the large number of ordinary investors who suffered losses) cannot ignore them.

"Key product features and risks should now be presented in a few key bullets in a text window appearing on the front cover of the offering document or marketing brochure." This reinforces the requirement to present risk disclosures in a clear and prominent manner. The SFC expects the key features and risks to be summarised for investors upfront, and it is of the view that "crowding this window with too many

[2] The SFC offered a different perspective in a letter dated December 29, 2008 (the "December 29 Letter") to the chairman of the local fund industry trade association, the Hong Kong Investment Funds Association ("HKIFA"), which is leading efforts to make representations to the SFC on various issues arising from the recent SFC directives. It does not agree with the widely held assessment within the local fund industry that the broader implications on distribution of investment products arising from the minibond saga are relevant only to the sale of structured products. The SFC made clear that it believes that "investors in Hong Kong will certainly expect *all investment products* (emphasis added) to strengthen disclosures in both offering documents and marketing materials so long as they seek to solicit subscriptions in the Hong Kong market. This expectation necessarily applies to retail funds." In particular, the SFC noted that "enhanced disclosure is particularly crucial among those complex products such as UCITS III funds that adopt expanded powers and invest substantially in financial derivative instruments and thus expose the funds to significant embedded leverage and counterparty risks."

bullet points would be counter effective." Specifically, points to be covered in this text window include:[3]

- "What is the product and what does it do?"
- "What are the very key risks (e.g., that the product can invest up to a stated percentage in financial derivative instruments, such as swaps, CDOs); and any significant counterparty risks exposure etc.)?"
- "What is the worst case scenario that investors should be aware of?"
- "A reminder to investors that they should not invest in the product unless the intermediary who sells it to them has advised them that the product is suitable for them and has explained to them how it is consistent with their investment objectives."

In the weeks leading up to the issue of the December 5 Letter, the SFC had required the inclusion of the following generic warnings in an obvious and prominent manner in the offering document:

- "Investment incurs risks."
- "This product may not be suitable for everyone."
- "Investors should read the offering document for further details including product features and risk factors."
- "Investors should also consider their own investment objectives and seek financial advice as appropriate."

However, the December 5 Letter requires far more enhanced disclosures (particularly risk disclosures), and explicitly imposes on the distributor the burden of ensuring product suitability. A number of observations come to mind:

- Merely cropping and "lifting" the disclosures in the main body of the offering document into the text window will not meet the SFC's expectations of plain language—issuers must strike a balance in using short simple sentences to fully convey the essence of key disclosures without diluting, deviating from, or contradicting information set out in the main body of the offering document.
- As the text window disclosure is required in both offering documents and marketing materials,[4] it would make sense to use the same or similar disclosures in both instances (to the extent practicable) to ensure consistency—this is likely to require better internal coordination at the outset between the different internal and external legal, compliance, product, and business development teams working on the offering document and the marketing materials.
- Funds offered in multiple jurisdictions should consider the treatment of such matters on an integrated basis across all documentation available in the different regional markets, notwithstanding that the requirements above currently apply only to the Hong Kong offering and marketing documents, in order to standardize the minimum qualitative and quantitative information relating to risk factors, and not to invite comparisons of unequal disclosure.

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3 The SFC stated in its December 29 Letter that "the actual contents in the [text] window . . . would be a decision for the individual manager, taking into consideration the specific nature and risks of the fund involved. . . . it would be the assessment of each fund manager as to how to achieve adequate and proper disclosure in the circumstances, and how to present the same so long as it upholds the principle [that there is prominent, upfront and clear disclosure of the key risks of the fund involved] and takes into account the needs of investors and the concerns in the market."

4 The effective date for the implementation of the new disclosure standards set out in the December 5 Letter was January 1, 2009. The practical impact of this compressed implementation timetable would be that issuers and distributors must revise all existing marketing materials in circulation (including websites) to comply with the new standards. This is in addition to ongoing preparatory work to comply with a new set of revised advertising guidelines (published in July 2008 and aimed at enhancing disclosure in marketing materials, codifying existing regulatory practices, and facilitating post-vetting of marketing materials) that were due to come into effect on the same date (the "Revised Advertising Guidelines"). In response to representations from the HKIFA, the SFC has, in a circular dated December 30, 2008 (*available at* www.sfc.hk/sfcRegulatoryHandbook/EN/displayFileServlet?docno=H532), agreed to a phased approach in implementing the Revised Advertising Guidelines. In essence, all new marketing materials are required to comply with the Revised Advertising Guidelines as well as the new disclosure standards set out in the December 5 Letter, from January 1, 2009. The SFC has agreed to extend the deadline for updating existing marketing materials to March31, 2009. If individual issuers continue to face practical difficulties, they are encouraged to discuss them with the SFC at the earliest opportunity.

The SFC had originally suggested that the reminder starkly advise prospective investors: "Do not buy this product unless the intermediary who sells it to you has advised you that it is suitable for you and has explained why, including how buying it would be consistent with your investment objectives." This has, not unexpectedly, ruffled the feathers of the local fund industry.[5] While the regulatory obligation on intermediaries to ascertain and ensure product suitability is not new, this is the first time that product issuers are required to carry such stark warnings on the offering document and marketing materials. In response to efforts by the HKIFA to negotiate the form of the language with the SFC, the SFC appears to have agreed to language which now reads:

> The investment decision is yours but you should not invest unless the intermediary who sells it to you has advised you that it is suitable for you and has explained why, including how buying it would be consistent with your investment objectives.

Whatever the final form of the language, the SFC has given clear signs to the industry that, in light of the minibond saga, it intends to enforce more vigorously existing requirements for intermediaries to know their clients' financial situation, investment experience, and investment objectives, and to ensure product suitability.

"Financial or other incentives in investing in a product should not be used or presented in such a way that it is likely to divert or mislead investors' focus from the proper consideration of the product." This is a timely reminder from the SFC in view of the current economic climate. With fund sales down, issuers and/or distributors may be tempted to offer gifts, premia, or rebates as incentives for investing. The over-zealous use of such incentives to conclude a quick sale may reap long-term problems for both intermediaries and investors. An investor may not make a proper objective assessment of the investment and may enter into a transaction that may not meet his needs; the intermediary may be exposed to allegations that the sales process was compromised as a result of offering incentives. It would be prudent for intermediaries to ensure that any incentives offered are of a nominal or modest value in relation to the total amount invested by investors, and that the sales and distribution process is monitored regularly to ensure that incentives do not become the driving force or primary focus of any investment decision.

SFC's Lead Shines Light on Future of Fund Distribution in Asia in Wake of Minibond Saga

There has been public clamor for simplicity in disclosure in other Asian markets as well. Other Asian regulators are expected to take a leaf out of the SFC's book and study the introduction of similar measures. At the very least, there may be a convergence of market practices in the two key Asian markets of Hong Kong and Singapore. As an early indication of this, the chairman of Southeast Asia's largest lender—DBS Bank (which is majority-owned by the Singapore government and a major distributor of the affected securities in both Hong and Singapore)—committed publicly in an interview with Singapore's major English daily newspaper that the bank would, in the future, preface every investment product it sells with a short product summary sheet. A mock-up of such a summary sheet, which was published later by the same newspaper, adopted a very similar presentation style and content to that outlined in the December 5 Letter. Subsequent media reports have other Singapore lenders indicating that they will follow DBS Bank's lead.

We do not expect the December 5 Letter to represent the final word on the SFC's requirements for enhanced risk disclosures, particularly as the HKIFA is currently in negotiations and discussions with the SFC. In the short-term, as the industry enters the implementation phase, the SFC may shape its position to respond to teething problems that have been identified and to market feedback. Findings from the investigations into the tens of thousands of complaints by angry investors are also likely to reform the SFC's position in the future.

5 A fundamental concern is that the warning does not address situations where it would not be practical or possible for a confirmation of suitability to be provided by the intermediary. For example, there may be no meeting or contact whatsoever between the intermediary and the investor to allow the former to conduct a full fledged financial needs analysis of the investor so as confidently to match the product to the investor's profile. The investor may also refuse to provide detailed financial information or supporting documents about himself, resulting in the intermediary having incomplete information with which to ensure product suitability. Hong Kong-based retail investors tend to regard themselves as savvy and requiring only product information from the intermediary in order to reach their own decisions to purchase the investment products (i.e., no assistance may be required or sought or expected to help ascertain the individual's needs and suitability of the investment products).

So far as we are aware, however, the December 5 Letter represents the first significant practical guidance by a major Asian regulator regarding enhanced disclosure for retail mutual funds in the aftermath of the minibond saga and current market volatility. It provides early insights into a regulator's likely concerns, and its expectations and priorities going forward. The overarching themes raised by the letter—such as clear, fair, and balanced disclosures of product features and risks, the use of visually reader-friendly and plain language to highlight in prominent terms such disclosures, and a renewed focus on enhancing sales and distribution processes to ensure product suitability—are likely to endure. The onshore fund industry in Asia is likely to face an increased burden, at least in the short-term, as regulation of the industry continues and expands on different fronts for product issuers and distributors.

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