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Client Alert

Financial Services

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Hedge funds, complex products and suitability – 6 April deadline

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Under the revised Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, which is scheduled to come into effect on 6 April 2019, intermediaries must determine whether a product they are selling is a complex product. If a product is a complex product, an intermediary cannot sell it to an individual investor, whether a professional or not, unless the intermediary is satisfied the product is suitable for the client. The obligation arises even in the case of an execution-only transaction. The only investor categories to which the suitability obligation does not apply are "institutional" professional investors such as banks, insurance companies and fund management companies, and consenting corporate professional investors which have a dedicated investment function or independent advisor (**eligible corporates**).

Managers of hedge funds (and other unauthorised funds) who sell directly to investors need to determine whether their funds are complex products. If they sell through private banks or other distributors, they need to be ready to answer questions from their distributors as to whether their funds are complex products (although the person selling the product is ultimately responsible for determining whether the product is complex).

In making such determination, intermediaries are required to exercise due skill, care and diligence having regard to whether:

(i) the investment product is a derivative product;

(ii) a secondary market is available for the investment product at publicly available prices;

(iii) there is adequate and transparent information about the investment product 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 the investment illiquid and/or difficult to value.

Of these, factors (i) and (vi) are most likely to be of relevance to hedge funds. If a fund's net derivative exposure exceeds 50% it will be categorised as a derivative product. The SFC has issued guidance on the calculation of net exposure for managers of authorised funds, and the same guidance should be followed in calculating derivative exposure for hedge funds: Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds.

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Liquidity has always been one of the key requirements for retail products in Hong Kong. The required level of liquidity is not defined, although the monthly dealing requirement for authorisation of funds for sale to the public is a strong indication. Hedge funds which permit redemption less frequently than monthly are likely to be categorised as complex products. Private equity funds are highly likely to be categorised as complex.

If a fund is complex and is to be sold to individuals (or to professionals who are not institutional professional investors or eligible corporates), it will be necessary for the distributor to have procedures in place to ensure that:

- appropriate assessments are made of the investor's needs and circumstances;
- appropriate assessments are made of the product;
- the product is assessed as suitable for sale to the investor having regard to their needs and circumstances;
- appropriate records of such assessments are kept (and provided to the investor if so requested);
- staff are properly trained in the sales process, and in particular the features and risks of the products they recommend or sell; and
- the sales process is adequately monitored and supervised.

Assessing suitability should not be difficult when dealing with professional investors, but care should be taken when dealing with investors who, although they meet the asset tests to qualify as professionals, are potentially vulnerable owing to age, inexperience, educational level or infirmity.

Distributors (including managers who market the funds they manage directly to investors) are required to have a client agreement with their customers containing certain specified information, warnings, and a suitability statement. Consideration needs to be given to the form this agreement should take. It seems likely that many managers will wish to develop some form of simple agreement or terms and conditions, which will form part of their investor take-on procedures, to comply with the client agreement requirements.

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