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Attention: Consultation on proposals to enhance protection for the investing public

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Dear Sirs

CONSULTATION PAPER ON PROPOSALS TO ENHANCE PROTECTION FOR THE INVESTING PUBLIC

Allen & Overy appreciates the opportunity to express its views on the Consultation Paper on Proposals to Enhance Protection for the Investing Public (the **Consultation Paper**). Our responses to the questions set out in the Consultation Paper are set out below. We would be pleased to discuss the issues below further, or to assist in any way that the Securities and Futures Commission (the **Commission**) deems appropriate.

List of consultation questions in Part II

Consultation questions in relation to Overarching Principles Section

Question (1): Do you have any comments on the Overarching Principles Section of the Handbook generally or any particular provisions in the Section? Please explain your views.

We are generally supportive of the principles set out in the Overarching Principles Section of the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured

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Products (the **Handbook**) and support the enhancement of protection for the investing public in Hong Kong, subject to the following comments:

(a) Paragraph 5.3 – It is not clear from this paragraph the extent of the due diligence that a Product Provider should conduct. A Product Provider is not in a position, for example, to determine the competence of a distributor's staff when they discharge their duties.

(b) Paragraph 5.5 – A Product Provider is required to satisfy itself that each of the key counterparties and service providers engaged or appointed in respect of a product is competent and has resources to duly discharge its obligations under its terms of engagement and comply with all relevant requirements set out in any applicable product code. Our view is that this requirement creates an unreasonable burden on the Product Provider and is practically difficult to be fulfilled. In order to satisfy such provision, the Product Provider might need to conduct due diligence on each key counterparty and service provider, not only in terms of competency but also internal resources and operations which would be a difficult task. In addition, we doubt whether the Product Provider would have the authority and be allowed to conduct such due diligence. Accordingly, we would propose that Clause 5.5 be deleted as Clause 5.4 has already imposes a duty of due care and diligence in the selection of counterparties and service providers on the Product Provider which should be sufficient.

(c) Paragraph 5.6 – It is required that all offering documents be written in both the Chinese and English languages, which shall be of equivalent standing. This requirement seems to require a higher standard than the prospectus requirement under the Companies Ordinance which stipulates that a prospectus must either be in the English language and contain a Chinese translation or be in the Chinese language and contain an English translation. We could envisage that there would be practical difficulties in complying with such requirement and it would impose unnecessary burden and compliance costs on issuers. Furthermore, we query how equal weighting would work for the terms and conditions of a structured product given that the actual terms and conditions lodged with the clearing system is in English. Accordingly, we would suggest to adopt the Companies Ordinance standard and amend paragraph 5.6 accordingly.

(d) Paragraphs 6.5 to 6.8 - We generally support the proposal to include a Product Key Facts Statement (**PKFS**). However we have some concerns and recommendations in this regard. The inclusion of a PKFS has the potential danger that investors would be more inclined not to read, and possibly disregard, the prospectus entirely. It should be made clear to investors that it must not be seen as an alternative to reading a prospectus in full.

The prescribed page limit (of 4 pages) has been perceived by market participants as being too short to accurately describe the key facts of structured products generally, and in particular for more complex structures. It would be even more difficult if the PKFS were to also include the key features and risks of the structured product. There should be flexibility to allow for greater depth of explanation of new structures and more complex products. There is a risk that there may be disputes alleging that certain key information has been omitted from, or has not been sufficiently disclosed in, the PKFS even though such information is set out in detail in the prospectus. An undesirable knock-on effect of the fear of liability is that issuers may aim to over-disclose risks in the summary but, because of length constraints, will be forced to generalise risk disclosures to the point where they are all encompassing but meaningless.

Given the reasons above, we would suggest maintaining flexibility on the page limit of the PKFS depending on the types of product, bearing in mind the overall fundamental principle that the PKFS should be clear, precise and concise.

__Consultation questions in relation to the SP Code__

Question (2): What are your views on the proposed disclosure requirements in Appendix C *(Information to be Disclosed in Offering Documents for Unlisted Structured Products)* and Appendix D *(Advertising Guidelines Applicable to Unlisted Structured Products)* to the SP Code?

We are of the view that Key Product Counterparty (KPC) should not include hedge providers for non-repackaging deals. The disclosure of the basis on which a KPC is selected and the arrangement with the KPC as required under paragraphs 1(d) and 42(d) of Appendix C may amount to the release of commercially sensitive information.

In relation to paragraph 23 of Appendix C (Information on the guarantee for guaranteed structured products), there would be difficulties in explaining "any relevant issues relating to conflicts of laws or recognition of judgments and their implications for investors". This would involve the disclosure of complex information and issues that can be uncertain.

In relation to paragraph 28 of Appendix C, the disclosure of financial reports for the last two financial years of the issuer, guarantor and each KPC would generate a large amount of additional information and considerably lengthen the offering document. In light of this, would the Commission consider it acceptable that the financial statements could be incorporated by reference (as is the practice in other jurisdictions), especially if the entities were listed on a recognized stock exchange? In addition, the proposed code specifies that the audit report needs to conform to Hong Kong accounting standards or the IFRS. Some overseas issuers and swap counterparties are incorporated in the USA or the UK. The accounting principles applicable will be those of the USA or the UK (e.g. GAAP). It would be very costly to conform existing audit reports to either the HK accounting standards or the IFRS. This proposed requirement would add to the cost and may deter overseas issuers offering structured products in Hong Kong. The Hong Kong Listing Rules applicable to listed structured products do not have this requirement. Imposing this requirement would therefore create inconsistencies between products issued by the same product issuer but under different rules (i.e. the Listing Rules vs the proposed SP code). We would therefore be grateful if the Commission could reconsider whether this requirement can be removed or modified.

In relation to Appendix D of the SP Code, we are generally supportive of the principles and the requirements laid out. However, adequate and prominent risk disclosures as required by paragraph 1(b) may present practical difficulties in certain situations. It is too onerous to have to list out the risk disclosures particularly for certain mediums of advertising which are unsuited to such risk disclosures (for example, radio and TV advertisements which are subject to limited space or air time). If these risk factors were required to be included, they would most likely take up more time than the actual advertisement itself. It can be argued that sufficient risk disclosures are already laid out in both the PKFS and in the offering document themselves. In addition, we would seek clarification as to what types of generic advertising would not require authorisation (for example, can an issuer issue materials containing a generic statement that it issues ELIs (and not mention terms of any specific ELIs) without seeking authorisation?)

Question (3): What are your views on the requirement for Issuers to provide ongoing disclosure of the types of information set out in 7.6 of the SP Code throughout the term of a structured product? Please explain the reasons for your views. Are there any other matters which you think an Issuer should be obliged to disclose to investors on an ongoing basis?

One concern in relation to ongoing disclosure of information is the publication of the financial results of the Issuer, Guarantor and any KPCs. It would be a significant burden to publish all interim financial results (if available) in addition to annual financial reports in both English and Chinese. The need to translate such

financial reports would impose significant additional resources, even more so considering the Commission's proposal to give equal weighting to both English and Chinese versions. Furthermore, it would be virtually impossible to maintain 100 per cent. consistency between the two versions.

In addition, instead of issuing supplemental offering documents containing new financial information, would the Commission accept that a website address be provided to investors to access the financials online instead, with a prior written notice sent to the investors? Issuing and printing supplemental offering documents is administratively burdensome and costly for our clients.

Where the Issuer is required to keep the Commission and all investors of the product informed of any material adverse change in the financial condition of the business of the Issuer, Guarantor or their respective groups (paragraph 7.6(b)), there would need to be further clarification on what is "material to investors' interests". Furthermore, the disclosure requirements should be limited to the Issuer and Guarantor only, and should not include any of their respective corporate groups, as it would require a significant additional cost burden to be kept informed of all potential "material changes" of their respective corporate group entities.

Lastly, we would also like to seek clarification in relation to what constitutes a failure of a material portion of the collateral or a breach by a trustee/custodian, as provided by paragraph 7.6(d). Would the Commission please provide a materiality threshold.

Question (4): What are your views on the eligibility requirements for Issuers and Guarantors of unlisted structured products proposed by the Commission?

We are generally supportive of the Commission's proposals on the eligibility requirements for Issuers and Guarantors of unlisted structured products. However, the requirement that the Issuer or the Guarantor confirm that it has never been convicted of any offence under applicable securities or corporate laws or other laws involving fraud or dishonesty is onerous particularly for institutions that operate on an international basis. Would the Commission consider applying a materiality test, a geographical limit (for international institutions) or a time frame to this requirement?

According to paragraph 5.2 of the SP Code, the Product Arranger "should be independent of any Key Product Counterparty". However this requirement is not suitable if "independent" is taken to carry the same meaning as "unconnected". In fact, due to risk management purposes, it is common for the Issuer or the Product Arranger to belong to the same group of companies as the Product Counterparty. Accordingly, would it be sufficient that transactions be conducted at arms' length (with adequate information barriers in place) with disclosure of possible conflicts of interest between the parties.

We would also like to express our concern over paragraph 7.8(c) of the SP Code which requires the Issuer and, where applicable, the Product Arranger to provide compensation to investors where the relevant structured product and any relevant party fails to meet the requirements under the Handbook. We query why it is necessary to reference compensation in the SP Code and request it's deletion. Whether compensation is required is a matter of law and investors should rely on remedies available to them depending on their particular circumstances.

Question (5):

(a) What are your views on the proposed requirements applicable to SPV Issuers?

We do not have any comments on these requirements.

(b) What are your views on the current proposal to mandate the appointment of a Hong Kong-licensed Product Arranger for structured products issued by an SPV and make such Product Arranger responsible for ensuring an SPV Issuer's compliance with the SP Code throughout the term of the structured product?

It may be difficult to implement the proposal in practice, particularly if the Product Arranger were to be independent of the Issuer. Potentially, a lack of regulatory power given to the Product Arranger would mean that it is extremely difficult for the Product Arranger to ensure the Issuer's compliance at all times. Furthermore, it is unclear in paragraph 4.6. of the SP Code as to what information and undertakings the Product Arranger would need to provide to the Commission. We are of the view that the regulatory function would be best performed by the Commission.

(c) Do you think a Product Arranger should also be appointed for structured products issued by Issuers (whether SPVs or not) or guaranteed by Guarantors where these entities are not local Regulated Entities (i.e. where the Issuers/Guarantors are not licensed banks regulated by the HKMA or corporations licensed by the Commission pursuant to section 116 of the SFO)?

It should not be necessary for a Product Arranger to be appointed where the entities are not local regulated entities. Such entities would be governed by overseas regulatory bodies and already subject to its rules and regulations. This requirement also does not seem to be consistent with listed structured products. It would appear that a foreign issuer issuing listed and unlisted structured product will be subject to different requirements if this requirement was to be implemented.

(d) Other than what has been proposed, what other obligations or requirements (if any, both before and after an offering), do you think a Product Arranger should be made subject to? Please give a list of any such additional obligations with reasons.

We do not have other obligations or requirements to add. However, we would like to comment on the requirement that the Product Arranger must hold Type 1 and Type 4 licences (paragraph 4.2(a)). There is no advisory work being performed by the Product Arranger and hence we query why a Type 4 licence is required here. Furthermore, the Product Arranger is required to maintain "independent valuation of the structured product" (paragraph 4.5) - we question how this is to be conducted? Would the valuation have to be done by an independent third party, or would an independent party within the same group be eligible?

Question (6)

(a) What are your views on the proposed eligibility criteria for collateral in respect of structured products?

In general the eligibility criteria for collateral appear to be steering away from a disclosure based approach and towards a merit based approach. The onerous requirements may mean that a number of the current structures would be prohibited (see below for more details). This may have the consequence of limiting innovation and structures for investors, and consequently, may affect Hong Kong's status as a leading

financial centre. In our view, this would lead to an undesirable result for investors, depriving them of investment opportunities that may suit their particular investment profile.

Further clarification needs to also be sought in relation to the wording of the eligibility criteria. For example, terms such as "not be related", "appropriately diversified" and "undue risk" as set out in paragraphs 5.13(e), (j) and (k) respectively are set out without reference to an existing benchmark for eligibility. If such a benchmark cannot be established, then it is suggested that it be removed. In addition, we note that some current structures with a single asset being held as collateral may not be able to meet the "appropriately diversified" requirement. Also, it is common in the market that the issuer of the collateral is from the same corporate group as the Issuer or Product Arranger or KPC, therefore these requirements will have the effect of restricting many existing structures.

The proposed collateral requirements seem to preclude some of the current structures commonly adopted by market participants. For example, where an SPV issues a note and then enters into a swap agreement with a swap counterparty at the same time, payments received by the SPV under the swap will be used to fund payments under the notes. The Trustee of the notes takes security over the SPV's right to receive payments under the swap agreement in favour of noteholders. No additional collateral is available to noteholders. Each series of notes is ring-fenced against other series issued by the SPV. According to the proposed code, it appears that issuers are not able to issue notes using this structure. So long as sufficient disclosure is made regarding the structure and the risks investors take, would the Commission consider allowing this and other similar structures. The stringent requirements set out for collateral do not appear to be consistent with the disclosure based regime.

In relation to paragraph 5.17(a) and Note (1), we express our concerns that such requirements would limit or prevent some of the collateral arrangements commonly adopted by market participants to boost the credit worthiness of the investment product. For example, an ISDA Credit Support Annex (**CSA**) that serves to reduce the credit exposure of the swap counterparty. Being able to substitute credit support is a common and key feature of a CSA. Taking away the ability to replace collateral would have negative repercussions on any market development in this area.

(b) Do you think that collateral should be subject to any additional eligibility criteria? If so, what criteria?

We do not think that there should be additional eligibility criteria.

(c) What are your views on the requirement that investors' claims to collateral proceeds should be accorded priority and should not be subordinated to claims by counterparties to transactions with the Issuer that are related to the structured product?

We would like to point out that this requirement is not market standard . There are certain scenarios in some structures (e.g. SPV repackaging structures) where it is common that the swap counterparty will rank ahead of the noteholders. It is unlikely that trustees and swap counterparties would accept this subordination as such parties are not compensated to take on this risk. Importantly, if priority is given to investors, it would have a significant financial knock-on effect. The yield of the products would decrease significantly and would reduce the amount of entities willing to take on a significant amount of added risk (if they are not adequately compensated for it). The ultimate effect of this requirement is that the products on offer to investors will have lower returns which will potentially be less attractive to investors. In situations where the investors' claims will not prevail, we would suggest that it should be acceptable that the offering document includes adequate disclosure and risk warning to highlight this to investors.

Question (7): Do you believe that the Commission should take into account any additional eligibility criteria for reference assets, or any other factors, when considering whether or not to accept a proposed reference asset or asset class for a structured product? If so, please list such additional criteria / factors and give an explanation for each.

The proposed eligibility criteria as set out in the draft code seems to be more in line with a merit-based approval regime (as paragraph 5.7 requires reference assts to "be acceptable to the Commission"), which militates against Hong Kong's disclosure-based regime.

We also note that the eligibility criteria for the reference assets seem to be focused on Hong Kong securities and as such may have the impact of limiting investors' reach to the global investment market – which may have a detrimental effect on the competitiveness of Hong Kong as a global financial hub. The reduction of the range of reference assets available to Hong Kong based investors would deprive investors of products that could otherwise be beneficial additions to their respective portfolios.

As an overriding principle, would the Commission confirm that the overall intention is that as long as there is adequate disclosure in place, assets would generally be considered eligible by the Commission?

In considering whether the reference assets are acceptable, would the requirement of having information in both English and Chinese be more relaxed for foreign assets? Is translation required for every piece of information? There would be costs and time implications for foreign assets. If translation is required, would English and Chinese versions carry equal weighing or could one version prevail over the other?

We would also appreciate if the Commission could elaborate on the criteria or benchmark in determining whether the number of reference assets is reasonable "in light of the product strategy or objective and the intended target market" as provided in paragraph 5.8(b) Note (4).

Question (8):

(a) **Should indicative valuations of structured products be required to be provided daily? Do you think there are additional or other measures which could help investors to assess the performance of their investments? If so, please provide details.**

We understand from market participants that the current market convention is to provide indicative valuations ranging from a weekly to monthly basis. Many issuers and intermediaries have expressed concerns that they do not currently have the infrastructure in place to conduct daily indicative valuations. As such, it would pose a significant additional operational and cost burden on the respective parties if daily indicative valuations were in fact required. We also question whether daily valuation is suitable for unlisted structured products as they are designed to be held until maturity. In some cases, daily valuation may not even be useful for investors as pricing may fluctuate significantly throughout the day. To strike a balance between providing increasing product transparency to investors and the additional costs involved, we would suggest that weekly valuations be provided to investors.

Another point to note is that it is sometimes difficult for banks to provide valuations in extraordinary circumstances so it would perhaps be more appropriate for indicative valuations to be provided on a best efforts basis.

If indicative valuations were to take place, it is unclear how the valuation can be conducted "on an independent basis". Provided that there are information barriers in place, would valuations conducted within the same issuer or intermediary but in a different department, or in a related company to the issuer

or intermediary be sufficient? We understand from the banks that in some cases, an entirely "independent" valuation may not be possible for some products.

An important consideration that must be taken into account is the need to warn investors that such indicative valuations, given however frequently, do not necessarily reflect the firm or actual exit prices. Such disclosure ought to be made in either the prospectus or the PKFS to make investors aware of the fact that unlisted structured products are generally held to maturity, and that the valuations are purely indicative.

(b) **With regard to the proposal to provide liquidity by way of making firm price quotations, do you think an exemption is justifiable for structured products with a short scheduled tenor, e.g. of one month or less? How often do you think Issuers or their market agents should provide liquidity by way of making firm price quotations? Do you think that there are other circumstances or periods during the term of certain structured products in which liquidity provision should not be required or could not reasonably be provided? If so, why?**

We understand that firm price quotations are difficult to make in relation to unlisted structured products. These products are forward priced, which means that no firm quotation will be available before the sell order is executed. Due to the general illiquid nature of unlisted structured products, the firm value of such a product will vary significantly, depending on the size of the deal, the cost of unwinding the investment as well as general prevailing market conditions. As such, until a sell order is confirmed, it is generally difficult to achieve a realistic firm price quotation. As a result, if firm price quotations were made mandatory, then the issuer or intermediary will have to quote a very conservative, and perhaps unrealistic price to protect themselves in a comparatively illiquid market.

We would also be grateful if the Commission could clarify how long would a firm quotation price have to remain effective taking into consideration market fluctuations and price volatility. Even if firm price quotes were available, such firm pricing is still subject to the availability of the secondary market of the underlying collateral, which in turn is affected by the issuer of that collateral.

In light of the potential problems with quoting firm prices, we suggest that firm prices should be provided upon request for products with tenures of at least 6 months.

Where there are circumstances which make it impossible or impracticable for the Issuer to obtain valuations, for example, when a market disruption occurs, the Issuer should be exempt from providing firm price quotations. Also, certain limitations on size orders (on a given day) should be implemented to avoid disorderly price movement. Without imposing a cap on the maximum amount that the Issuer needs to buy back from its investors, the costs implications for the Issuer will be severe, for example where an Issuer is obliged to buy back the entire outstanding notional of its product on a given day.

Question (9): Please give your views on the use of annualised returns in offering documents and advertisements for structured products.

It would not be appropriate to place such disclosure side-by-side with actual returns as it may create confusion for investors and may potentially be misleading. Furthermore, an average investor may not fully understand all the assumptions behind how the annualised figures are calculated. There are also certain types of structured products where annualised return is not meaningful for investors. For example, for accumulators where investors can elect to sell or hold on to the accumulated shares in relation to the physical settlement periods during the life of the product, annualised figures would not be helpful.

We fully support the Commission's suggestion to place more emphasis on improving investors' understanding on annualised return so that investors would be better equipped themselves to make informed choices before investing in a product and in reading the offering documents and advertisements. Perhaps the implementation of annualised return can be implemented at a later stage after the Commission is satisfied that the investors have gained a better understanding of this concept.

Question (10): Please provide your views on the length of the transition period for compliance with SP Code requirements for unlisted structured products where the issue of documents has been authorized prior to the date of the SP Code's effectiveness.

There compliance period suggested is set at 6-9 months after the effective date of the SP Code. The new SP Code requires significant practical changes to the unlisted structured product programme itself, and in turn significant legal and documentation cost. Systems would need to be enhanced to cater for the new code. For example, to install systems to provide weekly pricing to investors. We suggest that compliance with the code should be done by the next annual renewal of authorization to ensure a smooth and accurate transition.

Consultation questions in relation to the revised UT Code

Question (11): In relation to proposals regarding investment activities set out in Proposal 1 (structured funds), Proposal 2 (funds that invest in FDIs) and Proposal 3 (investments in other schemes), other than the proposed general requirements, what other requirements do you think should be included? Please explain your views.

On a general basis, in relation to Proposals 1, 2 and 3, we consider that the requirements are sufficient for the time being though we have comments on the following requirements:

(a) Paragraph 8.6(f)(v) – it is required that the index should be objectively calculated and rules-based. We would suggest the Commission to clarify what is meant by "objectively calculated".

(b) Paragraph 8.8(a) – it is required that the management company and the issuer shall be independent of each other. We would suggest the Commission to clarify what is meant by "independent" and the level of independence required.

(c) Paragraph 8.8(c) – it is required that the valuation of the financial derivative instruments has to be conducted independently. We would suggest the Commission to clarify the level of independence required for choosing members of the valuation committee.

(d) Clause 8.8(e)(iv) – it is required that collateral must not be concentrated in one issue, sector or country. Firstly, we are of the view that this requirement is quite restrictive and we cannot see the benefit it will bring for imposing such restriction. Secondly, we would suggest the Commission to clarify what is meant by "concentrated" and the level of diversification required.

Question (12): In relation to the disclosure and reporting requirements set out in Proposal 4 (bilingual annual reports) and Proposal 5 (Product KFS), do you agree with the proposals? Please explain your views.

In relation to Proposal 4 (bilingual annual reports), we agree with the Commission's proposal that for SFC-authorised schemes which are recognised jurisdiction schemes, publication of a Chinese language annual report should be voluntary.

In relation to Proposal 5 (Product KFS), please refer to our response to Question (1) above.

Question (13): Do you have any comments on the revisions to the UT Code generally? Please explain your views.

Please refer to our response to Question (11) above.

Question (14): What are your views about the idea of UCITS schemes which have issued KIDs under their own E.U. regulator's regime using those KIDs in place of the Product KFS? The issue here is how we should balance the importance of developing broadly standardized Product KFS across all products sold to the Hong Kong public so that it is easy for Hong Kong investors to understand and compare different products, and the commercial needs of individual fund houses to reduce costs and lessen administrative burdens. Also, if a large number of Commission-authorized funds adopt KIDs instead of Product KFS, it may defeat the purpose of comparability under the Product KFS proposal. The Commission would like to hear your views.

UCITS schemes which have issued KIDs under their E.U. regulator's regime should be exempted from the requirement of issuing a PKFS provided that the KIDs provide substantially the same information as the PKFS, and the format and presentation they adopt are able to provide information to investors in a user friendly and easy to understand manner.

Question (15): Do you agree that the proposed approach to implementation of the revised UT Code is acceptable and practicable, taking into account the needs and circumstances of various stakeholders? Do you have any particular views as to exactly how long the transition period should be for Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements?

Generally, we have no comments on the proposed approach to the implementation of the revised UT Code though we would suggest the transition period to be not less than 12 months. Also, we would suggest the Commission be flexible in granting waivers and extensions to the Existing Schemes in relation to compliance with the new requirements under special circumstances.

Consultation questions in relation to the revised ILAS Code

Question (16): Do you have any comments on (1) the Product KFS requirements, (2) the enhanced disclosure requirements on "with-profit" features and internal funds, (3) the deletion of Chapters 5, 8 and 9 of the current ILAS Code, and (4) the codification of the existing practices regarding the computation of surrender values and the notification requirements on scheme changes?

In relation to the PKFS requirements, please refer to our response to Question (1) above. We have no comments on (2), (3) and (4).

Question (17): Do you agree that the proposed approach to implementation of the revised ILAS Code as acceptable and practicable, taking into account the needs and circumstances of various stakeholders? Do you have any particular views as to exactly how long the transition period should be for Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements (paragraph 214(c))?

Generally, we have no comments on the proposed approach to the implementation of the revised ILAS Code though we would suggest the transition period to be not less than 12 months. Also, we would suggest the Commission be flexible in granting waivers and extensions to the Existing Schemes in relation to compliance with the new requirements under special circumstances.

List of consultation questions in Part III

Question (18): Do you agree that some of the proposals in this part of the consultation paper should only apply to unlisted investment products? Please explain your views.

We agree that the proposals should only apply to unlisted investment products as listed investment products are sufficiently regulated by the Hong Kong Stock Exchange.

Question (19): Do you think that intermediaries should, as part of their "know your client" procedures, seek clients' information about their knowledge of derivatives and characterize those clients (other those professional investors) with such knowledge as "clients with derivative knowledge" to assist intermediaries in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable?

Please give your views on the contents of the proposed measures for intermediaries to assess whether investors have knowledge of derivatives.

We are of the view that such proposed requirement is unnecessary and might cause confusion as it appears that it is a duplication of the existing "know your client" requirement under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**SFC Code of Conduct**). In relation to derivative products, intermediaries are already required to assure themselves that their clients understand the nature and risks of the products and have sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products under paragraph 5.3 of the SFC Code of Conduct. Moreover, investment advisers are also subject to precise suitability obligations under the Commission requirements.

Question (20): Should a high net worth investor be considered to have specific knowledge and expertise if:

(a) he is currently working, or has previously worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or

(b) he has undergone training or studied courses which are related to the relevant product?

Do you have any other suggestions?

We have no objection to such assessment criteria, but the scope seems to be too limited. Other factors such as an investor's self education (e.g. via reading Commission's website and books) should also be taken into consideration. We would suggest that a list of assessment criteria be provided for reference to intermediaries but the list should not be exhaustive or conclusive. It follows that if an investor's knowledge, expertise or investment experience does not fall within any item on the list, it does not mean that he or she cannot be treated as a

professional investor - the intermediary should make a general assessment as to whether an investor should make an investment, based on their relevant knowledge and investment history.

We consider that it is important for an investor to understand the consequences and underlying risks which he or she would be subject to when being treated as a professional investor. We note under paragraph 15.4 of the SFC Code of Conduct, an intermediary is already required to provide to an investor a written explanation in relation to the risks and consequences of being treated as a professional investor.

Question (21): What amount should the minimum portfolio requirement be set at? Please give your reasons.

We would suggest maintaining the current threshold of HK$8 million as we do not see any substantial benefit if such threshold is changed.

Question (22): Where a distributor and/or any of its associates explicitly receives or will receive monetary benefits from a product issuer (directly or indirectly), which of the following three disclosure options would be more appropriate? Please explain your views.

Option 1.1 – Disclosure of dollar amount or percentage
Option 1.2 – Disclosure of percentage bands or ceiling (i.e. "x% to y%" or "up to y%")
Option 1.3 – Generic disclosure

We would opt for Option 1.2 as Option 1.1 would likely require disclosure of sensitive commercial information and Option 1.3 might not be relevant and direct enough. Option 1.2 is a good balance between the two.

Question (23): Do you have any suggestions as to how the percentage bands referred to in Question 22 should be set (e.g. up to 1%, over 1% to 2%, etc)?

We would suggest disclosure of percentage bands be set depending on the nature of the relevant structured products.

Question (24): Where a distributor does not explicitly receive any monetary benefits for distributing an investment product, which of the following disclosure options would be more appropriate? Please explain your views.

Option 2.1 – Specific disclosure of distribution reward
Option 2.2 – Generic disclosure

We would opt for Option 2.1 and disclosure should be by way of percentage bands or ceiling.

Question (25) Where a distributor makes a trading profit from a back-to-back transaction, which of the following disclosure options would be more appropriate? Please explain your views.

Option 3.1 – Disclosure of specific trading profit
Option 3.2 – Generic disclosure

We would opt for Option 3.1 and disclosure should be made by way of percentage bands or ceiling, but only to the extent that profit is made as a result of incentives offered to distributors by product providers.

Question (26): Do you consider it appropriate to restrict distributors from offering investors supermarket gift coupons, audio visual equipment and other kinds of gifts having monetary value (except discount of fees and charges) in promoting a specific investment product to investors?

We do not have a view on this provided that if gifts are permitted, their use is regulated for all investment products. In addition, investor education should be enhanced to ensure that investors do not make their investment decisions based on the gifts without paying sufficient attention to understand the nature and risks of the relevant products.

Question (27): Do you have any comments on the proposed information content of the Sales Disclosure Document which includes (a) capacity (principal or agent); (b) affiliation with product issuer; (c) monetary and non-monetary benefits; and (d) discount of fees and charges available to investors?

We are of the view that an additional Sales Disclosure Document is not required as the proposed information is already contained in existing documents (such as the account opening documents).

Question (28): Do you think audio recording of the client risk profiling process and the advisory or selling process for investment products should be made mandatory or the current record keeping requirements are sufficient? If audio recording is made mandatory, how long do you think these audio records should be kept for? Please explain your views.

Our view is that audio recording should be recommended but should not be made compulsory as we consider that the current record keeping requirements are sufficient. In our view, making audio recording compulsory might increase the cost and compliance burden of intermediaries unnecessarily with little additional investor protection and may be impractical in certain situations (e.g. for private banking clients).

List of consultation questions in Part IV

Question (29): Do you believe that a cooling-off period would generally be beneficial for investors, or do you believe that costs associated with its implementation would outweigh the benefits for investors?

While a cooling off period has the benefit of investor protection by mitigating any high-pressure sales tactics, and providing investors with some time to reflect on the risks and wisdom of their investment, there are certain costs associated with its implementation on other parties as well as on investors as a whole.

Impact on Issuers/Distributors

Implementation of a cooling-off period would place a significant administrative burden on issuers and distributors of the product.

Additional resources will have to be allocated to deal with cancellation requests and to overall manage a formal cooling off period. This will be very costly for issuers and distributors as there are already many sunk costs that need to be absorbed by such entities such as legal, documentation and maintenance costs.

Transferring Costs to Investors

To factor in the cooling off option, issuers are likely to take into account when pricing products, the hedging arrangements that would need to be unwound and the charges associated with a cooling off period. This would result in higher pricing for investors as a whole.

Moral Hazard Issues

As the Commission pointed out in the Consultation Paper, there are moral hazard issues associated with having a cooling off period. To name a few, investors may invest in a product without exercising much care and thought as they are likely to view this cooling off period as a free exit route. They have no incentive to really weigh the costs and benefits of their transaction since they know they can withdraw without too much effort. This presents a danger in undermining the suitability and know-your-client checking process imposed on the distributors.

We acknowledge and agree with the Commission that a cooling off period is a useful tool to rebuild and enhance investor confidence. If a cooling off period is to be implemented, we fully agree with the Commission that the refund amount should take into account the issuer's break costs (costs of funding during the period in which funding is committed and also the unwinding costs for any hedging arrangements) and that the refund amount should be subject to a market value adjustment to reflect the changes in the market value of the underlying. If this was not allowed, a likely consequence is that there will be an increase in the cost of the investment for other investors. We would also suggest that a cooling off period (if implemented) should only be available for longer tenor products and that only a short time frame be given to investors to unwind their trade (e.g. two or five business days depending on the tenor of the product).

Question (30): Please provide your views on whether investors should be given a period of time after placement of their orders during which execution of the trade is delayed and the investor is given an opportunity to cancel the order before the trade is executed. If your view is that this would generally be beneficial to investors, please provide your views on the types of investment products for which it should be considered and the appropriate cooling-off timeframe.

For the same reasons outlined above, we are generally of the view that a waiting period should not be made available to investors. This waiting period creates enormous burden for the issuers and distributors alike to monitor each investor's order to keep track of the waiting period for each investor. It is not difficult to envisage that a considerable amount of time and effort will have to be set aside to answer investors' queries in terms of the timing of the waiting period and whether it applies to his or her product (if it is implemented).

However, if the Commission is of the view that a waiting period should be made available for certain investment products, then it may be more appropriate for structured notes type products where the trade is executed after an offer period, as it may be easier for issuers/distributors to accommodate order cancellations during the offer period. In these types of offering, a short time frame (e.g. two business days) during the offer period could be considered during which an order can be cancelled. In any event, in the case of a structured note offering, the waiting period should not be allowed to extend past the close of the offer period so as to allow sufficient time for pricing and hedging arrangements to be finalised. Also, it should only be made available for retail notes offering with longer tenors. As the valuation or price fixing dates come after the close of the offer period, disputes as to the timing of the trade would be less of an issue. However in those circumstances, the investors should be the ones who bear the administrative costs incurred and the costs of unwind.

Contrast other types of products like equity linked investments (**ELIs**) where the trades need to be executed at the time of the order, there will likely be a much higher risk of disputes about when a trade should have been executed and whether they are entitled to any return between the time they place the order and the time of execution of the order. For ELIs and products whose trade are executed at the time of the order, this waiting period option should not be made available given the high risks of disputes and the significant costs/burden imposed on the issuers/distributors.

Question (31): Please provide your views on whether, and in what circumstances, you think a window could or should be provided to investors after the date the trade in the relevant product is executed during which an issuer should be required to buy back the product at an investor's request.

For the reasons already outlined in Question 29 above, we are of the view that a window should not be provided to investors which require issuers to buy back the product. As the code already provides for comprehensive disclosure in respect of the investment products, coupled with the KYC process in place, investors should be well placed and informed before they make an investment decision. Moreover, investors' concerns about being locked in are addressed by the market marking requirements imposed on the issuers.

The hedging arrangements in place would need to be unwound in the case of a buy back. Monitoring the window and managing the whole buy-back procedure would also create significant administrative burden for the issuers. Part of such costs would likely have been priced into the product in anticipation of the exercise of this right (which is detrimental to investors as a whole). If it is proposed that such a window be available to investors, it would only be fair that they bear the unwinding and administrative costs involved. This should only be available to products with a minimum tenor of two years and products which are illiquid. In addition, the time frame for this window should not be more than five business days.

Question (32): On the basis that a cooling-off period is incorporated in an investment product and a client has exercised his right under the mechanism, do you consider that a distributor should promptly pass on to the client the full amount of refund (including the sales commission) received from the product issuer less a reasonable administrative charge? Please explain your views.

Since the distributors have indeed allocated its resources, provided services and incurred costs (e.g. training and administrative costs) in the marketing, selling and distributing process, they should be remunerated for their work and in many ways, a full refund (including their sales commission) would be unfair to the distributors.

The risk of investors pulling out is a risk that distributors cannot hedge against. If distributors are required to bear this cost of cooling off period, it would act as a huge deterrent for banks to act as distributors and the potential consequence could be devastating for issuers and the investment market as a whole.

In the extreme, distributing banks may take the view that it is completely uneconomical to distribute these products (taking into account this refund risk), and we may end up with the unintended consequence of stifling the whole distribution network and consequently leading to the collapse of the whole investment products market.

In the meantime, a possible immediate consequence is that distributors are likely to demand higher commission fees factoring in this refund component which issuers will inevitably pass onto investors in the form of higher pricing.

Moreoever, as there are usually complex charging arrangements in place between issuers and distibutors, it is often difficult to apportion the precise amount of commission for a particular product and hence there is bound to be disputes with investors on issues such as quantum and calculation.

In light of the above, we are of the view that distributors should be allowed to keep their sales commission in the absence of any wrong-doing on their part. In the case of alleged mis-selling by the distributors, the investors can always resort to legal actions to claim their money back.

Please do not hesitate to contact us if you have any questions or wish to discuss any of the above matters.

Yours faithfully,

Allen & Overy