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

Dear Sirs

CONSULTATION ON PROPOSALS TO ENHANCE PROTECTION FOR THE INVESTING PUBLIC

This is a submission by Lovells in response to the Consultation Paper on Proposals to Enhance Protection for the Investing Public (the "**Consultation Paper**") published by the Securities and Futures Commission (the "**SFC**") in September 2009. This submission includes collective comments from Lovells and Lovells' clients. We set out below our key concerns, our response to selected questions raised in the Consultation Paper and our comments on selected sections of the Consultation Paper.

1. KEY CONCERNS

1.1 One of our key concerns is to ensure that Hong Kong remains a leading financial centre for funds and has an efficient authorisation process for UCITS funds. Consequently, we are greatly concerned with the situation where a UCITS fund is subject to conflicting fund management rules; that is, where there is one set of rules as set by the European Commission and Parliament applicable to all UCITS funds and another set of rules set by the SFC. For example, 8.8(e)(iv) of the revised Code on Unit Trusts and Mutual Funds (the "**revised UT Code**") states that:

> "The counterparty or other investment limit/exposure of the collateral as a percentage of a scheme's net asset value must not contravene the investment restrictions or limitations set out in Chapter 7."

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In the case of securities collateral, the SFC will only permit 10% exposure to a single issuer. On the other hand, UCITS has its own collateral requirements which require UCITS to reject collateral which has a credit rating below "A" or equivalent. We would submit that UCITS funds should continue to be managed in accordance with UCITS requirements rather than under competing SFC requirements. This is necessary for UCITS funds which are being offered in multiple jurisdictions including Hong Kong.

We would recommend moving those sections in 8.8 of the revised UT Code which affect fund management (such as 8.8(e)(iv)) to 8.9 of the revised UT Code so it is clear that it applies only to non-UCITS funds. We appreciate and acknowledge the requirement for additional disclosures to Hong Kong investors in order to ensure that all material disclosure is provided but are extremely concerned with conflicting rules affecting fund management.

1.2 A second key concern is the imposition of personal liability on the directors of the management company in accordance with paragraph C25 of Appendix C of the Handbook.

Our view is that the management company is responsible for ensuring that the fund is managed in accordance with its investment policy in order to achieve its investment objective and the other responsibilities which are set out in the Investment Management Agreements that we have previously filed with the SFC. However, we respectfully submit that the management company and its directors should not be responsible for the statements in the offering documents of the fund which are reviewed and approved by the fund company.

There is a clear and necessary distinction between the responsibilities of the fund company and the management company which are clearly set out in the Investment Management Agreement and this is essential since:

(a) The fund company and the investment manager must be independent of each other. The investment management company and its directors should not influence the fund company and its directors on the level of disclosure. The fund company has its own legal advisors and should make its decision on whether such disclosure is appropriate based upon its own legal advice without being subject to views of the investment manager.

(b) The market standard position would be that the investment manager is an independent contractor which the fund and its directors may decide to remove or replace at any time. To place an obligation on the fund company to ensure that it obtains a responsibility statement from the investment manager's directors would fetter its discretion to replace or remove the investment manager. That is, before the fund company can remove the current investment manager it will need to find a replacement investment manager whose directors are willing to provide such a responsibility statement in the offering documents. This would be extremely difficult to achieve since the replacement investment manager was not involved in the drafting of the offering documents. Consequently, after the introduction of these proposals, the fund company may be very hesitant to replace the investment manager due to the difficulties that this will create.

(c) On the basis of specifying clearly the investment manager's responsibilities, the investment manager is able to provide a competitive and low investment

management fee. A change in this position may result in significantly higher investment management fees.

2. **USE OF SPECIAL PURPOSE VEHICLES**

Question (5)

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

We agree in general with the proposed requirements applicable to SPV Issuers. As it is common for an SPV that issues collateralised structured products to have separate cells or segregated portfolios (where the assets and liabilities of each cell or segregated portfolio is ring fenced from those of the other cells or segregated portfolios), the requirements in the SP Code as they relate to SPV Issuers should be allowed to apply to a cell or segregated portfolio of an SPV, where applicable. This would avoid uncertainties as to whether a single SPV may be used to issue multiple segregated series of collateralised structured products.

3. **COLLATERAL**

Question (6)

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

As regards paragraph 103 on page 35 of the Consultation Paper, we agree that investors should be given the power or authority to give consent for the substitution of collateral.

However, investors' consent should not be the only means in a transaction through which authorisation to substitute collateral may be obtained. In particular, in a managed structured product transaction, investors invest in a product to take advantage of the expertise of an investment manager to efficiently manage the collateral, among other things. The requirement that investors' consent be obtained in every instant in order to substitute collateral may in fact harm investors' interests if the investment manager is not allowed to act promptly to substitute collateral without investors' consent, especially given that the value of a collateral security in the market may change rapidly but the process of obtaining consent will often take time.

To address the issue of investors' understanding of the level of risks involved in relation to the collateral, appropriate disclosures as to the type and nature (including, for example, ratings) of collateral that may be invested in should be sufficient information for an investor to determine the level of risks that the investor could be exposed to.

3.2 **(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?**

If a counterparty's claims to a pool of collateral are subordinated entirely to the claims of investors, it may increase the overall costs of the transaction as the counterparty will likely demand higher fees or premium in entering into the transaction with the issuer. Such costs will likely be passed onto the investors. Investors will therefore be paying a premium for the added protection as a result of the priority claim. While we are not suggesting that giving investors a priority claim over the collateral is undesirable, we urge

the SFC to carefully consider the implications, as such additional costs could be significant and could drive potential issuers, managers and arrangers away from issuing and offering products in the Hong Kong market.

4. OVERARCHING PRINCIPLES SECTION

Section I of the Handbook

4.1 GP3. Proper protection of assets

Appendix A - Section I - Page 6 - 3.5

Please advise if the protection of assets will be in accordance with normal market practice. For example, certain assets may be held via sub-custodians or through banks and in each case, the sub-custodian or bank would not provide any ownership rights to such assets. Instead, they may only owe a debt to the account holder.

4.2 Investor education

Appendix A - Section I - Page 12 - 7.3

We are of the view that education on new or novel products will be provided by the Product Provider to the intermediaries who are then obliged to educate their retail clients.

5. REVISED CODE ON UNIT TRUSTS AND MUTUAL FUNDS

Section II of the Handbook

5.1 Nomination of an individual as approved person

Appendix A - Section II - Pages 2 to 3 - 1.5 to 1.7

We would like the SFC to clarify the role of an approved person. For example, please clarify whether this is just a liaising role or otherwise.

5.2 Interpretation - Financial derivative instruments

Appendix A - Section II - Page 6 - 3.7

In order to ensure consistency with UCITS, we submit that the SFC should not treat repo agreements as financial derivative instruments ("**FDI**") as indicated in paragraph 133 on page 41 of the Consultation Paper.

5.3 Structured funds

Appendix A - Section II - Page 49 - 8.8(a)

Please confirm what steps are required in order to satisfy the requirement for independence. This requirement should be clarified so that the fund issuers understand the specific requirements which they must satisfy in order to establish independence from the swap counterparty.

Based on discussions with the SFC, we understand that different legal entities within the same corporate group should be permitted. We also understand that the SFC expects that the swap counterparty and the fund should have an independent board of directors.

We would like the SFC to clarify whether there are any other requirements which need to be satisfied in order to establish independence.

We would submit that an independent board of directors together with separate legal entities would be sufficient. We would submit that separate reporting lines should not be a criterion to establish independence since this is an unclear concept.

Appendix A - Section II - Page 49 - 8.8(a)(2)

These requirements are unclear. To assist in our understanding, please indicate whether indices reflecting an investment strategy would continue to satisfy these new index requirements. For example, please indicate whether the AIMS Index in relation to an application for the US Treasury Deflation-Inflation Fund would continue to meet these requirements.

Appendix A - Section II - Page 49 - 8.8(c)

Please clarify the requirements with respect to the fund administrator. For example, please clarify the meaning of "a regular basis". Is it sufficient that this is weekly or must it be daily?

Appendix A - Section II - Page 49 - 8.8(d)

Please clarify whether the generic market standard legal opinions would be acceptable. For example, would an opinion given by ISDA's lawyers to all ISDA members constitute a "proper legal opinion"?

Appendix A - Section II - Page 49 - 8.8(e)(i)

Please clarify the meaning of "short settlement cycles".

Appendix A - Section II - Page 50 - 8.8(e)(iii)

Please clarify the meaning of "high credit quality" and "high price volatility".

Appendix A - Section II - Page 50 - 8.8(e)(iv)

Diversification would add to the costs of holding collateral.

We would submit that this would be unduly onerous on UCITS funds which are already subject to collateral requirements in accordance with UCITS regulations. The UCITS collateral requirements are different to the SFC's requirements set out in Chapter 7 and this would place UCITS funds under two conflicting collateral diversification regimes.

Appendix A - Section II - Page 50 - 8.8(e)(v)

Please clarify the meaning of correlation. For example, is it the case that if the issuer of the FDI is likely to be a bank, the issuer of the collateral cannot be a financial institution?

Appendix A - Section II - Page 50 - 8.8(e)(g)

We would submit that percentage breakdowns by asset class and nature and credit rating would not be helpful for investors and would be unnecessarily burdensome. Since collateral will be reviewed daily and this disclosure is provided quarterly, such information

would become outdated very quickly. It would be more helpful if the prospectus stated the eligible collateral with any credit rating requirements.

Will the SFC consider alternative methods of publication such as fund factsheets?

5.4 **Funds that invests in financial derivative instruments**

Appendix A - Section II - Pages 52 to 53 - 8.9

We consider that the current drafting of 8.9 is unclear. Please consider clarifying the drafting by moving 8.9(j) and (k) either to 8.8 or to a new 8.10. Since 8.9 has a negative impact on UCITS funds, it should be made absolutely clear that all of 8.9 does not apply to UCITS funds.

5.5 **Ongoing disclosures**

Appendix A - Section II - Page 60 - 11.1B

Please clarify what constitutes "material adverse change in the financial conditions or business of the key counterparties to a scheme".

5.6 **Reporting to holders**

Appendix A - Section II - Page 61 - 11.6

We note that under the proposal at paragraph 161 on page 47 of the Consultation Paper, publication of a Chinese language annual report is voluntary. Please ensure that the drafting in 11.6 matches the SFC's proposals. That is, we would like the SFC to clarify in 11.6 that the requirement to translate financial reports into Chinese is voluntary with respect to offshore funds.

5.7 **Advertising materials**

Appendix A - Section II - Page 62 - 11.14

We would like to understand the rationale for the 3-year retention period for the advertisements issued and the supporting materials for substantiation of information presented thereon.

5.8 **General information**

Appendix A - Section II - Page 69

Appendix C - C25

The directors of the management company would be unable to accept full responsibility for information provided by third parties. As the SFC is aware, index funds will need to disclose information on the underlying index. Such information is obtained from the index sponsor (for example, the Hang Seng Indices) and the index sponsor would refuse to provide assurances to the fund and the management company that the information provided is accurate.

It would not be equitable to require the directors of the management company to accept full responsibility for information received from third party providers. It would be more

equitable if the directors would only be liable for ensuring that the information is **materially** accurate.

Appendix C - C26

Please confirm whether this is the minimum required information to be maintained on a scheme's website.

6. **PRODUCT KEY FACTS STATEMENTS**

6.1 We propose that the Key Facts Statements ("**KFS**") should be read together with the offering documents and investors should not make their decisions based on the KFS alone but the KFS should not form part of the offering documents. The concern here is that distributors would only distribute and investors would only read the KFS without distributing or reading the prospectus. Consequently, investors would not receive full disclosure since it would not be possible to summarise all the information in the prospectus to just 4 pages.

A solution would be to make clear that the KFS should be read together with the prospectus but not form part of the prospectus. Consequently, both the distributors and investors will be aware that it is not sufficient to read the KFS alone. In this situation, funds issuing the KFS would have the same liabilities with respect to the KFS as they would with respect to other marketing materials. We would like the SFC to make this clear its Handbook. It should also be clear that the KFS is not intended to represent complete disclosure on the fund and therefore must be read together with the prospectus.

6.2 If the KFS forms part of the offering documents, this would cause issues for offshore funds since the home regulator would not review or approve the KFS. It also gives rise to issues relating to unfair treatment of investors. Hong Kong investors would receive additional information which is not Hong Kong specific and this would apply equally for all investors. As set out above, it may not be possible to distribute the KFS to other investors in Europe since the home regulator would not approve such KFS. Again, a solution would be to state that the KFS does not form part of the offering documents but should be read together with the offering documents.

6.3 We would respectfully submit that the best approach would be to ensure that, at the point of sale, the distributors will be obliged to:

(a) provide the KFS and remind investors that they should not make their decision based on this document alone; that is, it is not sufficient to read the KFS alone; and

(b) clearly explain to investors that the offering documents are also available.

6.4 Please clarify what is the SFC's position with respect to allowing overseas fund houses to use Key Information Documents (which are already produced for the European markets) in Hong Kong, while making clear that such European equivalent does not form part of the Hong Kong prospectus and therefore must be read together with the Hong Kong prospectus. In that context, it does not appear appropriate to include performance information (although optional), as these will go out-of-date very quickly. The same reasoning applies with respect to total assets.

6.5 **Scenario analyses required for guaranteed funds and structured payout funds**

The scenario analyses provided to investors would normally be simplified so that investors can easily understand the scenarios and therefore such scenarios would be subject to extensive assumptions and qualifications. The current page limit would make it extremely difficult to list those assumptions and qualifications. Failing to provide such assumptions and qualifications may result in such scenarios being potentially misleading.

6.6 If these template KFS are completed, it is unlikely that, with the required information, they will be 4 pages or shorter in length. We would suggest that whilst the format should be recommended, managers and product providers shall be afforded certain discretions to omit information which is either not relevant or unavailable. We note that certain parts of the KFS templates are optional, for example, the past performance section in the General Funds template, which would not be relevant for a new fund being launched. Our suggestion would be that product providers be given a greater discretion as to what information to include, whilst complying with the spirit of the KFS templates.

We are grateful for the opportunity to comment on the proposals. Please do not hesitate to contact me at 2840 5690 if you have any questions or if you wish to discuss any of the above in more detail.

Yours faithfully

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