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Office of Hon. IP LAU Suk Yee, Regina

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30 December 2009

Mr. Martin Wheatley
Chief Executive Officer
Securities and Futures Commission
8th Floor, Charter House
8 Connaught Road
Central, Hong Kong

Dear Martin,

**Consultation on Proposals to Enhance
Protection for the Investing Public**

I wish to submit below my comments on the questions posed in your Consultation Paper:

Questions (1) – (3)

The large numbers of complaints from investors alleging various malpractices which had arisen from the collapse of Lehman Brothers highlighted the need to enhance investor protection. Nevertheless, the over-arching principle must be to enhance investor protection in a way which does not overburden the financial services industry or stifle market development. While greater vigilance is necessary, care should be taken to avoid overkill. A balance has to be struck in achieving these objectives.

On specific proposals, I welcome the proposal in para. 25 (b) to bring forward legislative amendments to transfer the authorization of offering documentation in relation to

- 2 -

structured products out of the Companies Ordinance prospectus regime to the Securities and Futures Ordinance. I also welcome the proposal to require on-going disclosure of material information to investors who purchased unlisted structured products.

Questions (4) – (8)

Apart from enhancing eligibility and due diligence requirements of issuers and guarantors, in the light of experience of the sale of Lehman Minibonds, I recommend that action be taken to improve oversight and regulation of, if not prohibit, arrangements which involve real or potential conflict of interest. I believe conflict of interest exists in the design of sales arrangement of the Lehman Minibonds, in that a special purpose vehicle (SPV), Pacific International Finance Limited (PIFL), was set up to issue the notes, while different parts of Lehman Brothers acted as calculation agent, arranger, initial subscriber of notes, swap counterparty and guarantor, etc. Cayman Islands-incorporated PIFL itself had limited share capital of US\$1,000 only, and the assets held by its custodian were earmarked for use as security for the performance of PIFL's obligations under its notes and would not be available to meet any debts owing to any creditors. Small investors had little knowledge of the assets at the time of purchase of the notes, and no reference is made in the program prospectus to how their claims to collateral proceeds would be protected should a credit event occurred. I support the SFC's proposal to appoint a Product Arranger in the case of SPV issue, to enhance ongoing protection of investors. I support the proposal in para. 94 that a Hong Kong-licensed Product Arranger be appointed for each structured product issued by an issuer or guaranteed by a Guarantor who is not a locally Regulated Entity. More information is needed on what sort of individuals/entities would be considered appropriate for acting as Product Arrangers. I also support greater initial (where possible) and on-going disclosure of the assets comprising the collateral, so that investors would have a better idea of how much their investments are worth.

Questions (9) – (10)

The proposals in paras. 121, 125-126 are supported.

Questions (11) – (15)

The concern of foreign fund managers about added time and cost arising from preparing Chinese language annual reports is valid. In order to strike a balance between maintaining Hong Kong as an attractive financial centre and protecting the investing public, the

- 3 -

SFC should proceed with option 2 which requires a mandatory abridged version of the Chinese language annual report.

For Product KFS to be effective, it should enable the investing public to grasp the most vital information of an investment product in the shortest time available. For this reason, although fund managers accustomed to the EU regime might prefer the KID format, it would be better for Hong Kong to require a uniform, simple, easily comprehensible product KFS for the local investors. However, if in future an internationally accepted standard format emerges, the SFC could consider adopting that format.

Question (19)

The proposals to enhance “know your client” procedures on the part of intermediaries are to be welcome. Yet to make sure that such procedures do not become sheer paper requirements, it is necessary for the SFC or the Hong Kong Monetary Authority, whichever is appropriate, to ensure that staff of intermediaries have received adequate training in, for example, the nature of derivative products. It is also necessary for such “know your client” procedures to become mandatory and open to spot checks from time to time. A frequent complaint from Lehman investors is that they had been misled by bank staff on the nature of the products and the risks involved. Precautionary measures such as audio-recording should help. Consideration should also be given to providing clients with a copy of their audio tape.

Question (20)

The Lehman incident revealed much confusion in the public mind about the definition of a “professional investor”. It is important that the definition be tightly drawn - not just defined in terms of a certain net worth - and clearly understood. The definition proposed in this question would have the effect of excluding all but a few financial service professionals. This may be good news to the lay investor. In addition, the SFC may wish to consider other protective measures such as asking the investor to sign a statement signifying that he understands the worst-case scenario, i.e. the maximum loss, and that he consents to being classified as a “professional investor”.

Question (21)

I agree the minimum portfolio requirement for the purpose of defining a “professional investor” could be suitably increased to reflect the average net worth of wealthy individuals and investment trends.

- 4 -

Question (22)

It is noted that the proposed disclosure only applies to benefits receivable by institutions but not those receivable by sales staff. The SFC should consider extending the disclosure requirement to include those receivable by frontline sales staff. Small and medium-sized distributors might have an incentive to provide their frontline sales staff with more benefits to encourage them to push sales aggressively. It would be beneficial for investors to enter into a transaction with a fair idea of the benefits receivable at both institutional and staff levels.

As regards means of disclosure, option 1.2 - disclosure of percentage bands or ceiling - should provide a reasonable balance.

Question (23)

Percentage bands instead of percentage ceilings should theoretically provide more significant information to investors, provided the range is kept small.

Questions (24) – (25)

No comment on disclosure options for business models 2 and 3, but benefits accruing to co-distributors/promoters such as Sun Hung Kai Securities which was involved in assisting, promoting, distributing and training the bank staff involved should be disclosed.

Question (26)

Although the use of gifts such as supermarket coupons as promotional tools has been widely cited as a mis-selling practice, this marketing channel in itself would not have been effective if the products did not appear attractive to the investors. From our experience of handling investor complaints, the practice of describing the Minibonds as "principal-protected" or linked to the credit of six or seven triple-A rated, blue-chip companies, lulled the investors into a false sense of security and was even more damaging. Many investors claimed that they had been misled into believing that the Minibonds were equivalent to time-deposits or similar ultra-safe products. Prohibition of such mis-selling practices is more important than prohibition of gifts.

Question (27)

No comment.

Question (28)

All risk profiling process should be audio-recorded for audit purposes. Clients should be given copies for cross-checking. An intermediary should keep a particular audio record until all investment products sold to a particular client had reached their scheduled maturities, been redeemed early or sold by the investor on the secondary market.

However, to enhance operational efficiency and convenience to a client, an intermediary should be exempted from audio recording if a client had purchased similar products several (say five) times already, unless the client specifically asked to continue with this practice. All audio records should be kept by the intermediary until the scheduled maturity of the product has been reached, product redeemed early or sold by the investor on the secondary market.

Questions (29) – (32)

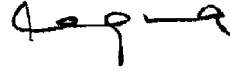
A cooling-off period is controversial as that may be seen to be unfair to the intermediary, which might incur additional administrative costs, and might afford the investor a chance to get out when the going gets rough, even though risks and nature of the product had been fully explained and all due procedures followed. The costs and benefits of such arrangements need to be carefully weighed and any such arrangement meticulously designed to avoid abuse. If such arrangements are to be introduced, I agree with the two criteria proposed by the SFC: namely, where a relatively long lock-up period is involved and where the product is unlikely to be frequently traded. I also agree it is justifiable to deduct a reasonable administrative charge if a cooling-off mechanism is to be introduced.

General Comments

So much for the specific questions posed. The document has not, however, addressed the questions of providing the SFC with the power to order compensation as in other jurisdictions, and the possibility of establishing a Financial Services Ombudsman. I believe the SFC or the Hong Kong Monetary Authority should be given the power to order compensation in tightly defined circumstances involving clear mis-selling. Consultation would need to be conducted on the possible establishment of a Financial Services Ombudsman.

- 6 -

Yours sincerely,



Mrs. Regina IP LAU Suk-ye

c.c. Professor K C Chan, SBS, JP, Secretary for Financial Services and the Treasury