MESSAGE

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From: HKSFA <info@hksfa.org>
Date: 31/12/2009 02:10 PM

Subject: Consultation on Proposasls to Enhance Protection for the Investing Public

Dear Sirs,

Attached please find our response to your Consultation Paper on "Proposals to Enhance Protection for the Investing Public".

Thank you.

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Consultation_Enhance Protection for the Investing Public_d091231.pdf

HKSFA 香港財經分析師學會
THE HONG KONG SOCIETY OF FINANCIAL ANALYSTS

31st December 2009

Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

Dear Sirs,

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

We have reviewed your consultation paper and we are in general supports the proposals to enhance the investor protection set out in the Consultation Paper, especially those focusing on the disclosure enhancement on unlisted structured products and the Intermediaries conduct.

Providing a level playing field for all investors with sufficient safeguard of investors' interests is crucial for maintaining Hong Kong's status as one of the world financial centers. At the same time, HKSFA holds the view that investors should be responsible for their own investment decisions should they have the full access to all the relevant information related to the risk and return characteristics of the investment products or have received proper and appropriate investment advices from the Intermediaries who have marketed the products to them. Strengthening the investor education is the ultimate solution for protecting the investing public.

We believe the disclosure-based approach coupled with conduct regulation on intermediaries who sell investment products in Hong Kong should continue to be the foundation of the regulatory regime for the financial industry in Hong Kong.

Please find below our responses to the questions raised in the Consultation Paper.

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 agree with the Overarching Principles which apply to the all products within the scope of the Handbook. We emphasis that proper and full disclosure together with fair dealing with clients should be the most important elements in the regulatory regime of investor protection.

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 agree with the proposed disclosure requirements in Appendix C and Appendix D to the SP Code that can strengthen the information available to the investing public in judging whether the captioned structured products fit with their investment objectives and risk preferences.

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?

We agree with the requirements for issuers to provide ongoing disclosure of all the relevant and important financial information set out in SP Code throughout the term of a structured product to ensure that investors can have access to the key information that may affect their value of their investments in these products.

Given the issuers, in general, do not have the access to the end investors of their structured products; the distributing intermediaries of these products should be responsible for the timely dissemination of this information to their clients.

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

We agree with the eligibility requirements for issuers and guarantors of unlisted structured products proposed by the Commission at the time of issue of the structured products. Ongoing disclosure of the eligibility throughout the term of the structured products is important to investors and should be covered by the proposed disclosure requirement for issuers (refer to question 3). However, it is important for the Commission to provide some guidance on the consequence or any actions from the Commission should the issuers and guarantors fail the eligibility requirements before the expiry of the captioned structured products.

Question (5)

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

We support the proposed eligibility requirements applicable to SPV issuers.

(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?

We agree with the requirement to appoint a Hong Kong-licensed Product Arranger for structured products issued by an SPV to ensure the SPV issuer's compliance with the SP Code throughout the term of the structured product by leveraging on the local regulatory regime on the Product Arranger.

(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)?

Yes, we agree with the same reasoning in the response to question 5b.

(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. Please explain your views.

We do not have other obligations or requirements to be proposed.

Question (6)

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

We support the proposed eligibility criteria for collateral that can help strengthening the investors' confidences in collateralized structured products.

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

We have no further comment.

(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?**

The proposed requirement to assign higher priority to investors' claims to collateral proceeds can be controversial if the counterparties of the SPV should rank more senior than the investors under the existing legal framework.

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.

Given the disclosure-based regulatory regime in Hong Kong, the Commission should request for mandatory disclosure by the issuer on whether the reference assets meet the eligibility requirement proposed by the Commission. Having the Commission to assume the responsibility to approve the reference asset is a step towards the merit-based regulations that we believes is not undesirable for the long term development of the financial industry in Hong Kong.

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.**

Providing daily indicative valuations on structured products can help investors understanding better the relationship between the performances of the underlying assets and the structured products. However, the requirement of the independent valuation of the structured products may be challenging as these valuations are usually determined by the proprietary models of the issuers.

(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 support the proposed requirement on issuers to provide firm bid prices on the structured products launched by themselves upon the request of the investors. Given the firm bid prices will fluctuate with the valuation of the underlying assets and various market factors, the last firm bid prices that were updated a few days ago would not be useful to investors who want to exit the product immediately.

The issuers may not be able to provide firm bid prices for structured products in case of market disruption event or extreme market volatility.

Question (9)

Please give your views on the use of annualised returns in offering documents and advertisements for structured products.

We agree that the use of annualized returns in offering documents and advertisements for structured products can help investors comparing the returns of structured products with different tenors. The issuers should provide clear explanation between the actual return and the annualized return of the structured product.

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.

The proposed general requirements should be sufficient.

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.

We support the requirements for publishing bilingual annual reports and the production of Product KFS that can facilitates investors' understanding of the captioned funds as well as the comparison of vital fund information.

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.

In general, we agree that many proposals in Part III of the consultation paper are more applicable to the unlisted investment products while a few of them can be applied on listed investment products as well.

The proposal on investor characterization to identify "clients with derivative knowledge" should apply to both listed and unlisted structured/derivative products sold to non-professional investors as the suitability assessment process for listed structured products/derivatives of Intermediaries should be similar to that of unlisted structured products. For example, listed equity warrants exhibit similar risk characteristics of the OTC options of the same underlying stock.

The proposal on assessing the knowledge, expertise and investment experience of professional investors should apply to both listed and unlisted investment products as the assessment is not targeted to identify the investment specialties of the investors but rather their overall capacities in understanding the risk and return characteristics of various investment products.

The proposal on pre-sale disclosure of monetary and non-monetary benefits, use of gifts in promoting investment products, sales disclosure document, and the audio recording of selling process should apply mainly to unlisted investment products due to the greater transparency on the fees charged on listed product transactions and the normally more complex product characteristics of unlisted investment products.

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 agree that the understanding of the clients' knowledge of derivatives, which should be part of the KYC procedures, should form the basis for the intermediaries to determine whether the investment advices and offers on unlisted derivative products are suitable investment vehicles for non-professional investors.

The two proposed criteria for determining whether non-professional investors without prior trading experience in derivative products can be classified as "clients with derivative knowledge" may be too restrictive and deviating from the spirit of disclosure-based approach. It should be the responsibilities of the intermediaries to judge whether their clients have the sufficient knowledge or experience in derivatives markets to understand and analyze the suitability of the structured products being marketed to them. It would also create huge administrative burden and potential confusion to the intermediaries and the investing public on how to assess the validity of the training courses or the relevance of the work experience linked to the derivative products. What kind of training or course on derivative products will be acceptable by the Commission? Will the self-declaration by the clients be sufficient or official records of training and work experience will be necessary?

We reckon a proper training or courses on derivative products should cover the conceptual framework for understanding derivative investments (forwards, futures, options, and swaps), derivative markets, and the use of options in risk management.

For clients who do not possess the derivative knowledge but are interested in investing in listed derivatives (e.g. listed warrants), the suitability assessment should apply as well.

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;
(b) he has undergone training or studied courses which are related to the relevant product?
Do you have any other suggestions?

We agree a high net worth investor should be considered to have specific knowledge and expertise if he satisfied either criteria (a) or (b).

We suggest the Commission to review the Professional Investors Rules. The current regime has the implicit assumption that high net worth investors satisfying the qualitative criteria as stipulated in the section 15.3 of the Code of Conduct should be treated as "Institutional Investors" like fund managers and financial institutions in the context of investors protection. Intermediaries can be exempted from their suitability compliance in case they deal with professional investors.

Unlike market professionals, high net worth investors do not necessary conduct investment activities as their main business activities everyday. Their primary investment objective is usually capital preservation while protecting their purchasing power via long term growth of their invested capital. While they have sufficient financial resources to construct a more diversified portfolio that can weather against potential negative return on their investment portfolio better than retail investors, we cannot assume that they are sophisticated and experienced investors who can assess the suitability of all the investment products on their own.

The disclosure-based approach is certainly more relevant to these high net worth investors who are in a better position, when compared with the general public, to make informed decisions and protect their own interests by virtue of their experience and financial resources.

Some of the existing criteria like the minimum number of transactions per year may not be totally relevant as the frequency of trading activities is more a reflection of their investment style (i.e. more active and trading oriented) than their investment knowledge and expertise. More emphasis should be placed on the person's prior experience in various investment product and dealing, awareness of the risks involved in trading in relevant markets.

There should be clearer differentiation between market professionals and the high net worth investors with the relevant knowledge, expertise, and investment experience in the area of investor protection. We propose the Commission to remove the waiver of suitability compliance by the intermediaries for their high net worth clients who have been classified as professional investors.

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

The minimum portfolio requirement should be set at level that a reasonably diversified portfolio can be built with this size of wealth to weather the potential erosion of their invested capital under adverse market conditions. The conclusion may vary with the investment style and the asset allocation preference of the investors. For example, investors with HKD 8 million may not be able to build a well diversified portfolio if they opt for direct investment into bonds and structured products that have usually the minimum transaction amount of USD 100,000.

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

The full disclosure of the explicit monetary benefits received by a distributor from a product issuer at the pre-sale stage would be more appropriate. Investors can make their own judgment on whether the investment recommendations from the intermediaries are free of influence by the monetary benefits offered by the product issuers. The disclosure should be, ideally, in percentage of the transaction amount or the ceiling percentage as the alternative format.

However, the product distributor should be obliged to disclose on the exact amount of monetary benefit received from the product issuer on the post-trade basis upon request from their clients if the monetary benefits are not quantifiable prior to or at the point of sale.

We disagree with the proposal that disclosure of the benefits receivable by the sales staff is not required as the potential conflicts of interests still exist. The recommendation by the sales staff can potentially be biased by the benefits they received.

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)?

Either form is acceptable.

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

The specific disclosure of distribution award (option 2.1) with the proposed methodologies for determining the benefits in the consultation paper would be more appropriate. Same principle for disclosure as mentioned in question 22.

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

The pre-trade disclosure of specific trading profit in percentage ceiling would be the more appropriate option. Percentage ceiling allows more flexibility for the distributor to execute the back-to-back transactions. Distributors should be obliged to disclosure the final spread being charged for the captioned transactions upon requests from their clients. Any trading profit in excess of the ceiling should be passed back to the clients

This is particularly important for unlisted investment products that have limited transparency on the dealing prices transacted in the over-the-counter market.

Unlike the principal transaction that involves the cost of capital and financing costs, the distributor will only risk their capital in back-to-back transactions in case of pre-settlement risk like default of their counterparties before the transactions are settled.

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 support the restriction on distributors to offer investors with gifts having monetary value in promoting a specific investment product to investors to avoid distraction of the investors' attention to the features of the investment product. The distributor should instead lower the transaction costs borne by the investors by the similar monetary value.

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 agree with the proposed content of the Sales Disclosure Document and the proposed application for unlisted investment products only.

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.

We think the mandatory audio recording of the client risk profiling process and the selling process for investment products may not be practical and applicable for private banking industry as a significant part of the selling process and client risk profiling exercise are conducted during in-person meetings between the client and the investment advisor from the distributor. The current SFC record keeping requirements should be sufficient.

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?

The cooling-off period is more suitable for investment products with long lock-up period that may have limited liquidity. The on-going liquidity provision by the product issuers via firm bid prices upon request from investors can serve the purpose of the cooling-off period that aim at providing the exit window for investors who are not comfortable about their previous investment decisions.

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.

We do not support the proposed delay in trade execution to give investors opportunity to cancel their orders as it may create the risk of dispute with investors about when a trade should have been executed.

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.
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.

We support the proposed requirement on the issuer to buy back the unlisted structured product under normal market conditions upon the investor's request.

We do not support the refund of the sales commission from the distributor in case the proposed cooling-off mechanism is triggered since the distributor has already provided the professional service to the client. The commission should be returned to the investors if the products are found to be unsuitable for the client.

Yours faithfully,
For and on behalf of
The Board of The Hong Kong Society of Financial Analysts

Richard Mak, CFA
Director