

## MESSAGE

To: LawReform/SFC@SFC  
cc: "Mazzochi, Richard" <[Richard.Mazzochi@mallesons.com](mailto:Richard.Mazzochi@mallesons.com)>  
"Sip, Angus" <[angus.sip@mallesons.com](mailto:angus.sip@mallesons.com)>  
"Siu, Minny" <[Minny.Siu@mallesons.com](mailto:Minny.Siu@mallesons.com)>  
From: "Sip, Angus" <[angus.sip@mallesons.com](mailto:angus.sip@mallesons.com)>  
Date: 30/12/2009 02:14 PM

Subject: Mallesons' Response - SFC's Consultation Papers issued in September and October 2009

Confidential communication

Dear Sirs,

Please see attached our submissions as follows:

1. Mallesons' Response to the Consultation on Proposals to Enhance Protection for the Investing Public; and
2. Mallesons' Response to the Consultation on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance.

Kind regards,

**Minny Siu | Partner**

**Mallesons Stephen Jaques**

13/F, Gloucester Tower, The Landmark, 15 Queen's Road Central  
Central, Hong Kong

T +852 3443 1111 | M +852 6390 4561 | F +852 3443 1299

[minny.siu@mallesons.com](mailto:minny.siu@mallesons.com) | [Partner profile](#) | [www.mallesons.com](http://www.mallesons.com)

A list of the principals of the firm may be obtained from our website: [www.mallesons.com](http://www.mallesons.com)



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"Consider the environment - think before printing!"

MALLESONS STEPHEN JAQUES

# Response to Consultation Paper on Proposals to Enhance Protection for the Investing Public

30 December 2009

This document contains the response of Mallesons Stephen Jaques to specific issues raised in the “Consultation Paper on Proposals to Enhance Protection for the Investing Public” issued by the Securities and Futures Commission (“SFC”) on 25 September 2009 (“**September Consultation Paper**”).

**Mallesons Stephen Jaques**  
13/F, Gloucester Tower  
The Landmark  
15 Queen's Road Central  
Central  
Hong Kong  
T +852 3443 1000  
F +852 3443 1299  
[www.mallesons.com](http://www.mallesons.com)

# MALLESONS STEPHEN JAQUES

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## Introduction

Mallesons Stephen Jaques is pleased to respond to certain proposals raised by the SFC in the September Consultation Paper. We have participated in various industry forums during the consultation period and, having regard to the global initiatives with respect to similar issues, we believe that the measures proposed by the SFC are a balanced and proportionate response to the Lehman Minibonds incident and other systemic issues arising from the recent global financial crisis. We welcome and support the overriding principle to enhance the regulatory environment for the sale of unlisted structured products.

We take this opportunity to thank the SFC for the opportunity to engage with it on the proposed reforms to the structured product market in Hong Kong, and look forward to working with the SFC and the industry participants in relation to their implementation.

In this submission, we focus on certain legal (rather than commercial) issues concerning the SP Code. We do not attempt to deal with the proposals concerning the UT Code or the commercial aspects of the SP Code - we believe the industry bodies representing the relevant financial sectors in the market will adequately address their respective sectors' views. Unless otherwise specified, capitalised terms used in this document have the meaning given to them in the September Consultation Paper.

If you have any queries in relation to our submission, please do not hesitate to contact:

Richard Mazzochi  
Partner  
Direct line +852 3443 1046  
richard.mazzochi@malleasons.com

Minny Siu  
Partner  
Direct line +852 3443 1111  
minny.siu@malleasons.com

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## Executive summary

We generally support the proposed enhancements to the regulation of offering of unlisted structured products to the public proposed in the September Consultation Paper. Many of the proposals reflect current international trends and proposed reforms in other jurisdictions.

We urge the SFC to clarify and provide further guidance on some of the operational provisions of the SP Code (relating to on-going disclosure, product design and intermediaries' "know your client" obligations).

We submit useful references may be drawn from international benchmarks and certain aspects of Chapter 15A of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited ("**Listing Rules**"). A large volume of listed structured products have been issued pursuant to the Listing Rules. The Listing Rules have provided a sound foundation for those issuances.

## Response to September Consultation Paper

### A SP Code

*The SFC has proposed introducing a new SP Code to set out guidelines and criteria for the SFC to consider before exercising its power to authorize the issue of offering documents or advertisements for unlisted structured products offered to the public in Hong Kong. The SP Code will form part of the SFC Handbook. The two main proposals in the SP Code are enhancing disclosure and increasing product transparency.*

We recognise the need for a set of rules and guidelines regulating the issue of offering documents and advertisements relating to unlisted structured products. We recommend that the SFC draw upon benchmarks set in international markets, and adopt existing mechanics for Hong Kong listed structured products. The Listing Rules have operated effectively for a substantial period of time, making them a valuable point of reference.

While we generally endorse and welcome the introduction of the SP Code, we make the following comments in relation to certain proposals in the SP Code:

#### A.1 Enhancing Disclosure and Product Transparency

##### i) Paragraph 28(b) of Appendix C to SP Code - Conformity of financial statements with HKFRS or IFRS

*This proposal requires that the auditors' report of an issuer (and any guarantor) must conform with either the Hong Kong Financial Reporting Standards issued by the Hong Kong Institute of Certified Public Accountants ("HKFRS") or IFRS.*

We are concerned this requirement will impose an unduly burdensome requirement on foreign issuers and guarantors whose financial statements and auditors' reports have been prepared in accordance with accounting standards generally accepted in their home jurisdiction (for example, US GAAP, UK GAAP or Australian GAAP), without offering specific benefit to the investing public in Hong Kong.

Requirement for an issuer of structured products offered to the public in Hong Kong to convert its audited accounts to comply with the HKFRS or IFRS will be a very time consuming and costly process. This proposal is out of step with the international financial market for similar offerings. We also suggest useful references be drawn from the disclosure requirements for listed structured products under the Listing Rules. The Listing Rules do not restrict the accounting standards to be adopted by a listed structured product issuer for its financial statements<sup>1</sup>.

We suggest the rationale for disclosure of financial statements is to enable an investor to make an informed assessment on the financial position of the issuer and, provided the relevant financial statements are prepared in accordance with other internationally recognised accounting standards, whether such statements also comply with HKFRS or IFRS is immaterial in that respect.

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<sup>1</sup> Rule 15A.21 and Paragraph 11 of Appendix 1 Part D of the Listing Rules.

ii) **Paragraph 7.6(b) of SP Code - Ongoing disclosure of material information**

*We agree with the general principle (as set out in paragraph 7.6 of the SP Code) that structured product issuers should have ongoing disclosure obligations to keep investors informed of relevant information which may affect their investments.*

The requirement under paragraph 7.6(b) of the SP Code for an issuer to disclose and keep the SFC and investors informed of any “*material adverse change in the financial condition or business of the Issuer or the Guarantor or their respective corporate groups which could reasonably be expected to be material to investors’ interests in the structured products, including, without limitation...where the credit rating ...falls below the levels required by [the SP Code]*” is very wide and may be difficult to apply in practice. Further guidance from the SFC on the specific ongoing disclosure requirements will enable the industry to adopt a consistent approach for implementation of their compliance procedures, which will in turn facilitate a more coherent and transparent market.

We submit the “material” threshold should be benchmarked against the on-going disclosure threshold for listed structured products under the Listing Rules<sup>2</sup>. The SFC may consider merging the application of Paragraph 7.6(b) of the SP Code about “*material adverse change*” with Paragraph 7.6(c), and qualifying such disclosure requirement to information relating to the issuer and/or the guarantor which:—

- might be reasonably expected to significantly affect their ability to meet their commitments under the relevant structured products;
- is necessary to avoid the establishment of a false market in the relevant structured products; or
- might be reasonably expected materially to affect market activity in and the price of the relevant structured products.

The above disclosure threshold has been well established in the Hong Kong financial market in the listing sphere, and has been applied consistently. We urge the SFC to align the on-going disclosure requirements under the SP Code with the equivalent requirements under the Listing Rules for listed structured products. Taking this approach would also enhance consistency between two regimes that concern highly analogous products, thereby reducing the scope for regulatory arbitrage.

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<sup>2</sup> See paragraph 2 of the standard form of Listing Agreement set out in Appendix 7 Part H of the Listing Rules.

iii) **Appendix D to SP Code - Advertising to remain subject to SFC prior-vetting**

*The September Consultation Paper sets out a principle based guidance for the disclosure requirements of advertising materials for unlisted structured products offered to the public in the SP Code, but proposes that such advertising materials will continue to require prior authorisation and pre-vetting by the SFC.*

We welcome the proposal to codify the SFC's expectation and existing approach for advertisements in the SP Code. This will facilitate a more consistent approach for advertisements.

The SFC has issued marketing guidelines for collective investment schemes and listed structured products respectively to facilitate the marketing activities of these products. These have been widely accepted by the market.

We urge the SFC to consider dispensing with the pre-vetting requirement of advertisements for unlisted structured products so that a coherent approach is taken for different types of investment products.

**A.2 Eligibility requirements for issuer and guarantors**

*Paragraph 3.3(a)(ii) of the SP Code provides an eligibility requirement for an issuer or a guarantor to be not "the subject of any disciplinary proceeding in respect of its licence or registration to conduct any regulated activity...any action by an exchange, regulated market or self-regulatory organisation for breach of any applicable rules..."*

This requirement appears to be particularly stringent and may have unintended consequences. Most issuer groups (including some large and reputable financial institutions) are inevitably subject to some form of disciplinary proceedings or investigations from time to time. The current wording of Paragraph 3.3(a)(ii) of the SP Code will make it extremely difficult for financial institutions to satisfy the eligibility criteria.

We suggest the SFC should adopt a "materiality" test for determination of such criteria so that there is some degree of flexibility to disregard any irrelevant factors which do not pose a material negative impact on the appropriateness and/or the credit of an institution to be approved an eligible issuer under the SP Code.

**A.3 Other comments**

i) **Paragraph 5.1 of the SP Code - confirmation on "fair and appropriate"**

*This proposal requires issuers and product arrangers to satisfy themselves and confirm to the SFC during the SFC authorisation process that a structured product offered to the public is designed fairly and is appropriate for the market(s) for which it is intended.*

We endorse the need for issuers to design structured products responsibly, by considering the class of investors for which they are intended. We also acknowledge that the regulation of product design by reference to concepts such as "fairness" is consistent with international regulatory measures and industry-driven principles, some of which have been in place for a number of years.

For example, in the UK, the Financial Services Authority ("FSA") has issued regulatory guide detailing the responsibilities of product providers and distributors, which includes a requirement that product design be "fair" within certain parameters

of factors and considerations<sup>3</sup>. In relation to “appropriateness,” the Joint Association Committee<sup>4</sup> has released guidelines on “Retail Structured Products: Principles for managing the provider-distributor relationship” and “Retail Structured Products: Principles for Managing the Distributor-Individual Investor Relationship” (collectively the “JAC Principles”) to provide substantive guidance in relation to designing products that are appropriate for their intended class(es) of investors.

To enhance the effectiveness of this proposal, we recommend that the SFC clarify what it means by “designed fairly” and “appropriate”, through the use of definitions, explanatory statements and practical examples. We recognise the inherent difficulty in prescribing parameters for such concepts. However, providing these parameters will ensure the SFC’s policy intention behind the proposal is understood. In particular, it is critical that issuers and product arrangers are not required to assess investor suitability because they do not know the identity of individual investors. It will also help prevent the future misinterpretation of the requirements (for example, by encouraging an argument that issuers and product arrangers owe a common law duty of care to investors) and ultimately, provide greater certainty and confidence to the Hong Kong market.

In particular, the term “appropriateness” is a subjective term and implies a requirement for product suitability on the issuers. Such requirement is difficult for an issuer or product arranger to discharge in the absence of direct contact with the end investors. To address the concern with the requirement of “appropriateness” by issuers and product arrangers, the SFC may consider elaborating the language to the following effect<sup>5</sup>:

*“A structured product will be “appropriate for the market(s) for which it is intended” if the Issuer (and, where applicable, the Product Arranger) has considered the nature of the product and the nature of persons likely to consider acquiring them, taking into account the following matters:*

- (a) *discussions with the proposed distributors of the product, for the purpose of:*
  - (i) *identifying the target class of investors for the product;*
  - (ii) *identifying whether product features such as credit risk, volatility and term are appropriate for the target investors; and*
  - (iii) *assessing the potential return under the product against the structural costs and the net benefit of the product to the target investors;*
- (b) *an assessment of the product design pursuant to the Issuer’s own internal systems and policies; and*
- (c) *that the proposed distributors must determine whether the product is suitable for the target investors in accordance with their regulatory*

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<sup>3</sup> See the Regulatory Guide “Responsibilities of providers and distributors for the fair treatment of customers” and “Treating customers fairly - structured investment products” issued by FSA.

<sup>4</sup> A global working group of firms comprising European Securitisation Forum (ESF), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA).

<sup>5</sup> This is based on the FSA guidelines on treating customers fairly and the JAC Principles.

*obligations, including paragraph 5.2 and GP1 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("Code of Conduct")."*

In relation to fairness, we suggest that the SFC provide detailed explanatory materials and practical examples that are informed by its regulatory expertise, its understanding of the Hong Kong market and international initiatives to facilitate understanding amongst the market participants in its practical application.

ii) **Paragraph 7.8(c) of the SP Code - Remedial action and compensation to investors**

*This proposal requires issuers and product arrangers to take remedial action to rectify any situation where the structured product or any party in respect of the structured product fails to continue to meet applicable requirements under the SP Code, and to provide compensation to investors to ensure that investors are not disadvantaged because of such failure.*

The current provision of paragraph 7.8(c) of the SP Code is unclear in its application and lacks the supporting context. We submit any investor compensation regime must be supported by a comprehensive framework, with proper procedural guidelines. For example, there must be clear guidance on the basis and procedures pursuant to which an issuer or product arranger may be ordered to pay compensation to investors, and the available defences.

We note the SFO already contains comprehensive civil and criminal liability provisions for various forms of market misconduct<sup>6</sup>, and a statutory framework for investor compensation fund<sup>7</sup>.

If the SFC intends to create a compensation regime as an alternative to the current liability and compensation fund regime under the SFO (such as an alternative dispute resolution scheme as contemplated in the SFC's Report to the Financial Secretary issued in December 2008<sup>8</sup>), we urge the SFC to explore further the implementation details and draw useful references from other jurisdictions, including Australia<sup>9</sup>.

We are also concerned that the proposal that the SFC may order compensation to investors under paragraph 7.8(c) of the SP Code may imply that issuers and product arrangers owe a fiduciary duty or a duty of care to end investors. The traditional view under Hong Kong and English laws is that, in the absence of express contractual agreements between a product issuer and an end investor or peculiar factual circumstances, issuers and product arrangers generally owe no duty to investors and should not be held responsible for determining the suitability of products<sup>10</sup>.

<sup>6</sup> For example, sections 107, 108, 277, 279, 298, 390 and 391 of the SFO.

<sup>7</sup> Under Part XII of the SFO

<sup>8</sup> "Issues raised by the Lehman's Minibonds crisis - Report to the Financial Secretary" issued by the SFC in December 2008.

<sup>9</sup> Australian Securities and Investments Commission ("ASIC") has issued Regulatory Guide 126 in relation to compensation and insurance arrangements. This guide outlines, amongst other matters, ASIC's views in relation to the compensation requirements under the Corporations Act and also provides a mechanism whereby alternative compensation arrangements may be submitted to ASIC for approval.

<sup>10</sup> This view is supported by an English case, *Seymour & Another v Caroline Ockwell & Co & Another* [2005] EWHC 1137.

We also note that duties and responsibilities imposed on issuers and product arrangers under the SFC Handbook and the Code of Conduct are to the SFC and not to investors. The inclusion of the proposals under paragraph 7.8(c) of the SP Code may erode and/or extend the well-established legal principle (where no such duty has been implied in the absence of a direct contractual agreement).

## **B Part III - Intermediaries' Conduct**

*The SFC has proposed that intermediaries should, as part of their "know your client" ("KYC") procedures, seek information about clients' knowledge of derivatives and characterise clients as "clients with derivative knowledge" for promotion of unlisted derivative product, unless they are professional investors.*

We generally support the SFC's proposal that an intermediary's KYC procedures in relation to a particular client include a consideration of the client's knowledge of derivatives.

### **B.1 New Paragraph 5.1A of the Code of Conduct - Clients' derivatives knowledge for unlisted derivative product**

*This proposal requires that an intermediary can only promote unlisted derivative products to a client if (i) such client is characterised as a "client with derivative knowledge", and (ii) the intermediary complies with the existing requirements under paragraphs 5.2 and 5.3 of the Code of Conduct and (iii) the intermediary is satisfied that the recommendation is suitable for the client.*

We urge the SFC to consider the following points:

- (a) it would be helpful if the SFC could clarify that the proposal concerning derivative knowledge is secondary to the general KYC requirements in paragraphs 5.2 and 5.3 of the Code of Conduct and the intermediary's responsibility to act in the client's best interests under GP1 and paragraph 3.10 of the Code of Conduct. We suggest that the SFC stipulate (or otherwise make clear) that a client's working experience and/or previous training are non-exhaustive factors that are relevant to, but not determinative for the purposes of, assessing a client's understanding of derivatives and products containing embedded derivatives;
- (b) we seek SFC's clarification that this proposal does not change the fundamental responsibility, and discretion, of distributors in relation to conducting suitability assessments; and
- (c) to enhance a consistent approach and standard in the marketing and promotion of investment products in the market, we urge the SFC to:
  - (i) provide further guidance as to the meaning of "promotion"; and
  - (ii) clarify in the revised Code of Conduct whether an unlisted derivative product can be sold by an intermediary on an "execution only" basis, without triggering the requirements under paragraphs 5.2 and 5.3 of the Code of Conduct.

This approach accords with the MiFID<sup>11</sup> (which includes derivative knowledge assessment among other KYC requirements). It is also consistent with the discretionary approach

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<sup>11</sup> Markets in Financial Instruments Directive, Directive 2004/39/EC of the European Parliament and of the Council of 21 April 2004 on markets in financial instruments

advocated by the Monetary Authority of Singapore (“MAS”) in its recent consultation paper,<sup>12</sup> although we acknowledge that the MAS proposes that intermediaries be prohibited from selling to clients with limited knowledge of investment products.<sup>13</sup>

We also believe that the consultation process provides a good opportunity for the SFC to formally express that the regulatory requirements imposed on intermediaries with regard to suitability assessments and product distribution (including the existing Code of Conduct and the proposals raised in the September Consultation Paper) are not intended to give rise to a fiduciary relationship between intermediaries and their clients. This is an important clarification for the Hong Kong market, in light of the increasing regulation of that relationship.

## **B.2 Paragraph 15.3 of the Code of Conduct - Professional investors classification**

We welcome and support the SFC’s proposal to elaborate that, as part of the categorisation process for a “professional investor” under the Code of Conduct, a client’s knowledge and expertise may be assessed based on such client’s working experience or previous training on the relevant product.

Similar to our observation under paragraph B.1 above, we suggest that the SFC stipulate (or otherwise make clear) that an intermediary retains a general discretion to assess the specific knowledge and expertise of its clients. The assessment factors set out in paragraph 15.3 is not intended to be an exhaustive list of factors that are relevant to, or determinative for the purposes of, assessing a client’s specific knowledge and expertise.

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<sup>12</sup> “Consultation Paper - Review of the Regulatory Regime Governing the Sale and Marketing of Unlisted Investment Products” issued by the MAS in March 2009.

<sup>13</sup> Specifically, paragraphs 5.3.2 to 5.3.4 of the MAS consultation paper state: “We consider it important that the sale of complex investment products be accompanied by an assessment of whether the product is suitable for the investor, notwithstanding the investor’s knowledge and experience. MAS proposes to require the sale of complex investment products be allowed only with advice. This means that complex investment products cannot be sold on a “no advice” or “execution only” .....”