THE HONG KONG ASSOCIATION OF BANKS
香港銀行公會

Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

CEO-1791

SFC CEO'S OFFICE
23 DEC 2009
RECEIVED

22 December 2009

Mr. Martin Wheatley
Chief Executive Officer
Securities and Futures Commission
8/F, Chater House
8 Connaught Road Central
Hong Kong

Dear Martin

Submissions of Hong Kong Association of Banks (HKAB)

Following our meeting with yourselves and representatives of the Hong Kong Monetary Authority (HKMA) on 10 December 2009, we are pleased to enclose the following documents for the consideration of the Securities and Futures Commission (SFC):

1. the submission of HKAB in response to the "Consultation Paper on Proposals to Enhance Protection for the Investing Public";

2. the submission of HKAB in response to the "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance"; and

3. a discussion paper on "execution only" transactions and the definitions of "solicitation" and "recommendation" based on the Suitability Proposal which we introduced at the above-mentioned meeting. We shall follow up the discussions with your colleagues at the Intermediaries Supervision Division and the Enforcement Division in the very near future, with the presence of the HKMA.

As highlighted in both of our above-mentioned submissions, HKAB and its members share the statutory regulatory objective of the SFC in maintaining and promoting the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry.

THE
HONG KONG
ASSOCIATION
OF
BANKS
香港銀行公會

Following the financial crisis, the banking industry has been subject to various regulatory changes and new guidelines over the past year, which we believe have significantly enhanced banking stability and investor protection. However, compliance with such new regulations and requirements has come at a cost of additional operational changes and increased resourcing for the industry. Whilst we are supportive of the SFC's overall objective to further enhance the protection of the investing public, we also believe that it is important to balance investor protection with practical implementation of changes in order to ensure an efficient distribution system, and to avoid significant additional costs which would inevitably be passed on to the customers. Furthermore, we believe that the SFC shares HKAB's objective in maintaining Hong Kong as an international financial centre. We therefore look forward to an ongoing dialogue with the SFC at both the policy and working levels, with the presence of the HKMA as the frontline supervisor of the securities business of HKAB members.

As another immediate part of our ongoing tripartite dialogue at the working level, the Securities Working Group will be pleased to engage in further discussions with your colleagues at the Intermediaries Supervision Division, the Investment Products Division and the Corporate Finance Division with whom we have held various meetings over the past two months to provide further industry input to the SFC in developing the details of the final form of the enhanced investor protection measures before the SFC formally publishes the Consultation Conclusions.

Yours sincerely

Peter Wong
Chairman

Enc.

c.c. Secretary for Financial Services and the Treasury Bureau (with enclosures)

Chief Executive, Hong Kong Monetary Authority (with enclosures)

Securities and Futures Commission Consultation Paper on Proposals to Enhance Protection for the Investing Public

Submission of The Hong Kong Association of Banks

Introduction

This paper sets out the views of the Hong Kong Association of Banks ("HKAB") on the Consultation Paper on Proposals to Enhance Protection for the Investing Public ("Consultation Paper") issued by the Securities and Futures Commission ("Commission") in September 2009.

HKAB has over 90 members which are Registered Institutions ("RIs") involved in the provision of securities services as either product providers and / or distributors of varying sizes. HKAB has invited all RIs to provide written comments on the Consultation Paper to HKAB for developing and recommending a submission by the Securities Working Group of HKAB[1]. The Securities Working Group of HKAB has met over 25 times to consider the Consultation Paper having regard to written comments submitted by members, assisted by Linklaters. This deliberation process includes five meetings / briefing sessions with the Commission and the Hong Kong Monetary Authority (HKMA) in seeking clarifications on various proposals discussed in the Consultation Paper. This paper may accordingly be regarded as an industry response representing the views of both product providers and distributors of varying sizes.

Our responses to the questions posed for consultation are set out below, and are the result of much thought and discussion by our Members. Some general themes emerged from our deliberations, which may make a useful introduction.

First, we are committed to demonstrate to the Government, the regulators and, most of all, to the investing public, that lessons from the Minibonds incident have been learned and that our Members will work to restore the trust and confidence of investors in our market (Consultation Paper, Part I, paragraph 11.).

Second, in approaching our response to the Commission's proposals, we have kept at the forefront of our minds the Commission's exhortation to "focus on what is the right answer" in the context of recent events. (Consultation Paper, Part I, paragraph 14.)

Third, we are mindful that other countries are engaged in a similar process of review and reform of the public markets for structured products. The changes implemented in Hong Kong should reflect a balance between consistency with the reforms to be introduced elsewhere and sensitivity to the local market. We must maintain Hong Kong's competitiveness as a world financial centre, without stifling innovation and the operational flexibility of our banking industry.

In this connection, we would like to take this opportunity to re-emphasise the following objectives which were set out in HKAB's letter to the Commission of 7 September 2009, written following the Commission's soft consultation on certain of the proposals for reform. We believe that it is important for these objectives to be kept in mind in formulating new rules and guidance, and they underpin many of the responses to specific questions which follow.

[1] This paper has been coordinated by the Securities Working Group of HKAB. The Securities Working Group has representatives of 14 HKAB members providing retail, private, investment, corporate and institutional banking of various sizes. Its membership is drawn from Committee and Consultative Council members of HKAB as well as members represented on the Retail Banking and Private Banking Taskforces on Sale of Investment Products of varying sizes engaged in specific regulated securities activities.

- Maintain Hong Kong's status as an international financial centre – to achieve this objective the Commission should avoid making changes to the current regulatory regime which would make Hong Kong anti-competitive relative to other major financial centres. Members recognise that the first priority is the need to enhance investor protection. However, it is also important to ensure that market innovation will not be stifled by regulations so onerous that it becomes impracticable for distributors to sell certain products to investors. A balance needs to be struck between the objective of investor protection and the objective of ensuring a competitive and efficient market so that investors benefit from a full range of structured products.

- Keep the regulations and Code of Conduct principles based – this is important to allow the evolution of the industry and the availability to investors of new products as well as operational flexibility by banks and other intermediaries. The structured products market is a particularly fast-moving area. Accordingly, we believe that the Commission should avoid introducing any rules which are overly prescriptive in nature.

- Cater to the unique characteristics of different industry segments – the Commission should avoid a "one size fits all" approach and, where appropriate, regulations may be applied differently to different industry groups. In particular, some regulations may need to be applied differently to the private banks in recognition of their unique operating model.

With this background, we believe there is broad agreement on the general direction of change. The overriding need is to enhance the protection of the investing public: where we comment on the Commission's proposals to achieve this aim, our intention is to share what the industry believes to be a workable and practicable approach in implementing the agreed changes.

Following the financial crisis, the banking industry has been subject to various regulatory changes and new guidelines over the past year, which we believe have significantly enhanced banking stability and investor protection. However, compliance with such new regulations and requirements has come at a cost of additional operational changes and increased resourcing for the industry. Whilst we are supportive of the Commission's overall objective to further enhance the protection of the investing public, we also believe that it is important to balance investor protection with practical implementation of changes in order to ensure an efficient distribution system and to avoid significant additional costs which would inevitably be passed on to the customers.

Set out below are our responses to the specific questions raised in the Consultation Paper. A section containing additional comments from the private bank members is included at the end of the submission. In light of their unique operating model, private bank members are of the view that particular considerations may need to be taken into account by the Commission in formulating its policies for private banks.

HKAB has also made a submission to the Commission on the "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investment Regime in the Securities and Futures Ordinance" released by the Commission in October 2009. HKAB would like to emphasise that a number of the observations made in that submission, including the discussion about the definition of "structured products" to be adopted in the Securities and Futures Ordinance (SFO), are equally applicable to this submission.

HKAB and its members are committed to working with the Commission to achieve its statutory regulatory objective to maintain and promote the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry. To this end, HKAB and its members are keen to engage in an ongoing dialogue with the Commission (both at the policy and the working levels) and with the Hong Kong Monetary Authority ("HKMA") (as the frontline supervisor of the securities business of RIs) not only in relation to the specific proposals set out in the relevant Consultation Papers but also in relation to other issues involved in the sales of investment products which are of concern to the industry.

Executive Summary

HKAB is in broad support of the proposals for reform of the unlisted structured products market set out in the Consultation Paper. Our Members are committed to work with the Government and regulators to restore the trust and confidence of investors in our market.

We agree that the regulations should remain based on the twin pillars of an enhanced disclosure regime and an effective Code governing intermediaries' conduct. Both pillars should, as the Commission suggests, be administered as a flexible principles-based, rather than a rigid rules-based, system. While we agree with the broad aims of the proposals, we have tried, in our specific responses, to suggest improvements to the detailed implementation of the proposals to enhance investor protection consistently with the further objectives of: maintaining Hong Kong's status as a world financial centre; keeping the new product codes and the Code of Conduct principles-based; and catering to the unique characteristics of different industry segments.

The following summarizes briefly our position on aspects of the Consultation Paper under key headings.

Parts I and II of the Consultation Paper

Enhancing disclosure. We agree with the Commission that an offering document should contain "the information necessary for investors to make an informed judgment of the investment". The further requirement that an offering document should contain details with respect to the forty-six paragraphs of itemized information contained in the proposals should however be interpreted flexibly in light of this overall disclosure standard, taking a principles-based rather than a rules-based or check-box approach to this key provision for the enhancement of disclosure.

Product Key Facts Statements. We generally welcome the proposal that offering documents should contain a concise statement of the key features and risks of the investment product, and indeed this is in line with international developments. However, our Members' experience is that a pre-set four-page limit is not practicable or necessarily of benefit to investors and we look forward to working with the Commission to achieve the right balance between page-length and content in the context of particular products.

Ongoing disclosure. Disclosure of information during the life of a structured product is important to maintain transparency in the market and to keep investors informed about developments which may affect their investment. While we agree with the general approach suggested by the Commission, we believe that the requirements should be no more extensive than those which now apply to listed structured products. In any event, the benefits of providing information on a continuing basis should be weighed against the costs of doing so and the potential investor confusion due to information overload. In our view, the provision of an indicative bid price (see below) is the best way to provide a transparent reflection of the impact of market events on an investment and the proposals on ongoing disclosure may be thinned on this basis.

Eligibility requirements for reference assets. We agree that information about a reference asset, and the basis on which the return of a structured product is linked to the reference asset, should usually be transparent and easily available to investors. However, we are concerned that the factors which the Commission would take into account in determining whether a reference asset is "acceptable" to it, particularly that information be available in English and Chinese, may tend to limit the range of acceptable reference assets to those available in Hong Kong and China. An important use of structured products is to provide investors with access to assets which are not available in the local market. We believe that the principles underlying the eligibility requirements – transparency and accessibility – should be worked out more fully to include overseas assets and to provide (consistently with the retention of a disclosure-based rather than a merit-based system) for adequate disclosure of risk factors where appropriate to warn investors when information is less transparent, more difficult to access, or available only in one language.

Collateralised products. We agree with the Commission that the use of an SPV to issue structured products "has its justifications". One justification identified in the Consultation Paper is to provide credit insulation from the product provider; we believe there are other justifications, including the use of an SPV to repackage or securitize assets, using those assets as collateral, into a form appropriate for retail investors. The proposed eligibility criteria for collateral currently focus on only the credit insulation aspect of SPV structures and the requirements are so restrictive that we believe it will be very difficult to structure collateralised products which meet the criteria. We believe a pragmatic rather than rules-based approach to collateralisation will best serve investors.

Indicative prices. We agree that the provision of indicative bid prices (rather than "valuations") and the availability of a secondary market for structured products are key elements in enhancing investor protection. Indicative bid prices should be available on a basis to be disclosed in the offering document for the particular product to take account of its particular liquidity characteristics – we believe a requirement for daily prices would give a misleading impression of the liquidity of unlisted structured products which are buy-to-hold investments, as well as being impracticable. Indicative bid prices should be available on request by an investor, but will usually be on a best efforts basis and the actual secondary market redemption price will only be confirmed to the investor following execution. The actual redemption price will depend on market conditions and the size of the redemption order, amongst other things, reflecting the illiquidity of many of these products.

Parts III and IV of the Consultation Paper

Suitability. A key issue which is not addressed in the Consultation Paper is the question of when the suitability obligation should be triggered, i.e. what meanings should be given to the terms 'recommendation' and 'solicitation'. This ties in with the question of when products may be sold to investors on an 'execution only' basis. Another important issue is the application of suitability procedures to different types of investment product, for example, how the procedures can be streamlined in relation to simple and/or low risk investment products. We understand that such streamlining would be consistent with the policy intention expressed by the Financial Services and Treasury Bureau in its letter to HKAB on 29 July 2009. Urgent guidance on these issues is required to ensure that a balance is struck between the objective of ensuring suitability and that of promoting an efficient distribution system which ensures an appropriate range of product choices for customers. A separate discussion paper on this issue has been submitted to the Commission and we look forward to working with the Commission and the HKMA to develop this further.

Know your client - derivatives knowledge. We believe that the level of an investor's derivatives knowledge and experience can be assessed within the current framework of the "Know Your Client" (KYC) process under the Code of Conduct. We have reservations with the creation of a new category of "clients with derivative knowledge" and strongly oppose the proposal that no unlisted structured products may only be promoted to such investors. Many derivative products are simple and low risk and can be easily understood by investors including first time buyers. We are concerned that the current proposal would significantly restrict freedom of investor choice without providing significant benefit in investor protection. This would not only be detrimental to the public but may affect Hong Kong's competitiveness as an international financial centre. We submit that intermediaries should be allowed to sell unlisted derivative products to customers who are assessed as suitable investors in the products after applying relevant suitability procedures. We also believe that there would be difficulties in implementing the Commission's proposals in relation to derivatives knowledge in practice.

Professional investor – minimum portfolio requirement. We believe that the current threshold of HKD8 million is appropriate and should be retained. Altering the threshold would adversely affect the private placement market in Hong Kong. Furthermore, as the Commission recognises, for Code of Conduct purposes, the 'knowledge and experience' criteria (which are stringent) also need to be satisfied – when combined with the quantitative test, we believe these provide a high level of investor protection.

Pre-sale disclosure of monetary benefits. We appreciate the concerns of the public and of the Commission about potential conflicts of interest and agree that pre-sale disclosure in relation to commissions and other monetary benefits should be introduced. We believe that specific disclosure is appropriate where an intermediary sells a third party investment product to a customer on an agency basis or on a 'riskless principal' basis[2] and receives a commission from the issuer. In this case, we believe that where the monetary benefits are quantifiable they should be disclosed by reference to a ceiling of the investment amount. If all or some of the benefits are not quantifiable prior to or at the point of sale, generic disclosure would be appropriate in relation to those (non-quantifiable) monetary benefits.

Where an intermediary sells an unlisted investment product to a customer in a true principal trade (such as where the intermediary sells bonds which it owns or enters into an OTC derivative transaction with a customer) it would not receive any monetary benefit from the issuer of the product. Notwithstanding this, we would support a generic disclosure to the effect that the intermediary may make a profit from the transaction.

In relation to in-house products (which would include products designed by an affiliate of the bank or within the same legal entity), we believe that generic disclosure is appropriate. Banks have varied practices in terms of how they account for these transactions and allocate profits internally. Accordingly, even in those cases where it is possible to determine a specific monetary benefit attributable to distribution, the figures disclosed would not be comparable between different banks and would not therefore be meaningful from an investor's perspective.

2 'Riskless principal' transactions are technically structured as back-to-back principal transactions but where in reality the bank does not take on any true principal risk (for the avoidance of doubt, these do not include OTC derivative trades where the bank enters into a matching hedging transaction). In effect, therefore, these may be viewed as equivalent to agency transactions.

Cooling-off period. We believe that the best way to protect investors from the possibility of mis-selling or high-pressure sales tactics is to ensure proper standards of intermediary conduct are observed. Additionally, ensuring investors have access to an indicative bid price and a secondary market provided on request by the product provider allows investors who have second thoughts about their investment a more cost-effective exit than a statutory cooling off period.

Having said this, we would support the introduction of an 'option to unwind' in relation to long term investment products (which we suggest be limited to products with a maturity of more than 3 years) where there is no secondary market, subject to certain conditions. Firstly, we believe that this right should only be applied to unlisted structured products which are offered to the public. Secondly, the duration of the right should be limited in line with certain other Asian markets (where we understand the period is a maximum of 7 days). Thirdly, investors would need to be aware that the exercise of the option to unwind may come at a significant cost as the investor would need to bear any downward market price adjustments, costs of unwinding the transaction at the product provider level as well as certain intermediary expenses. For this reason, the term 'option to unwind' is preferable to the phrase 'cooling off' as the latter may mislead investors into thinking that they would be able to recover the full principal amount of their investment. Finally, we do not believe the right should be available to professional investors.

Gifts. We submit that gifts should be allowed so long as they are not likely to distract an investor's attention from the true merits of the product.

Audio recording. We support the objective of ensuring there is a robust audit trail in relation to sales of investment products and that equivalent requirements are applied across all intermediaries to ensure a level playing field. However, we submit that this requirement should be principle-based and that intermediaries should have flexibility as to how they achieve this objective (with audio recording being one but not the only means of doing so). Retail banks (but not private banks) are of course in any event already subject to audio recording requirements. The effectiveness of these and other measures implemented by retail banks over the second half of 2009 under the HKMA requirements as regards investor protection will be reviewed against the impact they have had on the selling process and other operational aspects of the retail banks. Given that the audio recording requirement is still subject to review by the industry, as agreed with the HKMA, we strongly object to the Commission making it mandatory or including it in the Code of Conduct at this stage. Upon finalisation of the audio recording requirements following this review, we submit that any requirements should be applied equally to all intermediaries to ensure fair competition.

Part I – Introduction & Part II – Products

Responses to the specific questions for consultation

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.

1.1 We generally agree with the spirit of the Overarching Principles section. However, we would welcome further interpretive guidance from the Commission on what constitutes a "conflict of interest" and to what extent conflicts of interest may be dealt with by disclosure and/or managed by appropriate measures.

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?

Offering Documents

2.1 We agree that an offering document should "contain the information necessary for investors to be able to make an informed judgment of the investment".

2.2 We welcome the retention of a "disclosure-based" approach to regulation of structured products and recognise that to work effectively this approach must be underpinned by disclosure which is clear and sufficient to allow an informed investment decision. We also support a "principles-based" approach to disclosure rooted in the overall disclosure standard rather than a rules-based check-box approach. We believe that:

- disclosure must be of information which is useful to investors in forming a judgment about the desirability of the investment for them;
- experience has shown that investors may be confused and are certainly intimidated by too much information (the "door stopper" prospectus problem);
- it is not possible to prescribe what items are always appropriate for disclosure across a constantly evolving range of sometimes complex structured products which may involve very different types of reference asset; and
- the approach to disclosure should also take account of the existence of the second pillar of intermediary regulation.

2.3 Accordingly, we believe that Appendix C of the draft Structured Products Code should be treated as a useful checklist of items which will typically be required for disclosure. In keeping with the Commission's declared intention to retain a disclosure- and principles-based approach, we would suggest that paragraph 6.1(c) of the draft Structured Products Code be replaced with a statement that the Commission will usually expect disclosure of the applicable items listed in Appendix C, or of equivalent information suited to the issuer, the product, and the reference assets for which authorisation is sought.

Product Key Facts Statement

2.4 We agree with the Commission that a Product Key Facts Statement, containing a concise statement of the key features and risks of the product, has an important role to play in ensuring effective disclosure of information about a product to a retail investor.

2.5 We also endorse the proposed disclosure standard for the Product Key Facts Statement ("KFS") (Structured Products Code paragraph 6.3) that it "shall contain sufficient information to enable investors to comprehend the key features and risks of the relevant structured product." We note, and agree, that the KFS should be developed in a way which allows investors to compare similar products more easily.

2.6 We believe, however, that experience has shown that a pre-set four-page limit on the length of the KFS is simply not practicable. We note that the template KFS for unlisted structured products is already 3 ½ pages long before product-specific information is included; and that the KFS for recently authorised simple Bull ELI products is up to 6 pages long. We do not think it is necessarily a benefit to investors to squeeze information about a complex product into four pages if this means having to leave out features or analysis which the product provider would prefer to include and regards as desirable to meet the KFS disclosure standard noted above. We believe a brief summary document could attain the targeted length limit only if its scope is refined to deliver the major features and associated risks of a particular product, consigning all generic disclosure to the rest of the offering document.

2.7 We expect that the KFS will, and should, evolve as individual products are authorized and we look forward to exploring with the Commission an appropriate balance between page length and content, having regard to this KFS disclosure standard.

Appendix C Contents Requirements

2.8 There follows a number of particular comments, by reference to paragraph numbers in Appendix C to the draft Structured Products Code, most of which illustrate a need for flexibility in how the checklist is applied. As noted above, we believe the offering document disclosure standard should be an overriding guide and that a flexible approach to disclosure of individual checklist items is appropriate. We hope the Commission will take this opportunity to move away from the formal checklist and waiver system associated with compliance with the Third Schedule disclosure requirements of the Companies Ordinance.

2.9 Paragraph 2(f) The *key* components *of the structured product and any embedded derivatives*. The usefulness to investors of disclosure of components and embedded derivatives is questionable for at least three reasons:

- it is likely to be very confusing for investors and to introduce technical terms which are difficult to explain succinctly;
- information about individual components of a product is not useful for investors and distracts from the ultimate payout; and
- identifying derivatives components may perpetuate a perception that there is something uniquely dangerous about derivatives or that complexity is inherently risky. (This is not the case, as the Commission pointed out in its report to the Financial Secretary on the Minibond Crisis (paragraph 16.6).)

2.10 We believe that the key disclosure for investors relates to how much they could lose and how much they could gain from the investment, together with the associated cost and risk, and not the mechanics by which the gains and/or losses would be determined.

2.11 Paragraph 10(c)(iv) Five year trading record. We believe that there should be flexibility to include fewer than five years' data for short-tenor products.

2.12 Paragraph 24(f) Disclosure *of conflicts of laws/recognition of judgments etc.* It is unclear what disclosure is expected. It is generally not possible to identify in advance specific conflicts of laws issues, for example, such as those which have arisen surrounding the collateral claim priority or "flip" clause in the minibond product. We would suggest the development of standard, generic risk factors to which specific, identified risks would be added for particular products as appropriate.

2.13 Paragraph 25 *Credit* ratings. An acceptable market standard form of disclosure should be developed on the basis of the rating agencies' own description of what their ratings mean.

2.14 Paragraph 28 (a),(b) Audited financial statements. We are concerned that the requirements presuppose Hong Kong qualified auditors and financial statements prepared under Hong Kong Financial Reporting Standards ("HKFRS") or International Financial Reporting Standards ("IFRS"). The draft Structured Products Code should confirm the acceptability of the audited financial statements for major international financial institutions prepared under their home regimes in at least the United States, Europe and Japan.

2.15 Paragraph 28, 29, 30 Reports and Accounts. We suggest that incorporation by reference of financial statements should be permitted where the financial statements are easily accessible to the public. Incorporation of financial statements by reference is the norm now in most major financial centres. It is practical and efficient for all parties, and it avoids the expense and waste of reproducing voluminous financial information in paper prospectuses.

2.16 Paragraph 34(b) Responsibility statements. We would seek reassurance from the Commission that it does not propose any change to the current well-established practice in Hong Kong and internationally: a guarantor and key product counterparty would be expected to take responsibility for their own descriptions and financial information; and the issuer would take responsibility for the rest of the offering document, subject to a carve out for third-party information having been properly extracted from a public source.

2.17 Paragraph 34(b) Compliance with the Code. Please clarify what is expected by the confirmation that the issuer will ensure that a product will continue to comply with the Code. This is impossibly onerous if it requires an issuer, for example, to replace collateral which is downgraded below investment grade or otherwise to rectify situations in which a product ceases in time to meet the original eligibility criteria.

Advertisements

2.18 We believe that every advertisement should be the responsibility of the issuer of the advertisement and should contain a responsibility statement to that effect (we agree with the draft Structured Products Code Appendix D paragraphs 25-27). However, we do not think the Commission should be prescriptive as to the manner in which issuers check advertisements and clear them for publication. It should not therefore be a requirement that a single individual delegate be responsible for review of all advertisements:

- this will require issuers of advertisements to introduce new procedures specific to Hong Kong in circumstances where existing approval procedures appear to be working satisfactorily;
- it is unfair and inconvenient to impose this burden on a single individual; and

- there are also serious concerns that the individual may incur personal legal liability: we believe that the primary responsibility is properly a corporate responsibility, and that existing legislation includes adequate provision to impose individual liability where that is appropriate.

2.19 We generally welcome the codification of advertising guidelines set out in Appendix D to the draft Structured Products Code, but we offer the following observations (references are to paragraphs of Appendix D):

2.20 Paragraph 1 Note 1 Description of derivative components. It will seldom, if ever, be appropriate (even if it is practicable) to include a description of derivative components in an advertisement. Disclosure should focus on what is important to investors: the pay off and associated risks.

2.21 Paragraph 24 Audio and visual advertisements. We believe the list of items to be included in a warning screen or voice-over would make these modes of advertising impracticable. If the Commission believes audio and visual advertisements should in principle be permitted, a more realistic approach to necessary warnings should be taken – for example, by ensuring the warnings are properly communicated and acknowledged at the point of sale.

Authorisation based on template terms

2.22 We note that the Commission already grants authorization for structured products based on template terms and encourage the Commission to continue to do so in respect of the proposed expanded universe of structured products that will be subject to SFO regulation. This enables products to be brought to market in a timely and cost efficient manner without which there would be delays in the offering and sale processes and an increase in administration costs if authorization is required each time at the product level.

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?

3.1 We agree that an important lesson to be learnt from recent experience is the need for improved transparency during the life of the product after issue. However, we believe that the best medium for reflecting all the factors that may impact an investor's interest in a product is its bid price. See further our response to Question 8. We are concerned that as currently drafted the ongoing disclosure requirements will result in too much information being transmitted to investors, including much information which is of doubtful relevance to their structured product or of which the impact may be difficult for an investor – particularly a retail investor - to determine.

3.2 We believe the balance currently achieved under the listing rules for listed structured products is sound and has worked well for many years. We do not think the rules for unlisted products should be more extensive.

3.3 This is the case particularly for paragraph 7.6(a)(iii) and (iv) (any current financial report, other financial filings) which could include very frequent filings with the US Securities and Exchange Commission, for example; and the extension of paragraph 7.6(b) (material adverse change in financial condition) to the issuer's "business" generally, and to its "corporate group". The relevance of this information to an investor's product may often be very difficult to determine.

3.4 We are also concerned that it is far from clear what would be "material" for disclosure under paragraphs 7.6(b) (material adverse change in financial condition) and (c) (material negative effect on ability to perform). We believe that the requirement to disclose a "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" should be dropped from paragraph 7.6(b) as being unclear and vague. This type of requirement is certain to lead to complaints and disputes if a product does not perform as expected and there has been an event or development which with the benefit of hindsight may have affected the performance and which could have been disclosed. We believe investors are adequately protected by the objective tests of (i) and (ii) of paragraph 7.6(b) and by paragraph 7.6(c). In paragraph 7.6(c), the obligation to notify should rest only on the party whose commitments are affected. We believe that this approach would match that taken in the listing rules for structured products listed on the Hong Kong Stock Exchange.

3.5 If the ongoing disclosure requirement of paragraphs 7.6(b) and (c) are to be implemented after appropriate modifications, it would help to ensure clarity and consistency if the Commission provided guidance as to information which is "material" for disclosure, similar to that provided by the Hong Kong Stock Exchange in its "Guide to the Disclosure of Price Sensitive Information".

3.6 We believe in any event that where information is required to be made available to investors, the requirement should be considered satisfied not only if the information is made available to the distributors for onward transmission to the investors, but also if the information is made available online at a website location provided either by the product provider, and specified in the offering document, or by a distributor, and specified in its customer documentation. In the longer term, we hope that the Commission will develop a centralised online repository for all filings in relation to unlisted structured products, similar to that maintained by the US SEC.

3.7 In paragraphs 7.6(a)(ii) and (iii), requiring that financial statements be made available not later than four months after the date to which they relate would be impracticable. The time period should be fixed by reference to the requirements of the home jurisdiction of the reporting entity, with allowance made for the additional time needed to prepare a careful Chinese translation of the material.

3.8 We are concerned about the intention and implications of paragraph 7.8(c), which refers to an issuer taking "remedial action to rectify the situation" and to provide compensation for investors in structured products which cease to meet Code requirements after authorization. We suppose it is not the intention of the Commission that issuers must effectively ensure that they and their products continue to meet initial eligibility criteria, and accordingly we would welcome clarification of the drafting. It would not be right for investors to have a right to compensation because, for example, collateral ceased to have investment grade status or even defaulted.

Question 4:

What are your views on the eligibility requirements for Issuers and Guarantors of unlisted structured products proposed by the SFC?

4.1 We have no objections to the concept of having eligibility requirements for Issuers and Guarantors of unlisted structured products. Our comments on Chapter 3 (Issuers and Guarantors) of the draft Structured Products Code focus mainly on (i) the need for "materiality" thresholds to some of the eligibility requirements; and (ii) removing eligibility as an on-going requirement, as explained below.

Materiality threshold

4.2 Some of the eligibility requirements should be subject to a "materiality" threshold, without which it would be impossible, or otherwise extremely impracticable, for some Issuers or Guarantors (particularly with a global multi-jurisdiction operation) to comply with the relevant requirements. In other cases, the eligibility requirements should be qualified such that they do not extend to cover events which do not relate to the credit or legal risk of the relevant Issuer or Guarantor. The purpose of these requirements is to protect the public by ensuring that Issuers and Guarantors are suitable, and immaterial matters should be screened out. For example:

- the particular requirements on "good standing" under paragraph 3.3(a)(ii) should be restricted to such actions by regulators or breaches or applicable rules which materially affect the Issuer's (or Guarantor's) (a) financial condition or (b) status as a licensed or regulated entity under the relevant regulations; and
- the prohibition on entering into restructuring agreements under paragraph 1(c)(iii) of Appendix A should be subject to a material monetary threshold, and should only apply in relation to restructurings which result from a deterioration in the creditworthiness or financial condition of the relevant Issuer or Guarantor.

4.3 We note that similar issues on materiality also permeate through our comments on other sections of the consultation.

Eligibility as an on-going requirement

4.4 The eligibility requirements should only be applicable at the time of issue of the structured products. Whilst it is perfectly acceptable to expect an Issuer or Guarantor to be of good standing and financial health before it is eligible to issue or guarantee structured products, a continuing obligation to comply with the eligibility requirement is tantamount to providing a covenant as to future financial performance which is beyond the control of the Issuer or the Guarantor.

4.5 For example, an Issuer or Guarantor which satisfied the core requirements at the time of issuance of the structured products, including a rating within the top three investment grades, subsequently became downgraded to a rating lower than the required investment grade. We believe it would be grossly unfair and inappropriate to hold the Issuer or the Guarantor as ineligible in relation to these structured products previously issued or require the Issuer and Guarantor to make rectification or compensate the investors (as contemplated in paragraph 7.8 of the draft Structured Products Code). This is part of the risk assumed by investors. Investments are forward looking and investment decisions must be made at or prior to the point of sale. There is also no such continuing eligibility requirements for the issuers or management companies of listed structured products or unit trust and mutual funds.

4.6 Accordingly, we believe that, as a general point, all eligibility requirements in the draft SP Code are to be "prospective only" in respect of structured products to be issued at the relevant time, and cannot be made applicable to structured products which have already been issued.

Question 5:

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

5.1 We have no particular comments on the proposed requirements on SPVs.

(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?

5.2 We have no objections in principle to the appointment of a Hong Kong-licensed Product Arranger for structured products issued by an SPV. However, we believe that the "absolute" responsibility imposed on the Product Arranger i.e. *to ensure that the Issuer at all times complies* with the Handbook requirements, is commercially impracticable and is inconsistent with the way structured products work. We suppose, and agree, that the investor protection function of the Product Arranger is to provide a Hong Kong-based conduit with responsibility to ensure the SPV does what it should do in administering the product: we believe the Product Arranger's role should reflect this.

5.3 At present, the duties of any local arranger for structured products are of an essentially administrative nature. This reflects the fact that the products are always structured such that there is little or no financial incentive for the local arranger. Requiring the arranger to assume the same liabilities as those of the Issuer is so disproportionate, in terms of risks and rewards, that realistically it would be almost impossible to find anyone who would be willing to become a Product Arranger. In addition, as the SPV Issuer is ultimately an independent legal entity over which the Product Arranger does not have effective control, it seems to be unduly onerous and impractical to hold the Product Arranger liable for breaches of the SPV which the Product Arranger would not be able to prevent.

5.4 Neither the Hong Kong Listing Rules nor Unit Trust Code imposes a similar requirement with respect to listed structured products or unit trust and mutual funds where the relevant Issuer or the management company has its place of business outside of Hong Kong. As the relevant SPV Issuer of unlisted structured products would be properly backed by a guarantee or the relevant collaterals, we do not consider that an SPV Issuer, by virtue of being a special purpose vehicle, entails a bigger risk for the investors so as to justify such an inconsistent approach between the SP Code and other existing regulations. Furthermore, we believe that such inconsistency could significantly hamper the development of unlisted structured products, and the ability of the industry in providing a full range of structured products to investors.

5.5 We suggest that the level of responsibilities imposed on the Product Arranger should be similar to those that apply to a "Representative" under Chapter 9 (Additional requirements for Non-Hong Kong based schemes) of the UT Code, which we believe appropriately reflect the ongoing role of the arranger as a representative agent of, or channel of communication with, the Issuer. The representative agent would act as the informational channel between the Hong Kong parties (namely the regulators and the investors) on the one hand and the offshore SPV on the other. We believe this role answers an important investor protection concern with SPV use.

5.6 Finally, we would observe that any Product Arranger would in practice be a member of the same corporate group as the product provider of the structured product. It is unlikely that the Product Arranger would therefore be available in the circumstances in which it is most needed – an insolvency of the product provider.

(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)?

5.7 We do not believe that a Product Arranger would be necessary for an Issuer which already fulfils the definition of "Regulated Entity" as an overseas banking entity which is subject to equivalent regulatory oversight to that of Hong Kong.

(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

5.8 For the same reasons as we set out in our response to question 5(b) above, we suggest that any obligations or responsibilities to which a Product Arranger should be subject ought to be consistent with its role solely as the Issuer's representative agent in Hong Kong.

5.9 The eligibility of the Product Arranger should not be affected by any minor, technical and non-material breach of the requirements set out in paragraph 4.2(b) of the draft Structured Products Code.

5.10 Similarly to our response to Question 5, the eligibility requirements for Product Arranger are to be "prospective only" in respect of structured products to be issued at the relevant time, and cannot be made "continuing" as being applicable to structured products which have already been issued.

Question 6

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

6.1 As a matter of principle, we support the introduction of eligibility criteria for collateral for the better protection of investors and improving the market's confidence in unlisted structured products. However, we have some specific comments with respect to the proposed criteria which are mainly directed towards requesting further clarifications and pointing out certain impracticalities. (Please note our response to Question 6(b) below, however, raises important issues about the purpose of collateralization which impacts the type of eligibility criteria that may be appropriate to different types of product.)

6.2 Paragraph 5.16 of the draft Structured Products Code requires the Issuer to ensure that the investor's security interests in the collateral are capable of being enforced "*in a timely and efficient manner*". Whilst we fully recognise the desirability for the collateral to be enforced as quickly as possible, we submit that the requirement on the Issuer to ensure a timely and efficient process should be removed. Enforcement of security, even in the simplest cases, involves many steps and parties, many of which are not controlled by the Issuer. Conversely, many of these steps and actions are within the control and discretion of the investors, the trustee and their advisers. In particular, in the event of the insolvency of the custodian or the Issuer of the collateral, matters may fall to the hands of the relevant administrator or court, with its own prescribed procedures and time line. The causes and eventualities in relation to the enforcement of collateral are so diverse that there can be no meaningful benchmark as to what is 'timely' and 'efficient', and as such, this requirement would be impossible to comply with for lack of certainty.

6.3 It is also impossible for the Issuer and the Product Arranger to confirm to the Commission that the collateralisation of the structured product adequately protects the interests of the investors (as required under paragraph 5.19 of the draft Structured Products Code).

6.4 In addition, these eligibility requirements cannot be of a continuing nature - it is simply impossible for the product provider to undertake that the collateral will continue to meet all these eligibility requirements during the tenor of the structured products since many of these involve market and other forces beyond the control of the product provider.

6.5 Other instances where the eligibility requirements of collateral need to be further clarified or are otherwise impracticable include:

- paragraph 5.13(e) – the meaning of "*not be related to the Issuer*" needs to be clarified;
- paragraph 5.13(j) – the requirement for collateral to be "*appropriately diversified*" is contrary to current market practice and in any event should not be necessary where the collateral already has a sufficiently high credit rating;
- paragraph 5.13(k) – the meaning of "*undue risk*" should be clarified or such requirement in respect of collateral should be removed; and
- paragraph 5.14 – marking the collateral to market on a daily basis would be impossible during market disruptions; and the requirement for valuation to be conducted "*independently*" should be clarified (given that this will be typically done by the Key Product Counterparty).

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

6.6 No, we do not believe any additional criteria are necessary. However, we hope that alternative criteria may be permitted where the product justifies a different approach. The draft criteria focus on the provision of collateral to reduce or replace the credit risk associated with the product issuer and/or the product counterparty. This is not the only possible function of collateral. The purpose of a product may be, for example, to "repackage" or securitize a given asset, with the asset itself providing the credit backing for the product. A simple example would be a repackaging of a domestic currency corporate or sovereign bond into a Hong Kong dollar product, with the product secured on the bond. A more complex example would be the securitization of mortgages or of an infrastructure project such as a toll tunnel or bridge. A different approach to collateral eligibility would be appropriate for such products, and we hope that a disclosure- and principles-based approach would be flexible enough to accommodate such products.

(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?

6.7 We are against any such requirement since it is inconsistent with the way many structured products work.

6.8 The financial return of any financial product is primarily a function of its risk. In the context of a structured product, the financial return to each party to the underlying transactions reflects the risk that is allocated amongst them. After all, the reason why the counterparty to the Issuer in the related transaction is prepared to pay the risk premium in the first place is because of the payment priority it enjoys, and it is these structures that enable structured products to give investors higher returns. It is possible to structure a 'safe' product in which investors' claims are always given priority, but such product would, of necessity, also be low-yield, which would arguably not be attractive to investors.

6.9 We should also point out that for repackaging transactions, due to the high yield nature of the structured products, the Key Product Counterparties typically rank more senior than (or in certain cases equally with) the investors.

6.10 We believe that such a requirement, if imposed, would fundamentally change industry practice in the Hong Kong market relative to international markets. This will significantly impair the competitiveness of Hong Kong as an international financial market for unlisted structured products.

Question 7

Do you believe that the SFC 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.

7.1 We agree with the general principles underlying the reference asset criteria proposals, that information about a reference asset, and the basis on which the return of a structured product is linked to a reference asset, should usually be transparent and easily available to investors. However, we are concerned that the eligibility criteria should not exclude a wide range of reference asset and classes: a primary purpose of the unlisted structured products market is to provide investors with access to reference assets which they cannot otherwise easily source themselves in Hong Kong.

7.2 We note that Paragraph 5.7 of the draft Structured Products SP Code requires the reference asset or benchmark to structured products to be "acceptable" to the Commission, which indicates a "merit-based" approach to regulating structured products contrary to the "disclosure-based" approach advocated by the Government and the Commission.

7.3 Consistent with an overall disclosure-based approach, we believe that investor protection would be better addressed by way of proper disclosure including by risk factor in cases where information on the reference asset may be more difficult to obtain or may not be available in English and Chinese, and by ensuring that existing suitability requirements are properly observed under the second pillar of intermediary supervision.

7.4 Although we agree that there needs to be sufficient disclosure to the investors regarding the reference assets, we are mindful that some of the disclosure requirements on reference assets set out in the draft Structured Products Code cannot be practically applied to certain kinds of reference assets (including those that already exist on the market), such that those disclosure requirements could in reality become eligibility criteria in their own right. The disclosure requirements ought to be flexible and commercially practicable enough to cater for different reference assets.

7.5 The suggested requirement for information on reference assets to be readily available in Chinese is onerous and seems a clear step backwards for Hong Kong in positioning itself as an international financial market. It is also inconsistent with the practice in the retail funds management world where investment managers may elect to invest in non-Chinese underlying assets.

7.6 The requirement on the availability of information should be limited to the extent that the same is available to the Issuer (for example, the "value" of some reference assets, such as the credit of a reference entity, may not be readily available, or be available in a form which is 'transparent' to investors.). To that end, a more flexible way to inform investors may be to allow the use of other proxy information (for example, traded prices on a stock exchange and/or credit ratings of the reference entity) or for the lack of available information to be disclosed as a potential risk factor.

Other important comments on this section of the consultation which are not covered by questions 4 – 7 above.

Paragraph 5.1 of the draft Structured Products Code

7.7 We believe that paragraph 5.1 should be deleted from the Structured Products Code. Given the stated intention of the Commission to retain a largely disclosure-based regulatory regime, and its general unwillingness to assess the merit of any particular unlisted structured product (a position with which we agree), we do not consider that it is right for the Issuer to confirm to the Commission that a product is 'fair' and 'appropriate', both of which clearly go towards a question of merit. In any event, what is "fair" and "appropriate" is open to different interpretations; accordingly, it would be critically important for the Commission to spell out these criteria in a more concrete and objective manner.

7.8 Further, while it is understood, and in fact is a well-settled principle internationally, that an Issuer or product provider should assess the appropriateness of any particular product for its intended market, encapsulating this in a meaningful representation to a regulator presents problems. We are particularly concerned about this type of representation in the context of any product which subsequently does not perform as expected or defaults for some reason and the propensity for the conclusion to be drawn with hindsight that it cannot therefore have been appropriate from the outset. We are mindful in this context of the Commission reminder that misrepresentation of any matter to the Commission is a criminal offence under the Securities and Futures Ordinance. We do not believe that product providers should be forced into making this kind of imprecise and subjective representation, when criminal sanctions apply.

7.9 Again, it is not possible for the product provider to undertake that these eligibility requirements be met continuously during the tenor of the structured products since these are beyond the control of the product provider.

Paragraph 5.2 of the draft Structured Products Code

7.10 We believe that paragraph 5.2 should also be deleted from the Structured Products Code. Typically the Key Product Counterparties are the Product Arrangers themselves (or entities within the same group of companies as the Product Arrangers). Accordingly, the Key Product Counterparty cannot be said to be "independent" of the Product Arranger. However, if "independent" is supposed to mean something else other than being 'related", then it should be clarified in the Structured Products Code. There were various suggestions at meetings held with the Commission that this independent requirement could be satisfied if there is a "Chinese wall" between the parties or if the two parties are "autonomous" and have different senior management teams (such as the arrangement for unit trusts and mutual funds). We believe that any such requirement of the Commission should be workable and should not fundamentally change the industry practice in the Hong Kong relative to the international markets.

7.11 We understand that the provisions relating to Key Product Counterparties only apply to products structured to use a SPV issuer, but this could be made clear. In particular, these provisions would not be practicable if extended to the hedging counterparties of bank issuers.

Paragraph 5.6 of the draft Structured Products Code

7.12 We acknowledge that in some circumstances it would be beneficial to have parties submit to the non-exclusive jurisdiction of Hong Kong. However where the relevant party does not have a place of business in Hong Kong, Hong Kong may not be the most appropriate forum.

Question 8

8.1 We believe that the provisions of the draft Structured Products Code relating to ongoing price disclosure are key to the successful development of the market:

- The availability of an indicative price for a product is, in our view, by far the best way for a product provider to communicate, and for an investor to assess, the impact of market events on a structured product.
- Provision of a secondary market by the product provider is the mechanism by which an investor can exit a product before maturity in the absence of a publicly available secondary market for buy-to-hold products.
- The ability to exit the product through the commitment to provide a secondary market also replaces any need for a "cooling-off" period (see our response to Part IV of the Consultation Paper).

8.2 We believe, however, that these key functions of an indicative and a secondary market bid price, should not be allowed to confuse investors into thinking that unlisted structured products can be traded or that price fluctuations should in themselves be closely monitored. Most unlisted structured products are illiquid and are structured as buy-to-hold investments which will likely yield their full value only if held to maturity.

(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.

8.3 We preface our comments with the observation that there is an important distinction to be made between a valuation and a bid price. Whereas a valuation reflects the product provider's view of the "value" of a product, a bid price represents the price at which a product provider would buy back the product (subject to market conditions). The bid price will reflect factors such as the provider's funding break costs, other unwind costs, the nominal amount of the transaction, the product provider's credit spread, volatility, correlation amongst the underlying assets, interest rates, etc which would not necessarily be reflected in a valuation. We believe that a product provider should only ever be required to provide a bid price; and we believe that this is more useful to investors because it represents the price for which an investor could sell his product.

8.4 We believe that a requirement to provide daily indicative prices is not practicable for many products on the basis of existing technological platforms. It would also wrongly suggest that buy-to-hold products are liquid or can be traded on the basis of price fluctuations and would be meaningless for products with illiquid underlying reference assets. From an investor's point of view, the cost of providing daily indicative prices would be reflected in the pricing of the product; and in volatile market conditions, a fluctuating daily price may be confusing. The frequency with which indicative prices are given should be determined case-by-case, taking account of the nature of the product and the reference assets. We note that fund products often specify weekly, bi-weekly or even monthly valuations. We would expect that product providers would commit to give an indicative bid price at least monthly, to coincide with distributors' obligations to deliver a monthly statement to investors, or on request. Many product providers may commit to provide more frequent indicative bid prices for appropriate products.

8.5 We are, however, troubled by the following suggested requirements:

- that valuations be "on an independent basis": what is meant by this? Valuation of proprietary products would necessarily be done by the product provider usually on the basis of proprietary methodology. As noted, we believe an indicative bid price is most appropriate.
- that a "timely and effective explanation" be given of "material fluctuation" in valuations of a product: some standard of what would be a material price change is needed to ensure consistency in the market if this proposal is implemented. Would an explanation go beyond identifying how price changes in underlying reference assets affect the product price? Explanation of underlying causes may be difficult. It may be a matter of opinion, may be misleading, and could border on investment advice. There will necessarily be considerable discrepancies and inconsistencies in approach between different institutions; and
- that details of valuation policies be included in the offering document (Appendix C paragraph 40): valuation policies may involve proprietary models, will often be complex and are unlikely to be of use to investors.

(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?

8.6 As mentioned above, we believe that the provision of a secondary market by the product provider is important for the development of the market by providing investors with an exit to their investments prior to maturity, and we generally support the provision of indicative price quotations to investors.

8.7 However, it must be recognised that a firm price is fundamentally different to an indicative price. Because a firm price will result in a binding contract if accepted by the investor, it would only be given after taking into account of all economic factors and other practical considerations prevailing at that particular time and may involve separate pricing of different underlying components of a complex product. In addition, for relatively illiquid investment products, the size of the position on offer can significantly impact the price quotation. Therefore, from a practical perspective, no firm price quotations will be available before a redemption order is actually executed or confirmed. Upon receipt of an investor's redemption order, an indicative bid price will be quoted and product providers will, on a best efforts basis, execute the order at the best available market price. The actual redemption price will be communicated to the investor after the order is executed/confirmed. If the Issuer or its market agent is required to provide regular firm quotations to its investors at large, only the most conservative firm quotation could be provided in order to protect the Issuer or market agent from the uncertain market movements and trade size. Such quotation would be significantly disadvantageous to the investors and would clearly undermine the benefits of providing liquidity to the investors in the first place.

8.8 At times, it may be impossible to provide a price quotation due to realistic constraints that are beyond the control of the issuer, for example during times of market disruption or extreme market volatility. Therefore, we believe that the Issuer or the market maker should only be required to provide quotations under normal market condition using its best endeavours. An exception to any price quotation requirement should also be allowed for products of 6 months maturity or less.

Question 9

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

9.1 We agree that the use of annualised returns should be approached on a case-by-case basis and supported by appropriate disclosure.

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.

10.1 Code requirements should come into effect at the time of the next annual update of programmes existing at the effective date: this would mean a maximum transition period of 12 months for any particular programme. We agree that all offering documents and advertisements authorized after the effective date must comply with the Code.

10.2 We would like to seek confirmation that no update of documentation be required for products that have already been launched prior to the SP Code's effective date. We also recommend that the maximum transition period of 12 months be applied not only to programs with annual renewal/update, but also to other products (e.g. products with one off approval for each issue) for consistency.

Question 11

In relation to proposals regarding investment activities set out in Proposal 1 (structured funds), Proposal 2 (funds that invest in FDI) 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.

11.1 There are no other requirements that we believe should be included.

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.

Bilingual annual reports

12.1 As Chinese is the preferred language for many investors, we agree that bilingual annual reports should be prepared for schemes that are not recognised jurisdiction schemes, even though their preparation will lead to increased costs to the funds.

12.2 In respect of the form of and the deadlines for preparing such bilingual annual reports, we would prefer either option 2 or option 3, as we are concerned that a full Chinese translation may not be completed in the time provided in option 1.

Product KFS

12.3 We agree with the proposal to introduce Product KFSs. However, we are of the view that:

- the general 4-page limit proposed for Product KFSs should not be adopted as it will be difficult to comply with in practice (see our response to Question 2); and
- although none of the following has been expressly required under Proposal 5 (Product KFS), distributor-specific information (such as dealing cut-off times) and lists of relevant intermediaries should be excluded from Product KFSs.

12.4 We also agree that the inclusion of TER and past fund performance should be optional. However, for ease of comparison, we would propose that where such information is included, it should be determined according to a consistent formula and presented using a consistent approach.

Question 13

Do you have any comments on the revisions to the UT Code generally? Please explain your views.

Structured funds

13.1 *8.8(a) Requirement of independence of the issuer of financial derivative instruments from the management company.* We note that the issuer of the financial derivative instruments will commonly be in the same group as the management company (and, in many cases locally, will also be the parent company of the management company. As (i) such relationship will be fully disclosed in the offering documentation and (ii) investing in financial derivative instruments issued by a third party issuer may increase the costs to the fund, we believe that notwithstanding such relationship, the issuer of the financial derivative instruments should be expressly deemed to be independent from the management company if certain criteria are fulfilled.

13.2 In particular, we are of the view the key criterion to be adopted is that the issuer of the financial derivative instruments and the management company should be deemed to be independent as long as potential conflicts of interest are avoided (for example, if the two entities belong to different "business lines" or have put in place appropriate Chinese walls. Alternatively, 4.8(a)(iii), (a)(iv) and (b) from chapter 4 of the UT Code (which stipulates the circumstances in which the management company will be deemed to be independent from the trustee/custodian) may also provide relevant insights into the criteria that can be adopted.

13.3 *8.8(c) Requirement that the valuation of financial derivative instruments be conducted independently.* We note that valuations of financial derivative instruments are commonly provided in good faith by the issuer of the relevant financial derivative instruments using internal models. As (i) it may not be feasible or appropriate for others to do so and (ii) 8.8(c) states that valuation should be carried out through measures 'such as ... engagement of third party services' (which implies that non-third parties can independently provide the required valuations of the relevant financial derivative instruments), we would propose that it be expressly stated that non-third parties can independently provide the required valuations.

13.4 *8.8(e)(iv) Requirement that collateral must not be concentrated in one issue, sector or country. We note that this requirement* would, for example, preclude the use of a basket of Hong Kong-listed shares as collateral. We are of the view that this requirement may therefore be overly onerous and would submit that such requirement be qualified accordingly.

Funds that invest in FDI

13.5 *8.9(f)(iii) Requirement that any OTC derivatives are subject to verifiable valuation on a daily basis, and can be sold, liquidated or closed at any time ... at the scheme's initiative.* We submit that this requirement be made subject to the "best efforts" of the management company, as there may be events which disrupt the ability of the relevant entity from valuing such OTC derivatives or unwinding them on any particular day.

Other comments

13.6 *Paragraph 7.11 Investments in other schemes.* We believe that additional language should be inserted to state that the assets of the *respective* underlying collective investment schemes should not have to be combined for the purposes of the limits laid down in 7.1 to 7.10 (e.g. the requirement that value of the scheme's holding of securities issued by any single issuer may not exceed 10% of its total net asset value). This would be consistent with the UCITS III regime, for example.

13.7 *Paragraph 22, Appendix 1 Requirement for ETFs to disclose the estimated total expense ratio of the scheme.* We do not agree with such requirement as there is no universal definition of 'total expense ratio'. Providing such figure may therefore not facilitate comparability between funds.

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 SFC-authorized funds adopt KIDs instead of Product KFS, it may defeat the purpose of comparability under the Product KFS proposal. The SFC would like to hear your views.

14.1 We are of the view that KIDs may be used as long as the general content requirements of the KIDs and Product KFS are broadly similar. This is because (i) the production costs for separate Product KFSs for every sub-fund (such costs being borne by the funds themselves) may be very substantial, and (ii) we believe that investors are sufficiently informed to interpret different disclosure formats.

14.2 However, in order to achieve the closest possible similarity in the format of the KIDs and the Product KFS, we respectfully submit that the Commission should work with European regulators to arrive at a format for Product KFSs that is as similar as possible to that for the KIDs.

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 (paragraph 191)?

15.1 We have no comments on the proposed approach to implementation of the revised UT Code. We are of the view that the transition period should be 12 months (taking into account the need to reauthorize the relevant offering documents).

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:

16.1 In respect of point (1), we request for guidance on the location of the Product KFS, such as whether it could be included as a content of the product brochure or an insert. Furthermore, clarification is needed on whether information contained in the Product KFS but duplicated in the product brochure, such as charges and upfront important risk warning, can be simplified/excluded in the product brochure.

16.2 In respect of point (4), we are agreeable with the suggestion not to include non-guaranteed returns and we would expect a future development of an industry standard for all insurance companies. The new requirements regarding notice period offer greater flexibility to insurance companies and we welcome the change.

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))?

17.1 We believe the proposed transition period of 9-12 months for Existing Schemes to fully comply with the Product KFS and other Disclosure Requirements is acceptable. However, when each new illustration requirement is introduced, significant system enhancements are required to cater for the new requirement. In light of this, we submit that a minimum of 6 months should be allowed for each new illustration requirement.

Part III – Intermediaries Conduct

General observations

There are a number of general observations which we would like to make on this Part of the Consultation Paper.

Firstly, we consider that there are a number of critical issues relating to intermediary conduct which are not addressed in the Consultation Paper. These include, in particular, the circumstances in which an intermediary may sell investment products on an 'execution only' basis without having to assess suitability. This issue is directly linked to the question of when the suitability obligation is triggered. The concepts of 'recommendation' and 'solicitation' in the Commission's Code of Conduct are not defined and this has resulted in uncertainty among members as to the precise circumstances in which suitability needs to be assessed. In the Commission's investigations relating to the sale of Minibonds and other structured products it became clear that the enforcement division of the Commission takes a very broad view of the concept of 'solicitation' – so broad that it virtually precludes the possibility of sales other than on an advised basis. We are grateful that the Commission and the HKMA are now taking the opportunity to look at these issues separately and our Members will continue to work with the regulators to develop helpful and practical guidance in this area.

Related to the above point is the question of whether there should be a difference in the application of suitability procedures to different types of investment products and customer behaviour. For instance, it may be that there should be greater scope for simplifying suitability procedures for selling simple and straight-forward investment products on an execution-only basis or at least under simplified suitability procedures. This is the approach adopted under the regulatory regime in the United Kingdom. We note that the Consultation Paper contemplates this type of approach (Consultation Paper, Part III, paragraph 20) where it states that "For products having features and risks which are not difficult for an average investor to understand, the suitability requirement can be achieved under simplified procedures". We welcome this clarification which we think accords with the policy intention expressed by the Financial Services and Treasury Bureau in its letter to HKAB on 29 July 2009. We suggest that the approach may be taken further by, for instance, allowing greater scope for execution only sales of simple investment products. Again, we have separately raised this issue for the Commission's consideration in a discussion paper and look forward to an ongoing dialogue with the HKMA in relation to it.

Responses to the specific questions for consultation

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.

18.1 We agree that many of the proposals in Part III of the Consultation Paper should only apply to unlisted investment products on the basis that the policy considerations underlying the proposals are less relevant to listed products for the following reasons:-

- listed products are subject to the requirements and oversight of the relevant stock exchange and as a consequence are generally subject to a higher level of transparency;
- listed products are generally less complex and many are indeed very straightforward, e.g. equities, vanilla bonds etc;

- listed products are more commonly sold on an "execution-only" basis with no solicitation by intermediaries; and
- issuers of listed structured products are subject to prohibitions in relation to the offering of commissions for the sale of structured products they have issued (see rule 15A.24A of the HKSE Listing Rules).

18.2 Furthermore, we would suggest that some of the proposals be limited to "unlisted structured products" (in accordance with the definition of "structured product" which the Commission is proposing to introduce into the Companies Ordinance (CO) and SFO and subject to such modifications as we have proposed in our other submission to the Commission on the "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance") and should not apply to more vanilla unlisted products. On this basis, there would be three categories of investment product: (i) unlisted structured products; (ii) other unlisted products; and (iii) listed products.

18.3 Specifically,, and subject to our detailed comments below on specific proposals, we believe that:-

- the investor characterization proposal (for investors with derivatives knowledge) as set out in question 19 should only apply to unlisted structured products sold to non-professional investors (as defined under the SFO). For the reasons given below, we are in any event strongly opposed to this proposal;
- the changes to the "professional investor" test, if introduced, should apply across all products – listed and unlisted, excluding ILAS (Insurance Linked Assurance Schemes) and MPF (Mandatory Provident Fund) products;
- the proposals relating to pre-sale disclosure of monetary and non-monetary benefits, use of gifts and audio recording should apply to all unlisted investment products;
- the proposal relating to Sales Disclosure Documents should apply to all unlisted 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 than 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.

19.1 We believe that the level of an investor's derivatives knowledge and experience can be assessed within the framework of the current "Know Your Client" (KYC) process under the Code of Conduct. We consider that these and the suitability requirements, appropriately applied and supplemented with enhanced investor measures adopted by the retail banks during 2009 in accordance with the HKMA's requirements, provide investors with adequate protection.

19.2 We do not support the proposal that no derivative products may be promoted to investors (other than professional investors) with no derivatives knowledge as we believe this would significantly restrict investor freedom of choice without providing any additional benefits in terms of investor protection.

19.3 The term "derivative products" covers a broad range of products with wide variations in product features and risk profiles. Some products are simple and low risk and can be easily understood by investors including first time buyers. Also, there are derivatives products specifically designed for hedging purposes to reduce the risk in the investor's overall portfolio. Given these considerations, we do not think that it is appropriate to categorise investors based solely on their knowledge of derivatives and restrict the sale of derivative products only to those investors who possess such knowledge. This may adversely affect the range of derivative products being offered to the public in Hong Kong, making Hong Kong's financial markets less competitive.

19.4 Furthermore, we think that the criteria proposed by the Commission to assess derivatives knowledge are too restrictive and would not be workable in practice. Requiring investors to attend courses is impractical as many would be unwilling to do so. Very few investors would have work experience in relation to derivatives. The criteria ignore the fact that investors may gain knowledge through other means (such as self learning). We also believe that there would be difficulty in establishing objective standards relating to: (a) the eligibility criteria for having undergone training or studied courses related to derivative products or (b) the current or previous job roles which are considered relevant to derivative products, giving rise to a risk of non-compliance by intermediaries with the requirements. It is also unclear how the proposed approach would apply to corporate accounts, for instance, the training courses/work experience criteria do not appear relevant in relation to corporates.

19.5 In light of the above, we have reservations with the proposal to create a new category of "clients with derivative knowledge" and strongly oppose the proposal that unlisted structured products may only be promoted to such investors. We consider that the existing Code of Conduct requirements, supplemented with the enhanced disclosure requirements and product eligibility criteria the Commission is proposing in this Consultation Paper, are preferable as they provide a more flexible framework for sales of investment products while ensuring adequate investor protection. We believe that, as long as the investors are found to be suitable after conducting suitability procedures, intermediaries should be allowed to introduce or sell derivative products to them whether or not they have derivatives knowledge.

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?

20.1 In practice, investors are rarely classified as "professional investors" for the purposes of the Code of Conduct as the criteria in paragraph 15.3 are very restrictive (in particular, the requirement that a professional investor should have 40 transactions per year). This is the case in the context of both retail banking and private banking. The "professional investor" concept is therefore mainly relied on by the industry in the context of the offer-to-the-public exemptions under the CO and the SFO where only the quantitative test (and not the qualitative test in the Code of Conduct) needs to be satisfied.

20.2 The Commission can therefore be assured that the existing criteria already ensure a high level of investor protection. Indeed, we feel that, if anything, the existing criteria are too stringent, in particular, the 40 transactions per year requirement. We would urge the Commission to review the need to maintain this requirement as part of its consideration of this issue.

20.3 There is also uncertainty in the industry as to the meaning of the phrases "relevant product" and "relevant market" and concern that if these phrases are construed too narrowly they would deprive the professional investor exemption of any practical use. For instance, if the concept of "relevant product" was taken to mean a specific product such as a currency derivative or a commodity derivative, very few investors would satisfy the criteria. We believe that these concepts should be construed broadly such that "relevant product" may for instance mean any product (whether or not subject to regulation under the SFO) which has similar risk characteristics to another. We would welcome clarification from the Commission on this issue.

20.4 Subject to the above, we do not object to the inclusion in the Code of Conduct of further guidance on when investors should be viewed as having expertise and knowledge in "relevant products". However, the criteria proposed are very narrow and are unlikely to be satisfied by most investors. Additional criteria should therefore be specified such as an investor's previous trading experience in the "relevant product". Most importantly, it should be made clear that the criteria are examples only and are not exhaustive. The overall requirement should be for intermediaries to satisfy themselves on reasonable grounds that the investor has the knowledge to assess the merits and risks of the "relevant products" having regard to any one or a combination of a variety of factors none of which should be determinative. We believe this to be the case currently but would welcome clarification from the Commission.

20.5 It may also be difficult for an intermediary independently to verify an investor's work experience/training records. Intermediaries should therefore be allowed to rely on declarations from investors that they have the requisite knowledge, expertise and investment experience.

Question 21

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

21.1 We believe that the current threshold is appropriate and should not be changed. The requirement is broadly in line with other markets (lower than some but higher than others). We would also point out that the requirement to verify the size of a client's portfolio by reference to a custodian statement goes beyond what is required in other jurisdictions and means that clients will often have significantly more assets than disclosed in the statement. Indeed, intermediaries often find it difficult, as a practical matter, to obtain such statements from investors and this undermines the usefulness of the professional investor exemption. We would therefore urge the Commission to review the requirement for a custodian statement and would be happy to work with the Commission to explore alternative means of verifying the client's portfolio, including self-certification.

21.2 Furthermore, we are concerned that changing the threshold would adversely affect private placement activities in Hong Kong.

21.3 Additionally, as the Commission points out (Consultation Paper, Part III, paragraph 48) the key test as to whether someone is classified as a professional investor for Code of Conduct purposes is the 'knowledge and expertise' test and not the quantitative test. As discussed above, this is a difficult test to satisfy and we believe that it ensures adequate investor protection when combined with the existing quantitative requirement.

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

22.1 We appreciate the Commission's concern about potential conflicts of interests and agree that some form of pre-sale disclosure is appropriate. We would however point out that RIs have been required (pursuant to the HKMA's circular dated 25 March 2009) to take measures to ensure that frontline sales staff are remunerated on a basis that takes account of factors other than financial performance, in particular, regulatory compliance. We would submit that measures taken by our members in light of this have already gone a long way towards addressing the conflicts of interest which the Commission is concerned about. Notwithstanding this, our Members do support the Commission's proposals on the basis set out below.

22.2 As the Commission recognises, there are a variety of ways in which product providers remunerate distributors. In some instances, monetary benefits will be quantifiable prior to the point of sale. In other cases they will not be, for instance, where the commission is linked to the volume of securities sold. Additionally, there are different distribution models for structured products – in some cases the distributor acts as agent and in others as principal.

22.3 Of the options proposed by the Commission, we support option 1.2 and within this option we would suggest that the percentage ceiling be disclosed ("up to y%"). We believe this option is appropriate where a distributor sells a third party investment product on an agency basis as well as where it sells it on a 'riskless principal' basis. By 'riskless principal' we mean transactions which are technically structured as (back-to-back) principal transactions but where in reality the intermediary does not take on any significant principal risk as the securities are only held momentarily (if at all) by the intermediary prior to delivery to the buyer and, following delivery, the intermediary does not have any ongoing exposure to the issuer. This type of transactions should be distinguished from true principal transactions which are discussed in our response to question 25 below.

22.4 We believe option 1.2 is preferable to generic disclosure as it provides greater transparency to investors. We prefer it to option 1.1 as determination of the precise amount of commission will often not be possible at the pre-sale stage.

22.5 In some cases, of course, it would still not be possible to determine at the point of sale a capped percentage figure applicable to the receipt of certain types of monetary benefit. In those cases we believe that generic disclosure (i.e. of the existence and nature of the applicable monetary benefit) in relation to those (non-quantifiable) benefits would be appropriate.

22.6 Please note that our comments above apply only in relation to distribution of **third party** investment products and not to in-house products. In relation to in-house products – by which we are referring to products designed either by an affiliate of the bank or within the same legal entity - we believe that generic disclosure would be appropriate. Discussions with our Members have revealed that they have varied practices in terms of how they account for in-house transactions and how they allocate profits and costs between the manufacturing and distribution arms of their organisations. Accordingly, even where a specific monetary benefit can be determined in relation to distribution, the figures disclosed would not be comparable between different banks and would not therefore be meaningful for investors.

22.7 As indicated in our response to question 18 above, we believe that these proposals should only apply to unlisted investment products.

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)?

23.1 See the response to question 22 above. We submit that disclosure should be made of the ceiling percentage and that this be done to the nearest percentage point.

Question 24

Where a distributor does not explicitly receive any 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

24.1 For the reasons given in response to question 22 above, we support generic disclosure in cases where a distributor sells an investment product issued by itself or one of its associates. Where no explicit benefits are received by the distributor, the difficulties involved in quantifying monetary benefits are particularly acute. The approach to calculation of the 'external distribution reward' is likely to vary significantly between distributors and it would be very difficult to achieve any consistency in the manner in which such rewards are calculated and hence would not provide a useful comparison for investors.

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

25.1 The position in relation to distribution of structured products on a riskless principal basis is considered above in relation to question 22.

25.2 In relation to true principal trades (which would, for instance, include the entry into OTC derivatives with customers as well as sales of securities, e.g. bonds, on a proprietary basis), the bank is selling a product that it owns and it does not therefore receive any reward from the issuer. In other words, it is not acting as a distributor of a product – it is transacting with the customer as counterparty. The bank does not owe the customer agency or fiduciary duties in these circumstances and should not be required to disclose its profit which is earned purely as a result of the intermediary assuming market risk in relation to the product. As the Commission observes (in paragraph 68 of the Consultation Paper) the amount of profit in these circumstances would depend on when and at what price the bank acquired the product and therefore it would not be possible to provide meaningful specific disclosure to investors. Notwithstanding this, we would, if the Commission considers this important from an investor protection perspective, support a generic disclosure to the effect that the intermediary may make a profit from the transaction. However, as far as we are aware, disclosure in these circumstances is not required in any other jurisdiction.

25.3 A summary of our position in relation to disclosure is set out in the table below:

Distribution model	**Quantifiable at point of sale?**	**Disclosure approach**
3rd party unlisted investment product sold on an agency basis or "riskless" principal basis	Yes	Specific disclosure of percentage ceiling
	No	Generic disclosure
In-house unlisted investment product	N/A	Generic disclosure
Proprietary trade in unlisted investment product	N/A	Generic disclosure (although there is no reward received by the intermediary in this case)

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?

26.1 We agree that gifts with a disproportionately high value which may possibly distract investors from assessing the risks and merits of a product should be prohibited. Generally, however, we did not think it is appropriate to impose any outright prohibition on the offering of gifts. We note that other jurisdictions do not have such prohibitions. In practice, gifts which are offered in the market are usually of a relatively low value and therefore the risk of customers being distracted from the merits of a product by the offering of such gifts is very remote. This is especially so in the private banking context.

26.2 Overall, therefore, we consider that there should be flexibility to offer gifts so long as this is not done in such a way that it may distract the investor's attention from the true merits of the product. Also, we are of the view that general relationship-based incentives (where customers are rewarded by reason of their relationship with the institution rather than by reference to an investment in any particular product) should be allowed. We would support changes to the Code of Conduct which reflect the above principles.

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?

27.1 Subject to the request from private bank members for a possible dispensation from compliance with such requirement (as set out below in the section relating specifically to private banks), we generally support the requirement for a Sales Disclosure Document containing the information suggested by the Commission. However, there should be flexibility to allow for one-off disclosure where an investor engages in a series of repeat transactions and flexibility on the means of distribution, e.g. via electronic means or CD ROM.

27.2 In relation to investment-linked assurance schemes (ILAS), we would welcome further guidance from the Commission on the format in which a sales disclosure document should take, and whether the sales disclosure document should be produced on a product level, rather than for each underlying investment to which the product is linked.

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.

28.1 We strongly support the objectives of ensuring there is a robust audit trail in relation to sales of investment products and that equivalent requirements are applied across all intermediaries to ensure a level playing field. However, we submit that this requirement should be principle-based and that intermediaries should have flexibility as to how they achieve this objective (with audio recording being one but not the only means of doing so). Retail banks (but not private banks) are of course in any event already subject to audio recording requirements. Sufficient time is needed to ascertain the effectiveness of these requirements in enhancing investor protection on the one hand and the overall impact on the selling process and other operational aspects of the retail banks on the other hand. We have agreed with the HKMA that this comprehensive review will be conducted in first quarter of 2010. Given that the audio recording requirement is still subject to review by the industry, we strongly object to the Commission making it mandatory or including it in the Code of Conduct at this stage. Upon finalisation of the audio recording requirements following this review, we submit that any requirements should be applied equally to all intermediaries to ensure fair competition.

28.2 Our private bank members have specific comments on audio recording which are set out below.

Part IV Post-sale arrangements – cooling-off period

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?

29.1 As noted in the Consultation Paper, cooling-off currently exists in relation to investment-linked assurance schemes (ILAS) and we assume that the relevant ILAS provisions will remain unchanged. The question therefore is whether it should be extended to other types of investment product.

29.2 Subject to the comments below from our private bank members, we support the Commission introducing a cooling-off period in certain limited circumstances, as outlined below. We believe that there are a number of important factors which should be taken into consideration in determining when cooling off right should be available and the consequences of it being exercised, namely:-

- Firstly, we do not believe that a cooling-off period should be viewed as a primary means of protecting investors. If the objective is to address mis-selling and high pressure sales tactics by intermediaries, this is best addressed by regulation of intermediary conduct and by measures to enhance investors' understanding of products. We believe that investors will benefit from a high level of protection in relation to sales of structured products as a result of the enhanced requirements which the Commission is proposing (in particular, the enhanced disclosure requirements). If the objective is to give investors a chance to exit a long-term investment, the solution is best provided by mandatory liquidity provision, as proposed by the Commission in Part II of the Consultation Paper.

- Secondly, the introduction of a cooling-off period would result in additional costs for product providers and distributors. Effectively, the distributor or product provider will be required to sell the investor a short-dated put option which the investor may not need or may consider unduly expensive. The additional costs involved may render certain products unviable or undesirable for the product provider/distributor.

- Thirdly, we are concerned that having a cooling-off period for investment products may promote moral hazard in that investors may not exercise the appropriate level of diligence when making an investment decision. Investors should of course be encouraged to take full responsibility for their investment decisions. An unintended consequence may be that investors no longer feel the need to read the prospectus in for the product.

- We note that, where a cooling-off period has been introduced in other jurisdictions such as in the United Kingdom and Australia, it has been limited to certain types of investment product, primarily long-term insurance products and unlisted funds. We are not aware of a mandatory cooling-off period in relation to securitized structured products in any other jurisdiction.

- Finally, we suggest that the phrase 'cooling off' period be avoided as it may lead investors to think that they would be able to recover the full principal amount of their investment. We believe that the term 'option to unwind' would be preferable, in particular due to the potential moral hazard associated with Chinese translation of the term "cooling off". Investors will clearly need to be aware that exercise of the "option to unwind" would come at a cost and we would urge the Commission to assume a central role in ensuring adequate investor education on this issue.

29.3 In light of the above considerations, we believe that the "option to unwind" should only be introduced in limited circumstances and should not apply where the product provider has created a secondary market for the relevant product such that the investor has an exit option. Any "option to unwind" should be subject to certain conditions, as follows:-

- it should, consistent with the position in other jurisdictions, only apply in relation to a limited range of investment products. We suggest that it should only apply to unlisted securitized structured products which are long-term, which are offered to the public and where there is no secondary market (as indicated above, this would already be significantly wider than in other jurisdictions). For the avoidance of doubt, ILAS for which cooling-off currently exists and unit trusts for which secondary markets already exist would be excluded. We suggest that a long-term product be construed as one which has a maturity of more than 3 years.
- to protect against the risk of moral hazard and to discourage speculation by investors, we believe that:-
  - investors should not in any circumstances be able to recover more than the principal amount invested (i.e. the investor should not get the benefit of any increase in the price of the investment during the "unwind period");
  - if the price of the investment product has fallen, the recoverable amount should be adjusted downwards to reflect the market price at the relevant time; and
  - the investor should bear any costs incurred by the product issuer in unwinding the transaction and any reasonable administrative costs of the distributor in connection with the sale and cancellation of the product (see our response to question 32 below).
- the period for exercising the option to unwind should be no more than 7 days from the date of the initial purchase order. This would instil better discipline in the investing public and would make investors reconsider their investment decisions promptly. It would also cause less disruption to the business operations of product providers and distributors. This duration is also in line with periods adopted by other Asian markets (such as Singapore).
- the option to unwind should not be available to professional investors (which for these purposes should mean someone who is a professional investor under the SFO and SFC Rules rather than under the Commission's Code of Conduct) on the basis that these investors are in a better position to protect their own interests and can be expected to make fully informed investment decisions. High net worth individuals and corporates who fall within the "professional investor" definition would of course receive the benefit of suitability obligations unless they meet the qualitative tests in the Code of Conduct (as indicated above – in response to question 20 – we consider these criteria to be very stringent).
- the option to unwind should not be available to repeat orders of the same investment product or in respect of reinvestment of profits or dividends.
- We suggest that there be a periodic review by the regulators of the operation of the option to unwind at which time we and our Members can provide input on our

Members' practical experience of administering such rights, with a view to assessing whether any changes should be made to the cooling-off provisions. We suggest that an initial review be carried out 6 months after the introduction of any such provisions.

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.

30.1 We believe that the manner in which the option to unwind is implemented for different investment products, i.e. whether it is based on delayed execution or is available post-execution, should be left to the discretion of the product provider. The product provider would need to determine the appropriate mechanism for building in the cooling-off period which may differ between different investment products. In practice, both options have their disadvantages. Delayed execution creates uncertainty as to the execution price and investors would generally lose out on any rise in value during the cooling-off period (conversely, if there is a fall in value investors may be tempted to cancel regardless of the underlying merits). If the cancellation right could be exercised post-execution, there would be costs involved in unwinding the transaction (in some cases, these could be significant).

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.

31.1 See response to question 30 above.

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.

32.1 Where the option to unwind is available, we agree that investors should receive a full refund of the amount they have invested (including sales commission) net of the deductions indicated in our response to question 29. These would include a deduction for a reasonable administrative charge to cover the time invested by the distributor in relation to the sale and processing of the unwind and any reasonable expenses incurred.

Additional comments from private bank members on Part II of the Consultation Paper

ILAS marketing materials

33.1 In paragraph 7.2 of the Overarching Principles section of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products, it is stated that "Issuers of advertisements shall ensure that prior to its issue, each advertisement in relation to a product shall be subject to a due review process conducted by a competent delegate designated by the senior management of the issuer of the advertisement to ensure that the advertisement complies with the applicable product code". Based on previous experience of member banks in seeking the Commission's approval on ILAS marketing materials, we submit that specific guidelines are needed on the designated person (e.g. qualification, preference on language, notification on change of designated person and duties etc). Furthermore, it would be helpful for the industry to understand the new approval flow of advertisements, specifically whether a written endorsement from the designated person is required before approval by the Commission.

Additional comments from private bank members on Part III and Part IV of the Consultation Paper

General Observations

34.1 Private bank members have a number of particular comments in addition to those outlined above. These comments reflect the unique nature of private banking business which is characterised by:-

- a focus on high net worth individuals, often classified as professional investors (within the definition in the SFO);
- the offering of a broader range of investment products (including products which are not authorised by the Commission) and a wider range of services, many of which are bespoke;
- a more tailored, personalised service in that typically a relationship manager looks after a small number of accounts which may include advisory or asset management services.

34.2 Private bank members are of the view that the differences in their operating model as compared to retail banks are significant and there ought to be relaxations for private banks on certain requirements currently proposed by the Commission. Private bank members note that the Monetary Authority of Singapore has power, on application by a private bank unit, to grant exemptions to such unit from compliance with certain requirements. The MAS looks at certain criteria (e.g. the type of investors that the unit serves, the range of product and services offered by the unit, and the policies and procedures on client acceptance and risk profiling that the unit has in place) in assessing an application. Private bank members invite the Commission to consider the approach adopted by the Singaporean authorities for private bank units.

Additional responses to certain specific questions for consultation

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?

34.3 As a general matter, private bank members commented that the "professional investor" concept is mainly relied on by the industry in order to obtain the private placement exemptions under the Companies Ordinance and the Securities and Futures Ordinance. Private banks rarely classify investors as "professional investors" for the purpose of obtaining the waivers provided in paragraph 15.5 of the Code of Conduct as the criteria in paragraph 15.3 are very restrictive (in particular, the requirement that a professional investors should have 40 transactions per year). As such, private banks currently fulfil all of the Code of Conduct requirements for their clients (including the requirement to ensure reasonable suitability as provided in paragraph 5.2).

34.4 Private bank members strongly advocate that the Commission reconsiders the current criteria for professional investors set out in paragraph 15.3 of the Code of Conduct. They believe that the criteria are currently overly restrictive and as a result it is very rare that investors may be classified as professional investors for Code of Conduct purposes. Accordingly, the criteria should be relaxed (in particular, the 40 transactions requirement) and that they should only serve as guidelines, rather than an exhaustive list, for the determination of whether an investor is a professional investor for the purpose of the Code of Conduct.

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?

34.5 Private bank members do not think that the requirement to produce Sales Disclosure Documents would be practical for private banks. Given the range of products offered to customers and the fact that most products are tailor-made to suit investors' particular investment needs, bespoke Sales Disclosure Documents would need to be created for each transaction (in contrast with the mass distribution market where the Sales Disclosure Document would be largely identical for different investors). This would be operationally very burdensome and could result in delay to the sales process and the execution of transactions. Private bank members would therefore like to seek a dispensation from the Commission to comply with such requirement (which may be given on the basis that disclosures are instead made in terms and conditions).

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.

34.6 The private bank members are of the strong view that audio recording should not be made mandatory for their business on the basis that meetings with private bank clients are often held outside the banks' premises (in restaurants, for example). Audio recording is simply not practical in these circumstances and may also be detrimental to the client relationship (many private bank clients would not wish conversations with their relationship managers to be recorded as they may discuss their private affairs in some detail).

34.7 Private bank members are of the view that their current systems are sufficient to protect investors' interests. Most private banks require their sales representatives to complete call reports (documenting the topics of discussion) after meetings with clients such that a proper audit trail will be maintained. Order execution (if it takes place over the telephone) is recorded. In light of the current system in place at private banks and the fact that the extent of the requirement for audio recording as proposed by the Commission is not in line with international practice, private bank members would like to seek a dispensation from the Commission to comply with such requirement.

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?

34.8 Private bank members generally support the other members' position in relation to cooling-off. They would add that cooling-off periods in fact should not apply to the private banking business model as they already have policies in place which allow investors to unwind their investments in normal market conditions as long as investors are willing to bear the unwinding costs.

<u>Discussion paper on "execution only" transactions and the definitions of "solicitation" and "recommendation"</u>

We refer to the discussions with the Hong Kong Monetary Authority ("HKMA") at the Retail Banking Taskforce on Sale of Investment Products (Retail Banking Taskforce) meeting on 5 October 2009 in which the HKMA requested the Hong Kong Association of Banks ("HKAB") to provide its views on "execution only" transactions.

We also refer to the subsequent email from the HKMA dated 14 October 2009 ("HKMA Email") advising HKAB that the "SFC would welcome inputs from the banking industry on certain concrete scenarios under which the selling of investment products do not involve any solicitation or any recommendation from a registered person. Under the SFC Code of Conduct paragraph 5.2, suitability obligation applies to a registered person in case of making of solicitation or recommendation. <u>Thus if no recommendation and no solicitation has been made, suitability requirements would not be relevant."</u>

HKAB's Securities Working Group has conducted meetings to discuss the industry's views in such regard. The views and proposal of the Securities Working Group, also endorsed by the Committee of HKAB, are set out below for the consideration of the HKMA for discussion with the SFC. Preliminary views have already been shared with the SFC and the HKMA at the meeting held on 10 December 2009.

<u>Proposed definition of "Execution-Only" transactions</u>

HKAB is of the view that "execution only" transactions should be defined as those transactions that do <u>not</u> involve any solicitation or recommendation from a registered person (i.e. "Non-Solicited" transactions). Accordingly, they are transactions to which the suitability obligation in section 5.2 of the "Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission" ("Code of Conduct") does not apply.

It follows that there needs to be clear definitions of the terms "solicitation" or "recommendation". The absence of any such definitions has been detrimental to the industry. It has resulted in confusion and uncertainty amongst intermediaries as to when suitability obligations apply. There is also concern amongst our members that the interpretations of these concepts have widened over time, with an increasing bias towards investor protection and without due consideration of the need to maintain an efficient distribution and execution process. Clear guidance on these issues going forward is therefore essential to ensure that suitability obligations are applied consistently and that any uncertainty is eliminated.

<u>Proposed definitions of "Recommendation" and "Solicitation"</u>

The concept of "recommendation" is relatively straightforward. In the view of HKAB and its members, it covers the provision of advice to a customer about whether to buy or sell a specific investment (e.g. a particular bond issued by Company A). As such, it involves the presentation of a "customized solution" to the customer.

The concept of "recommendation" should not in our view cover the provision of generic advice (e.g. invest in bonds rather than shares). Furthermore, it would not cover the provision of information about a product. If, therefore, a customer requests information about a particular product and this is provided by the intermediary who also explains the product features, this would not in itself be a recommendation unless the intermediary also gives advice to the customer about whether or not he or she should buy the product.

The concept of "solicitation" is highly subjective. We would like to point out firstly that in most other major jurisdictions the trigger for suitability is the provision of advice or the making of a recommendation. This is, for instance, the position in Australia, Singapore and the European Union (although the European Union has a concept of "appropriateness" which may be triggered where no advice is given, it should be noted that this imposes a much lower burden on distributors).

Therefore, as the position currently stands, Hong Kong is unique in requiring a full assessment of suitability where there is a solicitation. This in itself suggests that the concept should not be given a broad meaning if the regulatory approach in Hong Kong is not to deviate significantly from that in other major markets. Indeed, there is a question as to whether there should be more fundamental reform, removing the concept of solicitation as a trigger for suitability altogether. We would be happy to explore this point separately with the HKMA, although we do not address it here.

In addition to the concerns expressed above, if the concept of 'solicitation' is given a broad interpretation this could mean that any form of advertising, even if it is in the nature of general advertising, would trigger the application of the suitability obligation. This would have the consequence that virtually all sales of investment products would need to be carried out on an advised basis, as almost all sales are preceded by some form of advertising. Again, this could harm Hong Kong's competitive position as other jurisdictions take a less stringent approach on this issue. The drafting of paragraph 5.2 of the Code of Conduct also suggests that this was not intended in the first place. The paragraph requires an intermediary to ensure that any solicitation is suitable for the client. Clearly, this is not possible in the case of general advertising, and suggests that the concept was intended to catch more personalised communications.

In view of the above considerations and in line with the risk-based suitability framework submitted to the HKMA on 28 August 2009 and presented to the SFC and the HKMA on 10 December 2009, **we suggest that the concept of "solicitation" be construed as a**

one-on-one personalised discussion with a customer which contains an inducement to invest in a specific product. By "inducement" we mean that the communication must be promotional in nature and must be intended to persuade the investor to buy a particular product. On this basis general advertising would not be viewed as a "solicitation". General advertising would include advertising in newspapers or periodicals; on the internet; poster advertisements displayed on billboards or in bank branches; mass mailouts or making pamphlets on particular products generally available at a bank branch or elsewhere. Furthermore, the mere provision of information on a product would not be caught as there is no promotional element involved in the communication.

Waiver of right to advice

In addition to the issues considered above, there are other aspects of the suitability regime which we think require consideration.

One of these is whether a customer can waive his right to receive advice as to the suitability of a product. As you know, this is something which the Monetary Authority of Singapore has proposed in Singapore. It would enable a bank to agree up-front with a customer what level of service the customer wishes. The customer may elect not to receive advice on the suitability of products. In these circumstances, the bank would be able to introduce products to the investor and provide the customer with information on them, but would not be obliged to assess suitability. This approach protects an investor's freedom of choice. Where a customer chooses to waive this right, the intermediary should provide the customer with clear risk warnings as to the effect of the waiver, and obtain an acknowledgment of this. The intermediary would of course still be required to ensure compliance with other applicable obligations under the Code of Conduct, i.e. apart from suitability. These include, for example, the requirement in paragraph 5.3 of the Code of Conduct that the intermediary must ensure that the customer understands the risks involved in relation to investment in derivatives products and has the financial resources to assume these risks.

Illustrative Examples under Proposed Definitions

In order to further illustrate our proposed definition of what is deemed Solicited and Non-Solicited transactions, we have set out below some potential scenarios of both definitions.

Transactions to which suitability applies	**Transactions to which suitability does not apply**
Example 1. A relationship manager (RM) of a bank approached an existing customer and introduced a HKD corporate bond and explained why the product may be suitable to the customer having regard to the economic terms and major risk factors of the contemplated investment (including the issuer risks, worst case scenario, maximum exposures, suitability of the product with respect to the client risk profile, mechanism of the product and so forth). The corporate bond was subsequently subscribed by the customer. Rationale: There has been a solicitation as a personalized communication was made with the customer and the specific bond product was promoted to the customer. Additionally, there has been a recommendation as advice on why the particular product is suitable for the customer has been given. Proposed customized solutions were provided.	Example 1. A customer is sent a pamphlet in relation to a structured product as part of a mass mailing campaign and "brings in" the product and merely asks the bank to execute the transaction. Rationale: The investment was made at the choice of the customer without any prior one-on-one personalized discussions with the bank (i.e. there was no solicitation) and the bank did not provide advice to the client on whether to buy the specific product or not (i.e. there was no recommendation). General advertising including mass mailouts is not deemed solicitation.
Example 2. A potential customer (with no prior account relationship) contacted a bank's RM on his / her own initiative and expressed interest in a country fund of Fund House A. The RM explained that the bank does not distribute the requested country fund although there are similar products that the bank can recommend to the customer to consider. A risk profile assessment was subsequently conducted with the customer and a country fund of Fund House B which aligns with the assessment of the customer's risk profile	Example 2. A customer purchased an investment product on a non-advisory basis (making it clear to the bank that he/she did not wish to receive any advice) and initiated the order without any prior one-on-one personalized communication from the bank. Rationale: The investment was at the choice of the customer and there were no one-on-one personalized discussions with the bank (i.e. not deemed solicitation) and the bank did not provide advice to the

Transactions to which suitability applies	**Transactions to which suitability does not apply**
was introduced to the customer for consideration. The customer ultimately purchased the country fund of Fund House B. Rationale: One-on-one personalized discussions took place and the customer was introduced to a particular product for his/her consideration. This would be considered a recommendation. As there were one-on-one personalized discussions to induce the customer to invest in a particular product, this would also constitute a solicitation.	client on whether to buy the specific product or not (i.e. not recommendation).
Example 3. An existing customer contacts his bank by phone and asks for information about a particular product. The RM provides the information and the customer then asks for the RM's view on the merits of the product. The RM expresses a view that the product would be a desirable investment. Rationale: The RM has made a recommendation in relation to the product. However, there was no solicitation as the information was provided at the customer's request – the communication was not an "inducement".	Example 3. A customer who purchased an investment product on his/her initiative via Internet banking. Rationale: The Internet, by its nature, is a self-service channel whereby interaction or one-on-one discussion between the client and the bank's sales staff and proposed customized solutions would not be possible.

If the SFC and the HKMA are broadly agreeable with our proposed definitions discussed in this letter, as agreed at the meeting held on 10 December 2009, as a next step, HKAB will enlist the Securities Working Group in developing practical guidance with the SFC and the HKMA for members based on the agreed definitions. The practical guidance, in the form of an HKAB circular, will be issued to HKAB members involved in the sale of investment products. Obviously we shall seek the input and comments of both the HKMA and the SFC in the development and finalization of the HKAB circular.