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Hong Kong General Chamber of Commerce
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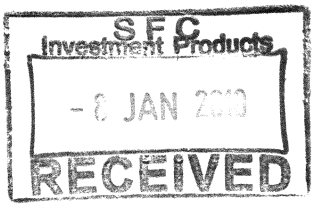

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Securities and Futures Commission
8/F Chater House
8 Connaught Road, Central
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Dear Sirs

Consultation on proposals to enhance protection for the investing public

The Chamber has considered the consultation paper on proposals to enhance protection for the investing public and our views are detailed in the enclosed paper.

Yours sincerely

Alex Fong
CEO

Encl.

SFC Consultation Paper on the Proposals to Enhance Protection for the Investing Public Submission by HKGCC – December 2009

1. Overall Comments

1.1 The Hong Kong General Chamber of Commerce has reviewed the major proposals in the consultation paper and would like to provide our input to the ongoing discussion on the matters. Overall speaking, while we agree to the principle of sustaining a transparent financial environment, we are worried that overregulation, though with all the good intentions, may stifle the development of the financial services industry and jeopardize Hong Kong's reputation as a wealth management centre.

1.2 The crux of efforts to find new and effective ways to offer additional protection for investors lies in whether regulators and the financial services industry are able to identity who are the more "vulnerable investors" - to whom high-risk, complex products should not be promoted - and how to define products which can only be promoted to a restricted group of investors. As a general principle, defining vulnerable investors in terms of their trading experience or professional background is dangerous. It is a slippery slope which, as the policy logic goes, might eventually lead to a de facto licensing system allowing only a small group of players to take part in the trading of certain products.

1.3 On the other hand, defining derivative-embedded products as products not suitable for "vulnerable investors" is too sweeping. There should be better ways to help investors make their own decisions, for examples, by enhancing the functions of product ratings. We are aware that the regulation of rating agencies is an outstanding issue at the global level and it is evident that ratings are not performing the functions they are supposed to be. However, as a policy direction, if the rating industry can be reformed to make the ratings system work, the choice may then be to individual investors.

1.4 The idea of installing a "cooling off" period will also be examined in detail below. We are of the view that the "cooling period" as it is proposed in the consultation document does not offer material additional protection. It might even raise false expectation on the part of investors.

2. Specific Comments

(A) Investor characterization

2.1 There should be little disagreement that when a licensed or registered person deals with his clients, he should be required to act in good faith and conduct proper assessment of their clients (the "know your client" requirement), and furnish appropriate advice and warnings to clients when complex and high-risk products, such as unlisted investment products embedded with derivatives, are involved in the dealings. This is all the more when intermediaries deal with average investors.

2.2 However, when the principle is put to practice, the proposals are unclear on whether the sale of complex unlisted investment products to average investors is allowed. Uncertainties also remain on intermediaries' liabilities.

2.3 According to the proposal in the consultation document, if a client is not characterized as a "client with derivative knowledge", the intermediary should not promote any unlisted derivative products to such a client in all circumstances." This looks like a de facto ban. But the consultation went on to discuss what intermediaries should do if a client not characterized as "client with derivative knowledge" wishes to buy an unlisted derivative productive on his own initiative. The recommendations for such a situation are only about exercising caution in serving the client and acting in the interest of the client pursuant to the Code of Conduct. A fine line seems to be drawn between differentiating whether an intermediary is promoting an unlisted derivative product to a client not characterized as "client with derivative or knowledge" or whether the client is seeking to buy such a product on his own initiative. As most fine lines go, this one is likely to create considerable uncertainties for the intermediaries, as it would not be easy to clearly tell, and prove, whether a client is instructing an intermediary to execute a purchase on the client's own initiative. Likewise, it would be difficult for an intermediary to counter possible allegations, in the event of a dispute about losses, that the "client initiative" is actually prompted by intermediary promotion in the first place.

2.4 While we agree that complex products embedded with derivatives should not be promoted to clients who have no or very little derivative knowledge, we do not agree that an outright ban should be imposed, provided that clients are well-informed of all the key facts and are not under undue influence of aggressive promotional and sales activities. Imposing a de facto ban on selling a particular product to investors who are considered having insufficient knowledge smacks of paternalistic policies of a nanny state. There is a danger of overcorrecting intermediary-client dealings after the Lehman mini-bonds saga.

2.5 On the other hand, intermediaries should be properly protected if a client not characterized as "client with derivative or knowledge" genuinely takes his initiative to invest in high-risk and complex products. To this end, regulations should be put in place to assist intermediaries in documenting that appropriate advice and warnings have been given in order to protect all parties. We are aware that some smaller companies find it difficult to conduct audio recordings in all circumstances. We hope that the regulatory authorities will allow intermediaries some flexibility in providing documentary proofs.

2.6 The recommended criteria for determining whether an investor has derivative or knowledge are not without issues either. According to the consultation document, investors may be regarded as having knowledge of derivatives through:

(i) Undergoing training or attending courses or derivative products;
(ii) Prior trading experience in derivative products; or
(iii) Current or previous work experience related to derivative products.

We are of the view that the three criteria are far too rigid and mechanical. The net effect is tantamount to limiting the sales of derivative-linked products only to those who are either professionals/ex-professionals (however "professionals" is defined), or those who have attended training. Imposing such a limit is likely to result in unnecessary restrictions of investment activities. Notions such as "prior trading experience" are also difficult to define. Training courses are invariably of different nature and quality. The consultation document did not indicate what courses would be regarded as sufficient to fulfill the requirement. We can anticipate that it would not be easy to give clear indications on these matters. Disputes are likely if such criteria are to be adopted.

(B) The definition of "professional investors"

2.7 We agree that the definition of professional investors can be reviewed from time to time. The objective of the review should not be about imposing further restrictions but updating according to market changes, so as to maintain the competitiveness of the financial services industry.

2.8 According to the proposal in the consultation document, when an intermediary considers whether a high net worth investor has specific knowledge about a product, the intermediary should consider whether:

(i) the person is currently working or has previous worked in the relevant financial sector for at least one year in a professional position that involves the relevant product; or

(ii) the person has undergone training or studied courses which are related to the relevant product.

We are of the view that these are far too restrictive. The proposal amounts to limiting the relevant trading activities to ex-professionals who had dealt with the product in question previously in a professional capacity. It will likely exclude a lot of high net worth individuals who had not traded in a professional capacity in the financial sector.

On the other hand, training courses are ill-defined and it is difficult to imagine that many high net worth individuals would attend "training courses" on derivatives. It is also not a proposal that would encourage financial product innovations if past experience on the part of investors would always be required for them to be regarded as suitable for investing.

(E) Product Ratings

2.9 We are of the view that regulatory reforms should not only focus on characterizing investors. Proper product ratings will go a long way to help all investors make informed decisions according to their own appetite for risks.

2.10 The G20 leaders have agreed in the Washington Summit in November that the regulatory regime for the credit rating agencies (CRAs) should be reviewed according to an international code of conduct. It is evident in the Lehman crisis that CRAs had not always performed their functions as they should be. But it does not take away the important point that better regulated CRAs will help investors make informed decisions by providing useful information.

2.11 In the consultation paper, SFC has stated its views on risk ratings:

Para 27 (c): we (SFC) do not believe that investors should be restricted in their choice of investments. We believe that limiting approvals of products to those judged suitable for all types of investors would result in a narrower selection of products available to investors and militate against Hong Kong's reputation and status as an international financial center; and;

Para 27 (d): we (SFC) do not believe that it is appropriate for regulators to assess products with a view to assigning a risk rating.

2.12 SFC seems to be sending out contradictory signals by proposing a regime for characterizing investors, under which sweeping categorizations will be made to divide investors into those who are suitable or not suitable for trading high-risk, complex and derivative-embedded unlisted products. But when it comes to making use of better risk ratings, SFC is sending out an opposite message by suggesting that it does not intend to restrict investment choices.

2.13 We are of the view that the use of credit or risk ratings should not be dismissed lightly. Given proper regulation of CRAs to make them more accountable for their rating advice, ratings remain important references for investors.

(F) Cooling-off Period

2.14 The "cooling-off period" is proposed to apply to "products where the investment is long-term and where there is no ready (and realistic) secondary market". It is proposed that investors would have to bear reasonable administrative cost and any price adjustments if they decide to get out of their investments. In other words, investors will not get full refund.

2.15 It should be pointed out that the "cooling-off period" as proposed, reasonable as it might seem to be, would not bring any additional material protection for investors. But it is worrying that a mechanism bearing the name of "cooling off" would give investors a false sense of security and lead them to believe, quite wrongly, that they would get their whole principal back within the "cooling off period". If a "cooling off period" is introduced along these lines, intermediaries will find it necessary to point out to investors that they would have to shoulder the cost in the event of a transaction, and this would only create confusion and disputes.

2.16 There may be other complicated issues involved. It has been pointed out that requiring investors to pay for any price differences at their end would not be the end of the story for the institutions involved because of the multiple transactions arising from hedging activities of the product issuers. Normal market operation could be disrupted as a result.