

**SUBMISSION IN RESPONSE TO THE SFC'S
CONSULTATION PAPER ON PROPOSALS TO
ENHANCE PROTECTION FOR THE
INVESTING PUBLIC**

1. Introduction

- 1.1 The SFC's proposals form a unified, internally consistent and readily enforceable raft of measures that appear apt to ensure that investors in a wide range of retail investment products would be facilitated in making informed investment decisions based on comprehensive, clear and accurate information concerning the various products. The rationalization and updating of the regime for the structuring, offering and advertizing of various investment products that would be achieved when the SFC's proposals are brought into effect constitutes, in my view, a positive, balanced and timely evolution of the regulatory oversight of the fundamental constitution of specific retail investment products and the manner in which they are marketed to the public in Hong Kong. I support all the SFC's proposals and urge that the timetable for their implementation be brought forward to the extent practicable.
- 1.2 By proposing the introduction of minimal changes to the Code of Conduct, the SFC maintains the value and flexibility of the Code as a more or less skeletal statement of principles and minimalistic requirements. Whilst the SFC already provides some guidance to the industry on how to achieve compliance with various regulatory requirements, such as the SFC's May 2007 Suitability FAQ, experience gained through conducting SFC investigations suggests that additional guidance may be necessary to facilitate some intermediaries in shaping their business processes and compliance systems in order to meet the SFC's expectations.
- 1.3 It is time for the SFC to build on its proven ability to engage constructively with the industry by playing an expanded role in promoting compliance with regulatory requirements. One way of doing this is through the provision of additional guidance (like the Suitability FAQ) in relation to key compliance requirements and any grey areas in the interpretation of the provisions of codes, rules and the Ordinance itself.

2. The SFC Handbook & Proposals re various investment products

- 2.1 The proposals for the introduction of a new SFC Handbook comprised of a new Code on Unlisted Structured Products and updated and revised versions of the existing investment product codes, are to be warmly welcomed as apt to address the identified regulatory concerns.
- 2.2 This unified approach, which in relation to the proposed new SP Code is premised on the enactment of amendments to the prospectus regime under the Companies Ordinance and consequential amendments to Part IV of the Securities and Futures Ordinance (one of the measures proposed

in the SFC's October 2009 consultation paper), would certainly facilitate the more effective regulation of the issuance and offering of structured products to be covered by the SP Code. By their nature, such products are inadequately regulated through the prospectus regime. The sooner these amendments can be made, the sooner the investing public can benefit from the protections afforded by the SP Code.

- 2.3 The proposed introduction of a requirement that each investment product authorized by the SFC for distribution to the public must be summarized fairly in a simple but comprehensive Product KFS should be welcomed by investors as a means of ensuring that they are provided with all the information needed for them to assess whether the product in question might be suited to their risk appetite and investment needs. The proposals directed at intermediaries deserve to be complemented and supported by measures to be proposed in future for the establishment of an Investor Education Council. Such a Council should emphasize the need for investors to fulfill their obligation to make informed investment decisions and to take the responsibility for making sure that they never buy any investment product without first understanding it and judging its suitability for their needs.
- 2.4 Intermediaries should also find the Product KFS a useful addition to the documentation by which they demonstrate the basis on which an investment product was considered suitable to be recommended to any given client. If used as a guide for identifying the features of a product that need to be explained to clients, the Product KFS would also facilitate investment advisors to discharge their obligations in this regard.
- 2.5 However, for the Product KFS to fulfill its intended functions, the SFC must be rigorous in its insistence on the disclosure of information that prospective investors need to be aware of before deciding to subscribe. For example, it should be made clear in relation to credit-linked notes that the risk of default of the reference entities increases in proportion to their number and that the risk of default of a single reference entity with a AAA credit rating is significantly increased where there are multiple AAA rated reference entities.
- 2.6 Moreover, any statement of the product risks should be required to be cogent and comprehensive for all product types. My impression is that the template Product KFS for structured products is designed to fulfill this requirement whereas others appear to be less specific in key respects. In any event, the statement "Please refer to the offering document for details including risk factors" must not be permitted to justify an inadequate description of the risks that would be assumed by an investor who purchased the product.
- 2.7 Appropriately, the draft product KFS template for ILAS products includes information about any market value adjustment ("MVA") clause, consistent with the new revisions of the ILAS Code to keep scheme

participants apprised of MVA reductions in ILAS products of the perhaps inaptly termed “with profits” variety. The SFC is to be congratulated for bringing transparency to such products as investors may otherwise believe that the MVA would only benefit them with an increased – instead of a substantially decreased – redemption payout. However, the proposal to allow existing ILAS schemes an additional 9 – 12 months after the “Long Stop Date” is over-indulgent to the scheme operators and potentially prejudicial to the interests of investors.

- 2.8 I would urge that bland generalized statements in the Product KFS should be avoided in favour of information that is genuinely meaningful. For example, the wording in the draft template for unit trusts or mutual funds includes a section headed: Is there any guarantee? The two sentences that follow, fail to inform the reader that by contrast with a guaranteed fund, investors in this unguaranteed fund may find that the capital they receive on redemption of the units could be considerably less than what they paid for them. It might be preferable to specify in the investment risks section an estimate of the maximum potential reduction in the redeemed amount under different scenarios – and to require updates of actual reduced payouts once redemptions have been made.
- 2.9 Requiring the entire range of fees and charges to be stipulated in the Product KFS will greatly facilitate prospective investors to assess whether the level of charges are reasonable and to see whether the investment advisor pockets a hefty frontend load. Therefore, it should be crystal clear what percentage of the investment amount will be used to acquire units in the first place, and any penalty to be incurred if redeeming the investment during a lock-up period. In addition, as investors need to be aware of the existence of trail fees and other indirect means by which investment advisers are rewarded for putting clients into particular funds (especially funds operated by affiliated parties of the advisor), the proposal in Part III of the paper to disclose these in a Sales Disclosure Document is very much welcomed and supported. Again, the SFC must be vigilant to ensure that the true position is stated so that investors can make a proper comparison not only between funds and fund houses but also between investment advisors.
- 2.10 As the Product KFS will be included in the offering materials of the investment products in question, the SFC will be judged by the rigour with which investment risks, key features and the real costs of the investment are fully and fairly described. The sooner Product KFS and the structural changes to be made through revised requirements included in the new Handbook are introduced, the better for the investing public.

3. Intermediaries Conduct

- 3.1 The consultation paper sketches out succinctly the cascading obligations on intermediaries that provide investment advice or that solicit clients to purchase investment products from them. Undoubtedly, the

characterization of clients is an important component in the equation that leads to the suitability of investment recommendations. The proposal to identify clients as having or as lacking knowledge of derivative products is to be welcomed. I would suggest that intermediaries should be required not only to seek information about a client's past trading in derivatives but also to ask the client whether she wishes to be regarded as having such experience. Apparently, many purchasers of Minibonds who subsequently acknowledged or claimed that they did not understand the product that they had bought, would (or should) be minded to disclaim experience of trading in derivatives if so asked.

- 3.2 This is perhaps an area in which the SFC could be more forthcoming about what it expects of intermediaries in the means by which clients are categorized and characterized as part of the process of identifying which investment products might be suited to their particular circumstances, experience and needs. For example, it is not stated that an intermediary should refuse to sell a derivative product to a person who lacks knowledge of derivatives (or refuse to sell any product that it deems to be unsuitable for the client). However, the observation rightly included in the consultation paper that an intermediary must act in the interests of the client in order to comply with GP1 will be recognized as a sufficient hint to intermediaries to either refuse point blank to sell an unsuitable product to any client or to ensure that any disclaimers signed by clients who insist on the purchase must clearly constitute informed consent if they are to satisfy the SFC. However, additional guidance in this regard would likely be welcomed.
- 3.3 One might take the view that clients with a relatively low level of financial resources, particularly where they are elderly, retired or unemployable, should perhaps be characterized as suited to purchase only guaranteed products. On the other hand, a client whose education did not extend beyond primary school might still have a large investment portfolio and might have attained considerable experience in trading a wide range of complex financial instruments. Of course, intermediaries must find their own method of characterizing clients and this is not something that the SFC ought to be too closely involved in. Yet some indication of how the SFC approaches this business of client characterization, and how to handle clients who insist on buying a product they cannot well afford or understand, would greatly assist intermediaries.
- 3.4 Professional investors. Experience has shown that some high net worth investors are almost as susceptible as investors of modest means to focusing on the expected upside of an investment whilst playing down or disregarding its potential downside risks. Whilst the SFC rightly emphasizes the importance of the trading experience and sophistication of a person with the qualifying portfolio value, best practice appears to be that intermediaries should advise all clients save market professionals that it would be in their interests NOT to claim to be categorized as a professional investor. Adjustment of the dollar amount of the requisite

portfolio value may not be any more indicative of sophistication in trading investment products and financial instruments than the current level, yet a higher threshold would be likely to result in more clients than at present retaining all applicable investor protections. In order to protect more investors from the perils of being regarded as professionals, it is recommended that the SFC should increase the threshold amount by at least 50% AND should revise paragraph 15.5 of the Code to ensure that the requirement of suitability under paragraphs 5.2 and 5.3 is not disengaged for professional investors other than market professionals.

- 3.5 The proposal to require pre-sale disclosure in a “Sales Disclosure Document” of all monetary and non-monetary benefits received by an intermediary or any of its associates in connection with putting their clients into particular funds is extremely welcome. In the interests of full transparency and a level playing field for all investment advisors, the SFC is urged to require the fullest practicable level of disclosure of such benefits, however they may be described. Options 1.1, 2.1 and 3.1 would be most conducive to achieving the requisite level of transparency. It is to be hoped that these requirements will enable the investing public to ascertain the extent to which self-proclaimed independent advisors are in fact independent. It would also facilitate a fair appraisal of whether a particular investment product was likely to have been recommended because it would bring the advisor a greater reward than a similar product from another issuer. The additional information proposed (in paragraph 86) to be included in a Sales Disclosure Document is also supported.
- 3.6 Gifts. I support the application to distributors of investment products of the restriction proposed by the HKMA in relation to the luring of investors by the offering of gifts and rewards other than reduced or waived fees or charges. Such gifts appear to appeal most to the investors of modest means who may be prone to focusing more on the gifts than on the downside risks of investing in a particular product; hence this proposal would likely protect those investors who are most attracted by gifts linked to their investment amount.

4. Post-sale Arrangements

- 4.1 The potential benefits of a cooling-off period of the nature described in the consultation document, appear to be outweighed by the risk of loss of capital to investors and the cost to intermediaries of implementation. However, there may be merit in introducing such an option for investors who may fairly be categorized as “vulnerable”. If the proposal were to be introduced on that limited basis, it might well benefit the type of investors who most need such type of protection whilst serving to ensure that all other investors should be careful to exercise due diligence in making informed investment decisions. In that event, and on the view that a small administrative charge should be sufficient recompense distributors, I

would advocate that any commission earned by the cancelled transaction should also be refunded.

5. Miscellaneous Comments

- 5.1 The SFC's affirmation of the maintenance and enhancement of the disclosure-based regime for the retail distribution of investment products is both timely and welcome. That affirmation, and the proposals aimed at guiding intermediaries to fulfill their obligations under such a regime, ensures that those best placed to ascertain the suitability of investment products recommended for clients remains with those whose business it is to give investment advice or to distribute the products: the intermediaries.
- 5.2 Judging from media coverage in the aftermath of the collapse of Lehman Brothers and the investigation of allegations of the mis-selling of Minibonds, the SFC's approval of prospectuses is still equated by some with a badge of suitability for all retail investors. It is suggested that the SFC might consider issuing a FAQ with a view to dispelling these misconceptions. The misconception that investors have no responsibility for avoiding unsuitable investments would also bear clarification.
- 5.3 As the last twelve months have illustrated vividly, intermediaries of all types and sizes face their own challenges in achieving compliance with regulatory requirements and in demonstrating that compliance to the regulatory authorities. In my view, the SFC could build on its proven ability to engage the industry proactively – as it did in the development of the current proposals – to provide more guidance on regulatory issues of mutual concern. The SFC's May 2007 Suitability FAQ is an excellent example of the type of additional guidance that facilitates the shaping of business practices and compliance systems to give effect to the substance as well as the letter of key regulatory requirements. More of this type of guidance is clearly needed.
- 5.4 I do not advocate involving the SFC in any appraisal of business practices or compliance systems nor in offering any advice, least of all legal advice, to intermediaries. Yet there are grey areas in the interpretation of regulatory requirements, and there are key compliance requirements, in relation to which the issue of more guidance by the SFC would help minimize non-compliance in future.
- 5.5 Facilitating compliance with regulatory requirements is as much the business of the regulator as is the unstinting enforcement of those requirements. We have seen much of the latter; let's see more of the former.

M.J. Kenny
Barrister-at-law
19 November 2009