SBI
E2-Capital *Our small ideas are BIG !*

21 October 2009

Securities and Futures Commission,
8th Floor, Chater House,
Central, Hong Kong

Dear Sirs,

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

In relation to the consultation paper on proposals to enhance protection for the investing public that was issued by the Commission in September 2009, we, SBI E2-Capital (HK) Limited, have the following comments for your consideration.

General Observations

We consider that the direction of continuing to apply a "disclosure-based approach" coupled with conduct regulation in relation to intermediaries selling investment products to investors is appropriate. However, in relation to the pre-sale requirements, which are currently focusing primarily on advertising guidelines and key facts statements, there should also be included in the revised Code of Conduct requirements more rigorous training requirements for intermediaries, in particular the sales force and customer services staff who are the point of access for retail investors to such products. Such training requirements should in fact be applied in relation to staff of authorized institutions and insurance agents (although we understand that these entities do not fall within the regulatory ambit of the SFC).

In addition to seeking to establish as a requirement an 'eligibility floor' (a minimum experience requirement for investors) before they can be introduced potentially high-risk products, we consider that there should be a strong focus on requiring institutions to improve the training of sales people in the characteristics of the product. If sales people properly and comprehensively understand the nature and the features of the product that they are marketing, including its risks, and are clear about the commissions, hurdle rates and hidden fees and/or risks inherent in the relevant structure and are trained so they proactively explain these risks and hidden costs to the potential investors, this may help raise both salespersons' and investors' awareness of the pros and cons of such investments. This may in turn over time increase public confidence in the quality of advice being offered by such institutions.

For the sale stage of the process, there is still a lot of cold-calling by financial advisers in the market. Is there any way that the Commission can tighten up on this aspect?

Part II Products

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Consultation on the proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products

Question 1: Do you have any comments on the Overarching Principles of the Handbook generally or on any specific provision

On Chapter 4 (Product Providers), the general duties of the Product Provider should include an obligation **proactively** to notify the Commission of any material adverse development in relation to the product, the issuer (to the extent that the Product Provider is aware) or the Product Provider itself (which may not of itself constitute a breach of the Handbook) that may jeopardize the interest of the investing public.

Question 2: What are your views on the proposed disclosure requirements in Appendix C and Appendix D to the SP Code?

The proposed requirements are acceptable.

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 structured products? Please explain the reasons for your views. Are there any other matters which you think an issuer should be obliged to disclose to an investor on an ongoing basis?

For interim reports, as such reports are normally shorter and with less detail than the annual reports, permitting four months after the due date is too long. We suggest two months.

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

The proposed requirements are acceptable.

Question 5:
(a) What are your views on the proposed requirements applicable to SPV Issuers

The proposed requirements are acceptable.

(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 Issuer and make such Product Arranger responsible for ensuring an SPV Issuer's compliance with the SP Code throughout the term of the structured product?

We agree with the proposed requirement for a Hong Kong-licensed Product Arranger to be appointed in the aforegoing circumstances. However, if such entity has no control over the operations of the SPV Issuer through shareholding or otherwise, it is difficult to see how it can ensure the SPV Issuer complies with the SP Code. At best, the Product Arranger could be required to use its best endeavours to procure compliance by the SPV Issuer with the SR Code. There could either be a requirement for a clause/provision in the distribution agreement between the Product Arranger and the SPV Issuer whereby the SPV Issuer undertakes to

comply with the SP Code during such time as its product is marketed in Hong Kong by the Product Arranger and/or a requirement that the Product Arranger obtain an indemnity from the SPV Issuer in relation to any breaches of the SP Code.

(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 (where the Issuers/Guarantors are not licensed banks regulated by the HKMA or corporations licensed by the Commission pursuant to section 116 of the SFO)?

Yes.

(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 obligations with reasons.

A Product Arranger should be obliged to ensure that the members of its staff who market structured products and FDI products have been properly trained, and receive continuing training, in the workings of the relevant product – this is so that, as the features and structures of such products evolve over time, the staff of the Product Arranger are able to understand and explain clearly such features/structures to potential investors.

Question 6:
(a) What are your views on the proposed eligibility criteria for collateral in respect of structured products?

The proposed requirements are acceptable.

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

We do not have any additional suggestions – see our response to question 7.

(c) What are your views on the requirement that investors' claim to collateral proceeds be accorded priority and should not be subordinated to claims by counterparties to transactions with the Issuer that are related to the structured product?

We agree in principal with this suggestion – but the problem is enforcement of claims, especially in relation to SPVs. One possible approach is for there to be a provision(s) in the trustee documentation to bind the trustee to settle any claims by investors on a priority basis – but this may not guarantee that investors will be dealt with prior to banks and/or other creditors. Another possibility is requiring a portion of the initial investment to be ring-fenced and held separately as a fund to settle potential claims.

Question 7: Do you believe that the Commission should take into account any additional eligibility criteria for reference assets, or any other factors, when considering whether or not

to accept a proposed reference asset or asset class for a structured product? If so, please list such additional criteria/factors and give an explanation for each.

Since such products, include the types of collateral underlying such products, have been evolving and are being used in different structures in different markets, it is not possible to define comprehensively exhaustive criteria. Consequently, the SFC should maintain an explicit discretion to vary or supplement such criteria in the light of experience in Hong Kong and other overseas jurisdictions where such products are being marketed.

Question 8:

(a) Should indicative valuations of structured products be required to be provided daily? Do you think there are additional or other measures which could help investors to assess the performance of their investments? If so, please provide details.

This may be relatively easy if reference assets are listed securities, funds or indices (for which indicative valuations should in theory be available on a daily basis, albeit with some time delay) but practical difficulties would arise in relation to less liquid assets. For less liquid assets we suggest indicative valuations on a weekly, if possible, or, at the minimum, a monthly basis.

(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 shortened tenor, e.g. of one month or less? How often do you think Issuers or their marketing 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?

The encouragement of liquidity in these investment products by means of requiring intermediaries to make firm price quotations is effectively mandatory market-making – this aspect may need more market consultation as this touches on other issues.

Question 9: Please give your views on the use of annualized returns in offering documents and advertisements for structured products?

If an offering document and/or advertisement for structured product refers to an annualized return, there should be clear, bold language making clear the basis – e.g. if the actual period is just 2 months, then this should be highlighted in red with a risk statement making it absolutely clear that the annualized return cannot be relied upon under any circumstances. Also the font size of the annualized return statement/percentage should be the same as the risk statement and appear side-by-side (to ensure that investors do not miss the caveat!).

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.

The proposed requirement (6-9 months) is acceptable.

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.

The proposed requirements are acceptable – with the SFC retaining the discretion to impose additional requirements or to vary or supplement existing requirements.

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?

Broadly, yes. On Proposal 5, see comment on question 14.

Question 13: Do you have any comments on the revisions in the UT Code generally? Please explain your views.

It is an enhancement and reflects the increasing variety of investment products. We agree with the proposal for the formation of a Products Advisory Committee.

Question 14: What are your views about the idea of UCITS schemes which have issued KIDs under their own EU 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-authorised 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.

If UCITs are marketed in Hong Kong and the Product Arrangers who are promoting such schemes wish to use KIDs in Hong Kong, we suggest that the Commission consider requiring a 'Hong Kong wrap' including additional info for the benefit of investors in Hong Kong, in order to bring the document up to the Hong Kong standard in terms of equivalence of information with non-UCITs products.

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)?

We agree with the proposed approach and consider the transition period in paragraph 191 acceptable.

Question 16: Do you have comments on (1) the Product KFS requirements, (2) the enhanced disclosure requirements on "with profit" features and internal funds, (3) the deletion of Chapter 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?

No.

Question 17: Do you agree that the proposed approach to implementation of the revised ILAS 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 Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements (paragraph 214(c))?

We agree to the proposed approach.

Part III Intermediaries conduct
Consultation on the regulation of intermediary conduct and selling practices

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.

We have no view on this.

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.

We suggest that the SFC, in conducting training for licensed persons on intermediary conduct for the enhanced "know your client" procedures, clarify through simulated case studies the suggested approach.

Question 20: Should a high net worth investor be considered to have specific knowledge and expertise if:
(a) He is currently is 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?

People who have structured such products and/or who have been involved in trading such products for financial institutions are among those who would seem to have the specific knowledge and expertise.

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

We recommend retaining the existing portfolio requirement of HK$8 million.

Question 22: Where a distributor and/or any of its associates explicitly receives or will receive monetary benefits from a product issuer (directly or indirectly), which of the following three disclosure options would be more appropriate? Please explain your views.
Option 1.1 – disclosure of dollar amount or percentage
Option 1.2 – disclosure of percentage bands or ceiling (i.e.' x% to y%' or 'up to y%')
Option 1.3 – generic disclosure

The best option is a clear disclosure of the benefit accruing to the distributor – if it is not an exact percentage but there is some type of formula, disclosure of this. Generic disclosure has little value.

Question 23: Do you have any suggestions as to how the percentage bands referred to in Question 22 should be set up (e.g. up to 1%, over 1% to 2%, ec)?

No.

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 view.
Option 2.1 – specific of distribution reward
Option 2.2 – generic disclosure

Option 2.1

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

Option 3.1. Generic disclosure has little value – the best option is clear disclosure of the actual benefit accruing to the distributor (while unpalatable to the distributor, this is in the best interest of, and is the most helpful to, the potential investor).

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?

Clearly, such corporate gifts have played a part in widening the base of retail investors interested in investment products. We understand the industry's desire to retain these as a

marketing tool. But we feel that in the Code of Conduct it must be made clear that an intermediary, in marketing a product, must focus on and properly explain the features and risks of an investment product to a potential investor and be prepared to answer questions and provide further explanations on the relevant product first **before** referring to any incentives to subscribe. For the HKMA to consider is the extent to which banks and authorized institutions promote and draw depositors' interest to the gifts associated with the investment products rather than the features and risks associated with them.

Question 27: Do you have any specific 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?

No.

Question 28: Do you think that 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.

On balance, notwithstanding the HKMA's proposed approach of requiring audio recording by authorized institutions under its supervision, we consider that the current record-keeping requirements of the SFC are sufficient for the intermediaries that are under the supervision of the SFC - and that audio recording be used as an alternative means of recording the content of the discussion with a potential investor. We favour the Commission reserving the right to impose audio recording as a requirement for intermediaries who have been subject to disciplinary action. Under such circumstances, it would be up to the Commission to decide the period of time that the audio recordings must be kept.

Part IV Post-sale arrangements – cooling-off period

Question 29: Do you believe that a cooling off period would be generally be beneficial to investors or do you believe that costs associated with its implementation would outweigh the benefits for investors?

Yes, in principle – however, this has to be balanced in relation to the commercial rights of the distributors and issuers of the relevant product. Also we note and agree with the point made in the consultation document that a 'cooling-off' requirement might lead to increased administration costs for Product Arrangers and issuers and result in potential increased costs for the investors - these in turn may reduce the attraction of the products to investors.

Given the experience of the Lehmann Minibonds, a cooling-off period is desirable but should not be long after the original subscription decisions – otherwise such a mechanism may be used as an excuse for an early exit from these products, for example, when an unfavourable valuation has transpired. It is important for investors not to enter into such investment arrangements lightly and not to be under the impression that their rights, having willingly entered into an investment arrangement following a proper explanation of the features and

risks of such a product, would take precedence under law over the rights of the distributors with whom they entered into the arrangement. More investor education on this aspect is required.

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 it would be generally beneficial to investors, please provide your views on the types of investment products for which it should be considered and the appropriate cooling-off timeframe

We agree with the suggestion that the cooling-off period would be of most benefit to investors where they would be subject to a long lock-in (including penalty charges for early exit, as is the case for a number of ILAS schemes) or where there is limited liquidity or redemption opportunity.

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

If it is clear that a trade has not been executed under the proper authority of an investor(s), the issuer should be required to buy back the product.

Question 32: On the basis that a cooling-off period is incorporated in an investment product and a client had exercised his right under the mechanism, do you consider that a distributor should promptly pass on to the client the full refund (including the sales commission) received from the product issuer less a reasonable administrative charge? Explain your views.

We agree with the Commission's approach.

Should you have any queries, please do not hesitate to contact the undersigned on 2533-5638.
Yours faithfully,

For and on behalf of
SBI E2-Capital (HK) Limited

Simon Harding
Director