

MESSAGE

To: consult/SFC@SFC
cc:

CEOO Ext :

From:
Date: 07/10/2009 10:44 AM

Subject: Consultation on proposals to enhance protection for the investing public

Securities and Futures Commission
8th Floor Chater House
8 Connaught Road
Hong Kong

Attention: Consultation on proposals to enhance protection for the investing public

Sirs,

I refer to your 'Consultation Paper on Proposals to Enhance Protection for the Investing Public' dated 25th September 2009 (the 'Paper') and write to seek your clarification in the following respects concerning the methodology of the exercise which also calls into question the relevance and accuracy of some of the materials contained in the Paper. For reasons that would be made evident below, I believe useful consultation is precluded unless and until there is proper clarification of the issues.

2. Paragraph 4 of the Paper (page 4) epitomizes two methodological defects of the Paper. They are the disjunction between issues and evidence as well as the absence of any relevant facts against which merits and demerits of different proposals could be assessed. To better illustrate the points, the said paragraph is reproduced below for easy of reference:

The collapse of Lehmans (sic) resulted in the early termination of a number of products it had arranged and which had been sold to the Hong Kong public, resulting in significant losses for investors. Over 20,000 complaints were received from investors in Lehman products nearly all of which contained allegations of mis-selling.

3. The extract raises three questions that are fundamental to the soundness of the consultation:
(a) Does the collapse of Lehman Brothers cause the 'allegations of mis-selling'? If so, there is no need for the consultation as there would be nothing to suggest the existing regulatory regime is in need of improvement.

(b) Conversely, if the mis-selling is caused by something else, then what is it?

(c) If the number of mis-selling is widespread and systematic, they are not allegations. If there are still only allegations, is the consultation not premature and therefore, illogical?

4. These semantic ambiguities and conceptual confusion are fundamental because meaningful consultation could not be had if they remain unaddressed. How could any honest and objective respondent know what is needed if he or she does not know what is inadequate in the existing regime that accounts for the failure to prevent the mis-selling from happening or detect it before the collapse of Lehman Brothers.

5. Without any methodological grounding, it is hardly surprising that the Paper stumbles as soon as it starts. In the paragraph purported to be 'Summary of underlying rationale for proposals' (page 8), the 'summary of the rationale and regulatory philosophy' has existence only as an empty phrase as the content of it is nowhere to be found. If it is my failure to notice the existence of it, please advise where is it or what is the 'regulatory philosophy' embraced by the SFC?

6. Having explained my concern with the fundamental conceptual ambiguity of the consultation, I would like to highlight how falsehood and irrelevance have been deployed in the Paper instead of material facts about the systematic mis-selling of Minibonds.

7. The following measures (page 9) are proposed to enhance the 'disclosure-based regulation':
(a) commercial interest of intermediaries selling the investment product, i.e. the commission

or benefits earned on the sale;

(b) ongoing disclosure requirement covering information between the completion of the sale and the maturity of the investment product.

8. How much and from whom fee that an intermediary would receive from selling securities to retail investors is definitely not an issue in this mis-selling scam. The potential conflict of interest arising therefrom is uncontroversial and is readily understandable even to layperson. Has this issue been raised and debated in the hearing of the selected committee of the Legislative Council Panel of Financial Affairs? The salespersons would be tempted to act unscrupulously only if there is absence of properly internal control during and after the sales. Is the internal control not more important than the amount of commission earned on different products?

9. As to the proposed ongoing disclosure requirement, its utility is illusory given the refusal of the SFC to acknowledge the fact that the essence of Minibonds lies in the so-called 'underlying security' which is financial derivatives traded in private over-the-counter market with maximum opacity. The crux to prevent malpractices of all sorts made possible by secrecy (or market opacity) is to ensure full disclosure in the offer documents so that the prospective investors are warned of the risks attendant to lack of transparency. This requirement of full disclosure is already provided for in paragraph 3 of Part 1 of Third Schedule to the Companies Ordinance. Therefore, the question to be asked is not how to improve the disclosure-based regime. This question only falls to be asked if and when the antecedent question, namely why the Minibond prospectuses are considered as compliant, is properly answered.

10. The lack of sincerity on the part of the SFC could be seen in one of the proposed code for structured products as stated in Appendix A of the Paper (Appendix A – Section I – 7) in the following terms:

4.2 The Product Provider shall avoid situations where conflicts of interest may arise including any actual or potential conflicts that may arise between different parties in respect of a product. Where such a conflict cannot be avoided, and provided that investors' interests can be sufficiently protected, the conflict shall be managed and minimized by appropriate safeguards, measures and product structure and these measures and safeguards shall be properly disclosed to investors. (emphasis added)

11. The Minibond is structured to conceal conflict of interest of this nature. However, has the legislature been so ignorant that it fails to make any provision to address it? How about paragraph 12 of Part 1 of Third Schedule to the Companies Ordinance where specific disclosure is demanded in respect of 'property purchased or acquired by the company or proposed so to be purchased or acquired, which is to be paid for wholly or partly out of the proceeds of the issue offered for subscription'. Is this provision applicable to the 'underlying security' of Minibonds, and if so, has it been applied by the SFC? Conversely, if the SFC considers that provision has no application to the Minibonds, could it explain why it is so?

12. Had the details required to be disclosed as stipulated in paragraph 12(1) are given in the Minibond prospectuses, the victims would have been alerted to the existence of the inherently irreconcilable conflict of interest in the product setup. Was the SFC aware of the conflict when the prospectuses were approved by it?

13. Instead of insisting full disclosure, the SFC seems to be anxious to leave a loophole to cater for the needs of the unscrupulous. In page 34 of the Paper, the SFC suggests that:

Details of the assets comprising or to comprise the collateral are required to be disclosed in the offering document. In some circumstances, however, the collateral may not have been identified or acquired as of the date of the offering document, In such a case, the SP Code requires that the Issuer provide certain information in the offering document and, subsequently, provide investors with the remaining details required by the SP Code by the business day in Hong Kong following the acquisition of the collateral. This would in effect be within two business days in Hong Kong after the relevant trade date, since the SP Code requires that Issuer acquire all collateral and create all security interests in such collateral for the benefit of investors (see paragraphs 102 to 105 below) at the latest by the end of the first business day in Hong Kong after the trade date.

14. Is there any merit or necessity of putting a product to the market before some of its crucial aspects are finalised. If so, the Paper fails to offer any explanation and the purported safeguard is so

ambiguous as to be almost a regulatory nullity.

15. If the extract above does not convince you the SFC is inclined to ignore the law by fabricating blame on the allegedly porous regulatory regime, there is another groundless statement in page 31 of the Paper where the SFC asserts that:

Structured products issued by SPVs are typically collateralised, and would rarely be supported by guarantees.

16. I have raised my concern with the SFC some months ago about the extent of non-disclosure of the Minibond prospectuses, illustrating my point by comparing them with the prospectus dated 8 April 2005 issued by HSBC Structured Notes (Cayman) Limited for its product known as 'USD Callable Basket Credit Linked Notes Due 2010 (Series No. 12)'. The latter is considered by the SFC as 'structured products' and it is supported by guarantee of HSBC Bank only.

17. In this instance the intent of the SFC to confuse the reader is fairly evident. Elsewhere in the Paper and other publications, distinction is drawn by the SFC between 'plain vanilla' and other more exotic structured products. The assertion 'structured products issued by SPVs are typically collateralised' would only be proper if it is intended to refer to the 'funded' collateralised arrangements under the master agreements promulgated by the International Swaps and Derivatives Association (the 'ISDA'). If that is what the SFC intends to say, there should be some reference, however tangentially, to the ISDA regime and the differences between 'funded' and 'unfunded' arrangements. Evidently, the Paper is not addressed to the finance professionals only and the amount of knowledge in finance possessed by the lay members of the public varies widely. Hence, should it not be the duty of the SFC to give adequate elaboration to anticipate the needs of the lay public if the consultation is meant to be a sincere exercise, rather than a deceptive gesture?

18. The vague assertion 'structured products issued by SPVs are typically collateralised' could also be understood as referring to the unusual piggybacked structure that characterises the Minibonds. The use of collateralised debt obligation as collateral is clearly unusual and it is known to have happened only in countries where the sense of rule of law is weak. If the phrase is intended by the SFC as referring to the Minibond-like structure, it is patently false. Therefore, please advise in what sense the phrase is intended by the SFC?

19. The indulgence in undue generalisation and brevity may be justifiable if there are deeds to clarify the meanings of the words. But the arbitrary conduct of the SFC only increases confusion that is already inherent in the generalisation. In respect of its own guidelines, the SFC has maintained that the addressees 'should look to the spirit of the Guidelines when applying them. It would defeat the purpose of having principle-based guidelines if the guidelines contained many detailed rules and particularly examples as such examples would run the risk of being interpreted as rules'. (paragraph 4 in 'Consultations Conclusions on the Draft Guidelines on Marketing Materials for Listed Structured Products' September 2006) The SFC then continues to state that

'... marketing materials that are presented as or give the impression of having an independent and objective view on a particular structured product should be identified as marketing materials, e.g. advertorials. We consider it axiomatic that paid advertisements in the printed media or paid airtime on the radio or television are marketing materials'. (paragraph 18, emphasis added)

20. In relation to the Minibonds scam, reports were made to the SFC about such 'advertorials' in the newspaper but they were effectively ignored, presumably justified by the alleged secrecy constraining the SFC. However, it is noted that on other occasions when the SFC exercises its disciplinary powers, it adopts a much more liberal approach in accounting for who (with names disclosed) has done what (culpable acts specified) and for which what penalty is imposed by the SFC. The selective use of 'secrecy' as an excuse for controlling what and how much information is given to the public has allowed the SFC to indulge in blowing its own trumpet while sweeping its faults under the carpet. If this is the 'regulatory philosophy' of the SFC, which is amply confirmed by its conduct in dealing with the Minibond scam including the half-hearted consultation as manifested in the Paper, how could the ordinary investors be protected?

21. Given the time constraint set by the consultation, please provide the information requested as a matter of urgency.

Yours faithfully

Philip Chiu

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