

Comments on Consultation Paper on Proposals to Enhance Protection for the Investing Public

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?

If the essence of the structure is that the investor is writing an option and collecting a premium from writing such an option, this structure should be clearly disclosed. The marketing of the product should not be allowed to give an impression to investors that the premium is masked as "interest" because fundamentally it is not an interest derived from deposits nor coupons from fixed income securities. It may be difficult for an average investor to comprehend the meanings and implications of "reference assets", "unsecured creditors".

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?

Since "credit worthiness" is mentioned as a counterparty risk, it would be appropriate for issuer to disclose the latest credit rating of the issuer/counter party. If there is more than one party, a summary of credit rating can be given. This is similar to a fund factsheet of unit trusts on fixed income securities to disclose the credit rating summary of the underlying securities. Since unlisted structured products may be more concentrated of taking credit risk, it is also practical to disclose the credit default swap spreads of that counter party/issuer(s) if applicable. The CDS spread is likely to be monitored by an informed investor, and thus to protect general investing public, those information should be conveyed to investors as far as practicable.

Related to **Question 8**, if valuation of structured products be provided daily is not practicable, the spreads of CDS which is highly liquid should be reported instead. This is because the major risk of the product hinges not so much on the basket of assets but the issuer/counter party. Thus, the information on the issuer/counter party should be disclosed even more prominently.

Question (9)

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

Annualized returns which is not guaranteed or have conditions should not be stated such that XXX products give 15% potential annualized return. The concept of "current yield" or "yield to maturity after fees" would be a better illustration. Without qualifying the annualized returns but let it be used in marketing a less than liquid structured products would cause investors to be confused it such is a "deposit liked" products. This misconception is one of the fundamentals issues that have caused

significant disputes on Lehman's products.

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.

A 3-month period of transition is recommended. Often structured products are marketed as "flow" and unique from each batch, product issuers would have adequate time to prepare accordingly to the SP Code even if they have been authorized prior to the date.

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.

From an investor point of view, it is desirable to have comparable Product KFS across unit trusts (mutual funds), structured products, and ILAS, etc. As for UCITS scheme has been quite well implemented in Europe, disclosure on product KFS that a fund is in compliance with UCITS would thus be adequate. Since exposure of FDI of the fund is restricted within the UCITS scheme, it may not be necessary to impose similar criteria to save costs for both regulatory and administrative costs in Hong Kong. Although I agree the disclosure based principal, mere disclosing of risk factors without educating the implications would not be adequate. It is desirable to educate investors to distinguish major asset classes with high liquidity (such as equities, sovereign, quasi sovereign and corporate bonds) from those with lower liquidity such as derivatives, ABS, MBS, derivatives on derivatives. Lumping them together and disclosing their respective worst case scenarios would even blur investor's understanding.

For example: an SFC authorized mutual fund with an objective of capital gain through investing into a basket of listed equities of Asia Pacific using MSCI Asia ex-Japan as benchmark is quite easily understood. However, adding a worst case scenario as "loss of all capital" would give a false impression to an average investor because the performance of a fund doesn't take a concentrated risk of single or a few securities nor it involves counter party risks which could render a portfolio to vanish.

I would recommend education of "kurtosis" and "negative skewness" be given to alternative asset classes (other than traditional equities, bonds) so that investors can have a more comprehensive risk understanding. Equity market volatility should be understandable but an average investor but those of alternative asset classes, some more illustration and analogy should be given.

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?

- (1) The Product KFS should disclose lock-up period, costs of surrender the scheme if not fulfilling the lock up period. Fees chargeable should also be clearly disclosed.
- (2) Since "with-profit" feature is at the discretion of insurers, they should be prominently disclose up front to investors. The risk to investor is very significant given it could be up to 100% of policy value.
- (3) It is fine to remove the obsolete clauses/chapters of the code as suggested.
- (4) Codification would aid investors to understand more of the actual practice.

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))?

The proposed approach should be implemented as soon as practicable. A 3-month period should be adequate to put the revised ILAS Code in force. The revised ILAS Code especially the disclosure part should be implemented across the board of all ILAS plans instead of just to new schemes.

From an investor point of view, quite often ILAS is perceived as a way of investment although the marketing is done through insurance agents and the like. Disclosure is still significantly behind those of general unit trusts. Commission in sales of ILAS, for instance, is not disclosed while it has been a long time practice by licensed advisers to disclose commission chargeable to clients on unit trusts.

Question (23) 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

Option 1.2 is recommended which is a balanced act to give investor awareness of monetary benefits yet not discouraging sensitive and changing commercial

information. Similar to the principal of making product KFS comparable, the disclosure should also be made across the board for unit trusts as well as ILAS that hold those underlying unit trusts. Otherwise, it would not be fair to an investor to compare across different investment options. Furthermore, practically, if one kind of product is having a much more stringent disclosure than the others, some financial advisers may be skewed toward one type of scheme with less disclosure. This scenario may not be helpful to protect investors nor promote the development of Hong Kong as a wealth management hub.