CONSULTATION PAPER
PROPOSALS TO ENHANCE PROTECTION FOR THE INVESTING PUBLIC

The Law Society of Hong Kong has the following comments on the Proposals put forward by the Securities and Futures Commission:

QUESTION 1: Do you have any comments on the Overarching Principles Section of the Handbook generally or any particular provisions in the Section? Please explain your views.
We have no comments on the Overarching Principles Section of the Handbook.

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?

We suggest amending the following disclosure requirements in Appendix C of the Code on Unlisted Structured Products ("SP Code):

3.(a) "Details of the terms of the offer……and the offer price **(if known)**." The exact offer price will not always be known until after the offer has closed.

3.(d) "Fees, charges and commissions payable by investors **either directly or through the structured product**."

3.(g) **"Whether early redemption is permitted and, if so, on what terms."**

10. (c) (iii) and (iv)
In our view this information is unnecessarily burdensome. In particular, it is unreasonable to expect either:
(i) a description of the rules on trading, settlement and disclosure requirements; or
(ii) 5-6 years of historical information (however limited) on the underlying share when such requirements are not required for underlying shares listed on the Hong Kong Stock Exchange.
It is also worth noting that this is more than is required by way of track record for a company seeking listing in Hong Kong.

13. The requirement for 5-6 years of historical information is unnecessarily burdensome. See 10 (c) above.

In relation to paragraph 13 of Appendix D, please refer to our comments on paragraphs 10 and 13 of Appendix C.

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?

7.3 Firm price quotations are not practicable or even possible for all structured products. Even where firm price quotations are possible, they will not be relevant to products which are not tradable or redeemable daily and it would be misleading to impose pricing requirements for products on days when they cannot be traded or redeemed.

7.4 It is unclear why daily valuations should be required. In situations where daily trading or redemption is permitted, the provision of a price under 7.3 would be sufficient. In other situations, it may not always be possible or practical to provide an accurate valuation. We suggest that valuations should be required only (i) on days when the structured product can be traded or redeemed or (ii) monthly (whichever is more frequent).

In relation to frequency of pricing and valuations, we would point out that under the Code on Unit Trusts and Mutual Funds, the requirement is to have at least one dealing day per month and (in general) valuations/prices need not be provided on non-dealing days.

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

In relation to the eligibility requirements for issuers and other parties it is not possible for a law firm to issue an opinion on the laws of a jurisdiction in which it is not licensed to practice local law. In practice this will frequently render the issuance of an opinion of the type described in 3.2(c) Note (1) impossible. In any event, it is not the role of members of the legal profession to advise the SFC on the suitability of a jurisdiction for the purposes of investor protection – that is the role of the SFC.

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

We have no comment.

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

The requirements of 4.2(b) are unreasonably harsh and inappropriate. If a licensed intermediary is not fit and proper to act as a product arranger on these grounds then it should not be fit and proper to remain a licensed intermediary either. As a practical matter, many intermediaries have been subject to disciplinary action which does not call their fitness and properness to remain licensed into question

(c) Do you think a Product Arranger should also be appointed for structured products issued by Issuers (whether SPV or not) or guaranteed by Guarantors where these entities are not local Regulated Entities (i.e. 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)?

The role of the Product Arranger is more onerous than that of, for example, a sponsor of an IPO, in that the obligations of the Product Arranger post-offer are more wide spread. We consider this to be inappropriate and see no reason why such an appointment should be required or what, if any, additional investor protection is required in circumstances where the issuer falls outside 3.3(b)(ii). We support the use of a Product Arranger in connection with the creation and issue of a structured product by an issuer falling within 3.3(b)(ii). We have reservations about the reference to undertakings in unspecified form. Such undertakings (if any) should not be used as a means of expanding Product arranger liability beyond that expressly set out in the SP Code

(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 additional obligations with reasons.

We have no comment

QUESTION 6:
(a) What are your views on the proposed eligibility criteria for collateral in respect of structured products?
(b) Do you think collateral should be subject to any additional eligibility criteria? If so, what criteria?
(c) What are your views on the requirement that investors' claims to collateral proceeds should be accorded priority and should not be subordinated to claims by counterparties to transactions with the Issuer that are related to the structured product?

In our view, the eligibility criteria are overly restrictive, will act as an unreasonable and unnecessary impediment to the issue and distribution of structured products, will unfairly limit the ability of mid and smaller players to participate in this market and will impose unnecessary costs on market participants (all or part of which will ultimately be borne by investors). Specifically:

(i) the collateral should be capable of being realized within a timeframe appropriate for the product being authorized. It would be inappropriately inflexible to require collateral to be realized at any time. Also, there is no reason why the collateral should be tradable – so long as it is capable of being realized either through trading, redemption or other means that will render it sufficiently liquid;

(ii) we do not understand why collateral cannot consist of structured products or securities issued by SPVs or similar entities. Such products are not inherently any more risky than products issued by substantive entities (and in some cases will be safer by virtue of being legally ring fenced from the parent's liabilities), will have their own credit ratings (although that should not be a pre-requisite);

(iii) we do not understand why collateral should be used solely for the purpose of securing the interests or investors and not for the purpose of enhancing the return on the structured product. We see no basis for concluding the two objectives are in any way mutually exclusive or otherwise in conflict;

(iv) we do not understand why there should be a restriction against issuers of collateral being related to the issuer, product arranger, guarantor or key product counterparty. The adequacy of collateral should be assessed on its own merits and not subject to arbitrary restraints which do not have a rational justification and which have the potential to unnecessarily add to the costs of a product (which costs will ultimately be borne by investors in whole or in part);

(v) daily marking to market may not be either practical or necessary. Please see (i) above;

(vi) while the suggestion that investors' claims to collateral should have priority over claims by counterparts has superficial appeal, in practice it may amount to the creation of a security interest with attendant implications for possible registration and raises a number of questions in the event of an insolvency of the issuer/guarantor. In addition, if investors' interests are to be given priority over counterparties, counterparties may demand their own collateral which effectively adds to the cost of issuing the structured product – ultimately, those costs will be paid for by investors

QUESTION 7: Do you believe 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 of structured product? If so, please list such additional criteria/factors and give an explanation for each.

We have no comments.

QUESTION 8:
(a) Should indicative valuations of structured products be required to be proved 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.

The provision of indicative valuations should be the shorter of (i) monthly or (ii) days on which the structured product can be traded or redeemed. More frequent valuations serve no meaningful purpose.

(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 short scheduled tenor, e.g. of one month or less? How often do you think Issuers or their market 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?

Firm pricing obligations should limited to days on which the structured product can be traded or redeemed. It is not meaningful to require a firm price to be given in circumstances where the relevant parties know that it will never be applied.

QUESTION 9: Please give your views on the use of annualised returns in offering documents and advertisements for structured products.

We support the use of annualized returns as they provide one means for investors to compare products. However, a consistent basis for calculating annual returns should be used – all costs and expenses should be taken into account and the relevant period for calculation purposes should run from the subscription or purchase day to the day on which the proceeds of redemption of sale are returned to the investor.

QUESTION 10: Please provide your views on the length of the transition period for compliance with SP Code requirements for unfinished structured products where the issue of documents has been authorised prior to the date of the SP Code's effectiveness.

Products which have been authorized prior to the date of the introduction of the SP Code should be grandfathered in their entirety. It is unreasonable to expect issuers to have to make the radical changes imposed by the SP Code post authorization.

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.

In relation to the Proposal 1 for structured funds:

(i) the issuer of FDI and the management company of a structured fund should be permitted to be related companies provided that they can demonstrate functional independence of each other. We see no reason for greater independence requirements than those which apply to trustees and custodians

(ii) we do not consider that there should be a blanket prohibition against securities issued by SPVs from being used as collateral. Such securities are not necessarily worse credit risks than other securities and may have their own credit ratings. We submit that securities which carry acceptable credit ratings should be acceptable even if issued by an SPV

(iii) FDI which are created by a recognized exchange (such as exchange created futures and options) should not be treated as FDI or, at least, exempted from a number of the restrictions and other requirements

In relation to Proposal 2 for structured funds, our only comment is that the 10% limit should not apply to futures and options contracts which are created by and traded on a recognized stock of futures exchange.

We have no comments on Proposal 3.

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? Please explain your views.

We have no comments on Proposal 4.

We support the proposal to require a Key Facts Statement subject to the following comments:

(i) the requirements for a KFS should not be such as to detract from the objective of providing investors with a succinct summary of the key features of a structured product. The principle objective of a KFS is to provide investors with a documents which they may actually read and understand (unlike a full length offering document which investors who lose money will routinely claim to have neither read nor understood);

(ii) investors should be required to acknowledge receipt of KFS and should be prohibited from denying knowledge of the information contained in the KFS.

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

In relation to the proposed changes to the UT Code:

(i) the trustee should have a specific obligation to comment and report on the manager's compliance with the new connected party requirements. It should not be left to the manager to self report on its own compliance;

(ii) total expense ratios and the basis for calculation should be mandatory disclosure obligations in annual reports.

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 standardised 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.

We support allowing UCITS schemes which have issued KIDs to use those documents in place of KFSs. The additional cost of requiring a different document containing substantially the same information is not justified. The differences between a KID and a KFC are not sufficient to cause concern regarding comparability given the intended brevity and common objective of both documents.

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 view 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 19.1)?

We have no comments on the implementation proposals or the implementation timetable.

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 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?

We support the proposed changes to the ILAS regime. Given that ILAS products are often sold as investment products (as much as insurance products), we strongly recommend:

(i) that the sale of term life policies disclose separately the cost of the investment component and the insurance component so that investors can make a meaningful comparison

(ii) that the projected surrender value and annualized return (loss) for each year of the term of the policy be disclosed. Where the surrender value is not a fixed amount (as is usually the case), that the minimum surrender value and annualized return (loss) be disclosed alongside any other forecast which the issuer wishes to include.

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 transitional period should be for Existing Schemes to fully comply with the Product KFS and Other Disclosure Requirements (paragraph 214(c))?

We have no comments on the implementation proposals or implementation timetable.

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.

In our view there a number of the conduct proposals should apply only to unlisted products and in circumstances where there is an advisory relationship between the relevant intermediary and the investor. As an example, issuers who distribute products through intermediaries (whether acting as agent of the issuer or agent of the investor or both) will often not have either an advisory relationship or the ability to assess suitability. In this situation (which is common), the unlisted product should be treated in much the same way as a listed product in so far as the intermediaries who do not have the primary relationship with the client are concerned. It would be unreasonable and inappropriate to impose the conduct requirements of an intermediary in such circumstances.

QUESTION 19: Do you think intermediaries should, as part of their "know your client" procedures seek clients' information about their knowledge of derivatives and characterise those clients (other than professional investors) with such knowledge as "clients with derivative knowledge" to assist intermediaries ensuring that the investment advice and product offered in relation to the unlisted derivative products are suitable?

In our view, such characterization is unlikely to be helpful in all instances. Many products which contain embedded derivatives are not inherently more risky than products which do not contain such products. Lehman mini-bonds illustrate the point – the derivative backed products were (in a number of instances) either less risky or no-more risky than a hypothetical equivalent product issued by the same issuer which did not contain an embedded derivative. Accordingly, while there may be some products which contain derivatives for which it would be helpful or appropriate for investors to have an understanding of how derivatives work; equally there will be many products where the investor's knowledge or lack of knowledge of derivatives would be irrelevant to their understanding of the characteristics of the product.

Given that products with derivatives embedded in them are (i) common and (ii) may offer risk reward characteristics which are superior to "plain vanilla" products, it may well be doing investors a disservice if they are denied an opportunity to invest in such products either expressly or by raising the KYC and suitability burden on issuers and distributors to a higher level.

In our view there should be no bar to intermediaries selling derivative based products to inexperienced investors. However, intermediaries should take into consideration an investor's knowledge or lack of knowledge of such products in deciding whether the product is suitable for the investor and when explaining the risk factors.

QUESTION 20: Should a high net worth investor be considered to have specific knowledge and expertise if:
(a) he is currently 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 studies courses which are related to the relevant product?
Do you have any other suggestions?

In addition to the criteria specified in the question, a high net worth investor should be considered to have specific knowledge and experience if he has previously dealt with the relevant products (or claims to have done so).

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

We see no reason to change the current threshold under the Professional Investor Rules. In particular, given that the Hong Kong market has historically been characterized by high levels of volatility, setting a higher threshold may be particularly problematic for capital raisings (and offerings generally) during periods of market adversity when companies are struggling to raise needed capital generally (paradoxically, history has shown that such times are generally the best times to invest in the market).

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 disclose 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

We support option 1. Full disclosure to investors is, in our view, the most appropriate solution. A limited exemption should be given to allow generic disclosure where the monetary benefit is not capable of being calculated at the time of sale. Commercial sensitivity does not justify failure to make an important and relevant disclosure.

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% etc)?

No applicable. See our answer to question 22.

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 views.
Option 2.2 – Specific disclosure of distribution reward
Option 2.2 – Generic disclosure

Where the distributor is an associate of the issuer, in our view either specific or generic disclosure is sufficient.

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

Where the distributor makes a profit by sourcing a product and reselling on a back-to- back basis, the full amount of the spread should be disclosed to investors. This is a long overdue requirement – in particular for fixed income products where the spreads charged by intermediaries on bonds purchased by retail investors are, by international standards, extremely high.

The claim that revealing this information would “reveal sensitive commercial information” is, at best, unconvincing and does not outweigh the obligations to the intermediaries’ clients.

Claims that the spread does not reflect counterparty credit risk, financing costs etc have greater validity but are, in our view, irrelevant. The same considerations apply on many other financial transactions (e.g. lending) where the profit or margin charged to the client is fully disclosed. Given that this applies to back-to-back transactions (and not to warehoused transactions), if the counterparty credit risk is unacceptable, the intermediary can (and should) simply refuse to execute the transaction. Also, given that settlement of both legs of the transaction would normally take place on the same settlement day, financing costs should be a non-issue.

The objections to disclosure have greater validity whether the intermediary is selling a warehoused product.

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?

We support the adoption of a model similar to that used in Singapore where there is no restriction on the distribution of gifts provided that there are safeguards in place to prevent the gifts from compromising the sales' recommendation or the investors' decision making process.

QUESTION 27: Do you have any 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 fees and charges available to investors?

We have no comments.

QUESTION 28: Do you think audio recording of the client risk profiling session 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.

We do not consider that audio recording should be mandatory in all circumstances for the reasons set out in paragraphs 94 and 95 of the Consultation Paper.

Audio recording is highly recommended in circumstances where:

(i) the client is a new client; or
(ii) the client is unfamiliar with the types of product under consideration; 0r
(iii) where the transaction is execution only.

In simple terms, an audio recording is an effective means of retaining evidence that the intermediary has adequately explained the risks of the transaction to the client. As such, audio recording provides a measure of protection to the intermediary against allegations of mis-selling as well as putting the sales staff on notice that their sales pitch is being monitored.

If audio recordings are to be mandatory, they should be kept for seven years or, if shorter, the life of the product plus 3-6 months.

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

Cooling off will not work for products which (i) are of a short term duration, (ii) are priced by reference to market prices and conditions and (iii) which involve the acquisition of term obligations (such as a derivative or term investment contract). Such conditions make unwinding both impractical and prohibitively expensive. The duration of the underlying investment is largely irrelevant to this analysis in so far as (ii) and (iii) are concerned.

There is also an obvious moral hazard that investors may be tempted to invest in such products and then take advantage of the cooling off period should the market or the underlying investment move against them during the cooling off period and allege that they were not told that they would have to bear the market risk. Given the history of mis-selling claims in Hong Kong, it is inevitable that many investors will allege that it was not explained to them that cooling off rights were subject to bearing any costs or market impact losses.

Given that a cooling-off period will result in considerable uncertainty for issuers and counterparties, such uncertainty will result in less attractive pricing of underlying non-exchange traded investments and contractual arrangements. As such, the pricing offered to investors would be expected to be less attractive than it would be absent such a cooling off period. As a group, investors will end up paying a price for the cooling off right and, collectively, will be worse off. In our view, a cooling off period is not in the interests of investors.

In our view cooling off for non ILAS products is inappropriate, not in the interests of the market, not in the interests of intermediaries and not in the interests of investors. We strongly oppose the introduction of a cooling-off period.

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 this 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.

While there will be circumstances in which an investor would benefit from the right to withdraw and order before it is executed and where such withdrawal will not adversely affect the issuer of the product or the intermediary distributing the product, such circumstances will not exist for all products. In our view while the objections to a post-execution cooling off period set out under question 29 above will not apply, we have reservations about introducing a broad right to withdraw which would apply to all products and all circumstances.

If a right to withdraw before execution is to be adopted, in our view such right should be exercised in writing not later than two business days before the settlement or execution date.

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.

Absent proven mis-selling, in our view investors should not have a right to require an intermediary to buy back a product. We see no basis for giving investors such a right. In our view, providing investors with such a right would impose an unreasonable burden on intermediaries. Also, such a right would affect the range of products and the cost of the products being made available to investors.

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

We are strongly opposed to the introduction of a cooling off period.

However, if a cooling off period is introduced, we see no reason why intermediaries should be required to refund all or any of the sales commission. Once the sale has taken place the payment of the sales commission has been earned and the exercise by the investor of a right to withdraw will not have altered the fact that the sales work will have been performed.

The Law Society of Hong Kong
Securities Law Committee
22 December 2009

131280