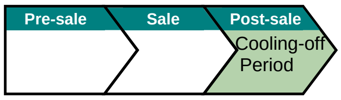

Part IV Post-sale arrangements – cooling-off period

Introduction

1. This Part IV discusses the request, in the Action Plan, to consider the feasibility of a cooling-off period for sales of investment products. Paragraphs 8 to 14 set out certain issues for consideration at a product-issuer level and also in terms of general implementation should responses to this consultation indicate support for its adoption. Since a cooling-off period would have implications not just for product issuers but for distributors as well, the feasibility of a cooling-off period must also be considered at the distributor level. Paragraphs 15 to 17 address these issues.

Cooling-off period

2. Following the FS Report, the Commission was asked, in the Action Plan, to consider the feasibility of a cooling-off period for the sale of investment products. It should be noted that the term "cooling-off" is a short-hand description for rights that investors may exercise to cancel an investment in a product or to sell a product back to the issuer or its agent.

3. Typically, a cooling-off period would be a period of days after an investor places an order or acquires an investment product during which the investor could cancel the order or exit the investment[34].

4. This requires consideration on several levels. We focus in paragraphs 8 to 12 below on issues arising at the product-issuer level. Introduction at the product-issuer level would, however, be dependent upon effective introduction at the distributor level, since the entitlement to a refund of at least part of the sales commissions paid by investors would be an integral part of any cooling-off rights. Without this, the focus at the product-issuer level would become more one of liquidity provision. In the case of a number of widely-available retail products, there is already a requirement in the Handbook for dealing or redemption to be available on a regular basis. In the case of unlisted structured products, requirements in this regard are proposed elsewhere in this paper.

5. It is important to note at the outset that a cooling-off period would not come without a cost to investors.

6. If an investor were to exercise his or her right to cancel an order or exit an investment during a cooling-off period, he or she would not generally be entitled to receive a full refund of the principal invested or, in some cases, of all of the sales commission he or she paid.

7. It is also important to bear in mind that there would in many cases be an increased administrative burden on product issuers and distributors in accommodating cooling-off periods and processing investor requests. Product issuers and distributors may seek to pass on certain of these administrative costs to investors in the price of the product itself and/or the commissions or sales fees charged, if they are not able to deduct these from amounts due to investors.

[34] Our review of several major jurisdictions indicates that, where cooling-off periods apply to sales of investment products, the length of time allowed may range from as little as two days to as long as 14-21 days (or even longer, in the case of certain long-term plans).

8. In some situations, it may be comparatively easy for product issuers to accommodate order cancellations. An example of this is where there is a specified offer period for an investment product prior to the date the trade is executed for the investor. It may also be possible for an investor to be given a short period of time, perhaps 24 hours, after placing his or her order before the product provider executes that order, and for investors to have the right to cancel the order within this 24-hour period. It may, however, be burdensome for distributors and product providers to implement this waiting period for each individual investor. In addition, investors would not be entitled to any return on the investment in the period between placing the order and the date of execution of the trade, thus creating the risk of disputes about when a trade should have been executed.

9. After the trade date, the investor would in effect be seeking to sell the product back to an issuer or its agent. The relevant price would need to take account of market movements during the intervening period and, in addition, reasonable costs incurred by the issuer in unwinding applicable hedging transactions. In these cases, our review of other major jurisdictions indicates that, where cooling-off periods apply to sales of investment products, the amount investors can expect to receive in respect of the product is generally the principal amount invested less certain deductions. The deductions take into account matters such as market losses incurred since the trade date, break funding costs and administrative costs, and vary depending on the type of product.

10. A cooling-off period may enhance investor protection in appropriate circumstances. We do not believe, however, that a "one-size-fits-all" approach should be adopted across all types of investment products. Investment products vary widely, and cooling-off periods may not be compatible with the nature of some products. Additionally, in some cases, investors may already be able to avail themselves of secondary market trading in the product or regular dealing days or other liquidity provision in order to exit the investment.

11. Cooling-off periods already apply in the case of ILAS. ILAS are insurance policies where policyholders are making a long-term commitment, either with a single premium payment or regular premium payments, and where substantial surrender or withdrawal charges may apply should they need or wish to terminate or redeem the policy earlier than its scheduled maturity date. In addition, therefore, to the situations described in paragraph 8 above, where there is a period during which orders could simply be cancelled before the trade date, we believe that a cooling-off period would be of most benefit for investors in situations:

(a) where there will be a relatively long lock-up period for the investment; and/or

(b) where there will not be dealings in the product or other liquidity provision on a frequent basis.

12. Consideration would also need to be given to whether this right, if proposed in respect of some types of investment products, should be limited in its application depending on an investor's circumstances, or whether it should be available to all retail investors[35].

13. Aside from the additional costs involved, consideration also needs to be given to other potential negative effects of the imposition of cooling-off periods. These include the

[35] Some of the jurisdictions we have reviewed exclude certain transactions, for example situations where the investor has invested in the same product previously or where the investor has already exercised a right or power under the terms of the product.

danger that investors will assume that they will receive a full refund of the principal amount invested, when in fact this is unlikely to be achieved in most circumstances, the potential for investors to become less vigilant in reviewing products at or prior to the point-of-sale, and the danger that the right may be abused by those investors who take advantage of the ability to exit an investment to engage in short-term trading without having to be penalised for costs incurred. To discourage speculation, the amount payable in respect of the product upon exercise of such a right would need to be capped at the total principal amount invested. There is also a question of whether, depending on the nature of the product, exercise of cooling-off rights by one or more investors would be fair to other investors who maintain their investment positions[36].

14. If this consultation indicates broad support for the introduction of cooling-off rights, consideration will need to be given to the regulatory means by which this should be achieved. We note that, in some of the jurisdictions we have reviewed, cooling-off periods, where they apply, are a statutory requirement. This would be one means by which Hong Kong could consider implementing this requirement and the consideration of whether the statutory route should be adopted is a subject for separate study and consideration by the legislature.

Question (29)

Do you believe that 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?

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 generally be 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.

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.

[36] For example, fixed costs associated with a product, such as fees charged by trustees or custodians or legal fees, would typically need to be met out of the investors' subscription or purchase amounts, and thus the proportion of these costs borne by the remaining investors would increase.

Refund by distributors

15. Some distributors have indicated that the implementation of a cooling-off period with respect to sales of investment products would impose an administrative burden on them due to the need to process each client's cancellation request. As reflected in paragraph 7 above, some financial institutions have also mentioned that this may lead to higher product prices as product issuers need to build additional margin into the price of the products to cover product unwinding costs.

16. The distributors' view was that, since they have provided distribution services and incurred costs, they should be remunerated for the work done.

17. Where a cooling-off period is incorporated in an investment product, the Commission considers that distributors could facilitate such a cooling-off arrangement by promptly passing on to the client the full amount of refund (including the sales commission) received from the product issuer less a reasonable administrative charge.

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 the sales commission) received from the product issuer less a reasonable administrative charge? Please explain your views.

List of consultation questions in Part IV

Question (29) Do you believe that 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?

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 generally be 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.

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.

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 the sales commission) received from the product issuer less a reasonable administrative charge? Please explain your views.