



Consultation paper on proposals to enhance protection for the investing public

Part I Introduction

Executive Summary

Impact of financial crisis

1. In the past twelve months following the collapse of Lehman Brothers Holdings Inc. (Lehmans), the global financial system has experienced its worst crisis since the Great Depression of the 1930s. The interconnectedness of financial centers and the increasingly connected global economy, has meant that few countries have escaped unscathed. However, it has been the financial infrastructure of the developed economies that have been hardest hit. Many developed economies have seen the collapse of financial institutions and the need for government intervention on a massive scale to prevent the collapse of their financial systems.
2. Hong Kong has not come through this period unscathed and the entire economy is suffering from the economic downturn that has followed. However, our financial sector has proved to be resilient in the face of the systemic pressures it has faced and we have not seen the major institutional failings that have been experienced in other international markets. We have also largely avoided the direct impact of the collapse of securitized mortgage products, which have been such a feature of the larger financial centers.
3. Nevertheless, the stress put on our financial infrastructure and in particular the direct impact of the collapse of Lehmans, one of the world's largest investment banks, has served to highlight significant concerns about how certain investment products have been sold to members of the public in Hong Kong.
4. The collapse of Lehmans 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.
5. It is important to distinguish between the debate now taking place – globally, regionally and nationally – about what structural changes to regulation may be required to prevent a future financial crisis and the actions we need to take to strengthen the regulatory regime for retail products, which the current financial crisis has merely served to highlight. These are very different issues, requiring different considerations.
6. This paper proposes enhancements to the regulation of the sale of retail products in response to issues highlighted by the early termination of Lehman products. The paper does not attempt to address any of the broader questions that have been raised about how our regulatory regime should be structured and what steps need to be taken, locally or as part of global initiatives, to address systemic weaknesses that may precipitate a future financial crisis.



Background work

7. In view of the global financial crisis since September 2008 and its impact on unlisted structured products offered to the public, the Commission submitted a report³ to the Financial Secretary in December 2008 (FS Report). This report recommended a number of measures to restore investor confidence in the financial market and to address areas relating to selling practices and complex products. The Financial Services and the Treasury Bureau has undertaken a review to consider what could be done to improve Hong Kong's regulatory framework and enhance investor protection and education. An Action Plan⁴ was formulated after consulting the Commission and HKMA to take forward various recommendations. In the long term, the Administration will review the structure of the regulatory framework and related arrangements that are to be implemented through primary legislation.
8. Subsequently the Commission has conducted a large number of investigations into the sale of minibonds (and other unlisted structured products) by intermediaries. The Commission has concluded the majority of these investigations by entering into an agreement with 16 banks and two securities intermediaries which provide for significant levels of payment for the vast majority of investors and also require various actions to be taken by the financial institutions involved.
9. Our review of the issues relating to the sale of unlisted structured products highlighted by the collapse of Lehmans together with work performed by the HKMA, has identified areas where our regulatory regime surrounding the sale of investment products could be enhanced.
10. Our focus in preparing this consultation paper is to put forward measures to strengthen our existing regulatory regime. Whether this can be achieved is always dependent on the individual action of all participants in the process, but we believe that our recommendations are aimed to define a regulatory infrastructure that better protects the interests of investors.

The need for change to be recognized

11. While the resilience that our financial infrastructure has shown during the financial crisis has attracted positive comments, the Minibonds incident has exposed issues in connection with the sale of investment products and has negatively impacted on the reputation of our market both locally and internationally. In order to restore the trust and confidence in our market we believe that the Government, the regulators and the industry need to collectively demonstrate that the lessons of this incident have been learned and that appropriate action has been taken. This consultation paper offers a number of suggestions as to what this action should be.
12. In determining what action should be considered we have been conscious of the need to formulate balanced proposals. The Commission has a long tradition of consulting on changes and we believe that this allows us to move forward in a pragmatic but nevertheless effective manner as we develop our regulatory regime.

³ "Issues raised by the Lehmans Minibonds crisis – Confidential Report to the Financial Secretary" issued by the SFC in December 2008

⁴ Action Plan on Recommendations in the Reports Prepared by the Hong Kong Monetary Authority and the Securities and Futures Commission on the Lehman Brothers Minibonds Incident prepared by the Financial Services Branch of the Financial Services and the Treasury Bureau and submitted to the Legislative Council in February 2009.



13. In developing the proposals in this paper we have already conducted extensive soft consultation. We have also looked closely at developed overseas jurisdictions with comparable regulations in place. Whilst mindful of the potential impact on the financial markets, we have first and foremost had in mind the need for additional investor protection in the light of the issues arising from the sale of unlisted structured products in our market.
14. Given the seriousness of the Minibond event, it is not possible to consider returning to business as usual and intermediaries must recognize the need for enhancement of the regulatory environment in which they sell investments to the public. While we wish to consult on these proposals we urge respondents to focus on what is the right answer in the context of recent events and then to consider how to implement the necessary changes.

How to read this consultation paper

15. The proposals in our paper flow directly from the recommendations made in our FS Report and a parallel report prepared by the HKMA. We have also taken the opportunity to codify some existing practice and to propose a few new matters, which can be conveniently considered at the same time.
16. This consultation paper contains a number of proposals and many of these are interconnected. These proposals should be considered as a set of integrated actions, which, together with some additional measures to be consulted on later this year, are collectively designed to enhance protection for the investing public. They should not be viewed individually.
17. However, while it is necessary to include this detail to assist the industry consider the implications for their business it is also possible to view our proposals in simpler terms. We suggest that the reader first considers an overview of all the proposals being put forward to provide context for any detailed consideration of individual proposals they may wish to undertake.
18. For the convenience of the reader, we have also grouped our proposals in this consultation in separate sections as noted below. This will allow those with an interest only in the matters which directly impact them to readily identify and consider those issues.

Part I – Introduction

Part II – Products

Part III – Intermediaries conduct

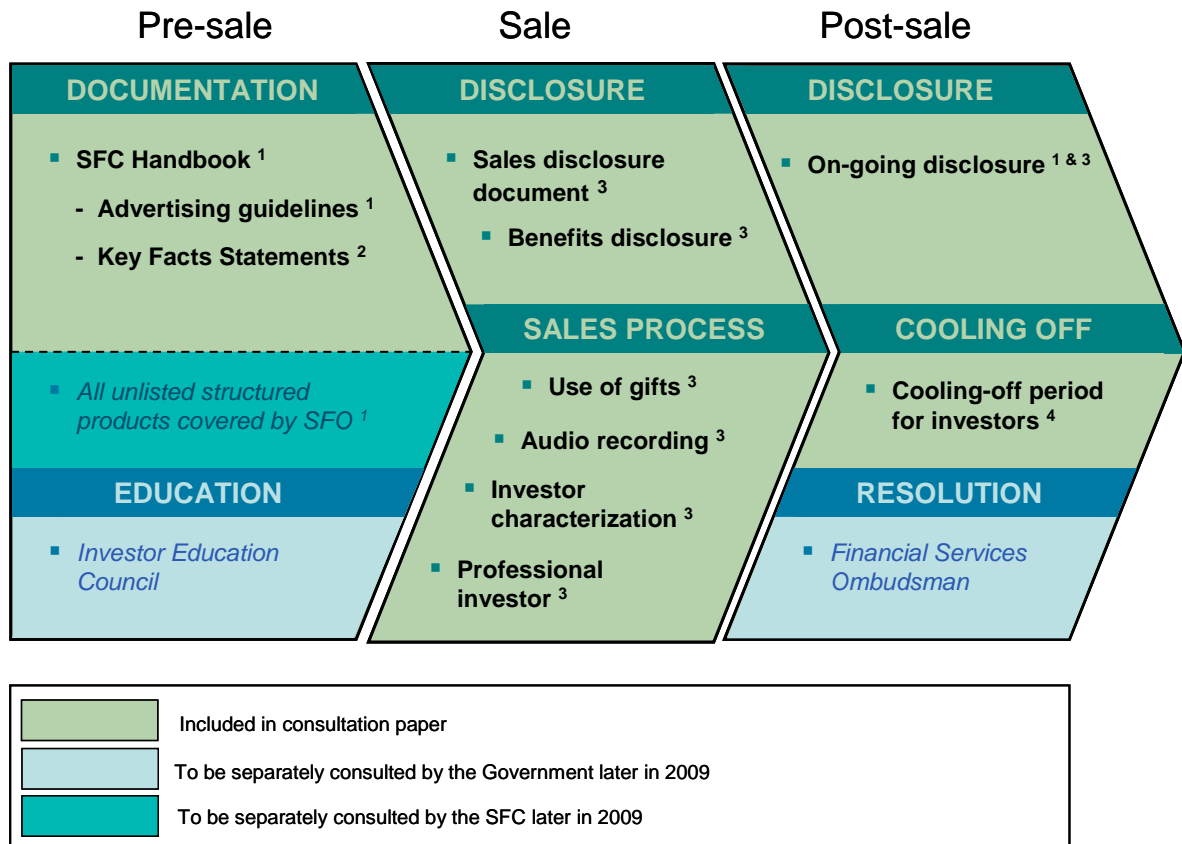
Part IV – Post-sale arrangements

Each section of our consultation paper is marked to indicate which of the above headings it falls under.

19. We would also add that the proposals set out in Part II of this consultation paper will apply only where the relevant types of investment products are offered to the public in Hong Kong, whilst the proposals set out in Part III of this consultation paper will apply to licensed or registered persons in Hong Kong in their sale of investment products, whether to the public or not.



20. How our recommendations relate to the three key stages of an investment life-cycle: Pre-sale, Sale and Post-sale, can also be visually illustrated as follows.



¹ As detailed in the part headed "Products" in Part II and in Appendix A to this consultation paper.
² As detailed in the part headed "Products" in Part II and in Appendices A and B to this consultation paper.
³ As detailed in the part headed "Intermediaries conduct" in Part III of this consultation paper.
⁴ As detailed in the part headed "Post-sale arrangements - Cooling-off period" in Part IV of this consultation paper.

21. Starting with this overview will assist readers in putting each individual proposal in context and show how they contribute to an overall effort to improve the regulatory regime surrounding the sale of investment products to the Hong Kong public.



Summary of underlying rationale for proposals

22. As noted above, this paper proposes additional measures to provide protection for investors for consultation. The paper does not attempt to address any of the broader questions that have been raised about how our regulatory regime should be structured. Accordingly, this consultation is premised on Hong Kong continuing to adopt a largely “disclosure-based approach”⁵ coupled with conduct regulation on intermediaries who sell products. Disclosure-based regulation is adopted in other major financial centers e.g. the US, the UK, Singapore and Australia and is in any event the approach which we believe continues to be appropriate for our market.
23. Each proposal set out in this paper contains the necessary information to consider that individual issue. This section attempts to provide the reader with a concise summary of the rationale and regulatory philosophy underlying our proposals. This is necessarily high level and reference should be made to the detailed sections for the complete background to each proposal. However, it is hoped that this summary will allow a reader to gain an overview of the consultation so that when considering a particular proposal it can be understood in context.

Documentation

24. While there is a responsibility for the selling intermediary to ensure that investors have an understanding of the key features of the product, as part of ensuring suitability, the effectiveness of documentation in communicating key features and risks of the investment product to investors can be enhanced.
25. In order to improve the effectiveness of documentation in communicating key issues to investors we have set out three key proposals:

Standardisation

- (a) The criteria that the Commission will normally consider in authorising offering documentation and advertisements (see Part II of this consultation paper), will be consolidated into a single SFC handbook as set out in Appendix A covering Unit Trusts and Mutual Funds (UT), Investment-Linked Assurance Schemes (ILAS) and Unlisted Structured Products (issued under the SFO). This will include a new Code on Unlisted Structured Products (the SP Code) as well as some updating of the existing Code on Unit Trusts and Mutual Funds (UT Code) and Code on Investment-Linked Assurance Schemes (the ILAS Code) and codify existing practice. This will clarify documentation standards and also allow common principles to be applied to all of these products.
- (b) At present there are two separate regimes under which the Commission authorizes the documents of products sold to the Hong Kong public i.e. the Companies Ordinance (Cap. 32) (CO) prospectus regime and the Offers of Investments regime in Part IV of the Securities and Futures Ordinance (Cap. 571) (SFO). The Commission is working with Government to bring forward legislative amendments to transfer the authorisation of offering documentation in relation to

⁵ Under the “disclosure based approach”, a regulator relies on the information provided by the issuer in authorising the offering documents and marketing materials. It does not verify the accuracy of the information so provided but relies on the issuers. This approach is different from the “merit based approach” under which a regulator assesses the suitability of products for consumers at the point of vetting of offering documents or marketing materials.



structured products out of the CO prospectus regime. Public offers of unlisted structured products will then be regulated under Part IV SFO Offers of Investments regime. For practical reasons, this proposal will be consulted on separately. This proposal will allow the Commission greater scope and flexibility in defining the appropriate documentation standards through the use of powers to publish codes and guidelines under the SFO.

Simplification

- (a) In order to improve the communication of key issues to investors we have proposed that all offer documents should include concise and easily-understood summaries, or product Key Facts Statements (Product KFS). These should be user friendly, standardized to the extent possible (to facilitate comparison between products), and be kept concise. While they cannot be a substitute for the full information contained in an offer document, we believe that these Product KFS will prove to be effective in ensuring that a product's key features and risks are communicated to investors.
- (b) Reference can be made to the section headed "Product key facts statements" in Part II - Products and to Appendix B to this consultation paper.

Disclosure

26. There are two areas where the current regime could be enhanced:
- (a) Investors were not aware of the commercial interest of intermediaries selling the investment product to them i.e. the commission or benefits earned on the sale.
 - (b) There may have been occasions when little information was readily available to investors in the period between the completion of the sale and the maturity of the investment product.

We have included three items in our consultation proposals to deal with these issues.

Monetary and non-monetary benefits

27. In reviewing the selling practice it is apparent that the level of commission (or benefits) earned is an important factor that should be disclosed by the intermediaries to investors. Concerns have been expressed about the possibility that the level of commissions may have been a factor which encouraged institutions to develop business strategies that inappropriately incentivised their sales staff to sell investment products. This in turn may have created potential conflicts of interest.
28. Requirements already exist in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) to "make adequate disclosure of relevant material information⁶" and "to avoid conflicts of interest and ... ensure that ... clients are fairly treated."⁷ In order to further mitigate against conflicts of interest and to enhance transparency, we propose to require disclosure to

⁶ General Principle 5

⁷ General Principle 6



clients at the pre-sale stage of commissions, fees and other benefits receivable from product issuers for the sale of the products.

29. We noted that overseas jurisdictions already require varying degrees of disclosure. While we consider that additional disclosure will benefit investors we also recognize that there are different ways in which this can be achieved. We also accept that there are some circumstances in which establishing the level of commission or benefit is complex.
30. Reference can be made to the section headed “Pre-sale disclosure of monetary and non-monetary benefits” in Part III - Intermediaries conduct of this consultation paper.

Ongoing disclosure requirements

31. We believe that it would be helpful to make material information available to investors on an ongoing basis to enable them to better monitor their investments in a volatile market. The single SFC handbook as set out in Appendix A requires ongoing disclosure to investors of material information in relation to unlisted structured products in addition to the existing on-going disclosure requirements already imposed on unit trusts and mutual funds and ILAS products.
32. Distributors of these products are also reminded of their obligations to pass on to ultimate investors the information that they receive from the issuers. Reference can be made to Paragraph 11 of Part III - Intermediaries conduct of this consultation paper.

Sales disclosure document

33. In their report to the Financial Secretary the HKMA recommended that consideration be given to providing a uniform statement of key facts to investors at the point of sale. This would include, inter alia, information about the capacity in which the intermediary was acting e.g. agent or principal and also any commission earned (see the part headed “Monetary and non-monetary benefits” above). We propose to specify the minimum content to be provided in a sales disclosure document.
34. Reference can be made to the section headed “Sales disclosure document” in Part III - Intermediaries conduct of this consultation paper.

Sales Process

35. The sale of investment products is covered by requirements set out in the Code of Conduct. Having reviewed these requirements and with the benefit of the information provided by the many complaints received regarding the sale of Minibonds, we believe that these requirements are still appropriate. However, concerns exist about the extent to which some intermediaries complied with these requirements in the sale of investment products to the public.
36. Based on our review we do not propose any substantive changes to the Code of Conduct and its core requirement in paragraph 5.2 “to ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.” However, we have proposed changes in the following areas.



Gifts

37. The HKMA noted that gifts were offered to investors in the marketing of some Lehman retail products and suggested that consideration be given to restricting the use of gifts as a marketing tool to promote a specific investment product. Accordingly we seek views as to whether an intermediary should not act in a way that should distract the client's attention from the features of the products by offering certain types of gifts as a marketing tool.
38. Reference can be made to the section headed "Use of gifts by distributors in promoting a specific investment product" in Part III – Intermediaries conduct of this consultation paper.

Audio recording of sales process

39. The SFC Internal Control Guidelines and FAQs (Internal Control Guidelines) contain requirements that intermediaries "document and record contemporaneously the information given to each client and the rationale for recommendations given to the client" The HKMA has imposed an audio recording requirement on banks selling investments to the public to ensure that full and complete records of the sales process are kept.
40. We understand the rationale for the HKMA's requirement but are equally aware of the concerns expressed by some intermediaries regarding both the practicality of making audio recordings in all circumstances and the difficulty that some smaller intermediaries may experience in establishing the appropriate infrastructure.
41. Given that several months experience has now been gained by banks operating this system we wish to consult on whether or not this audio recording requirement should be extended to cover all intermediaries selling investments to the public or if alternative methods of compliance with the Internal Control Guidelines remain acceptable.
42. Reference can be made to the section headed "Audio recording" in Part III - Intermediaries conduct of this consultation paper.

Investor characterization

43. A general concern has been expressed about the difficulty experienced by average investors in understanding the complex nature and features of some unlisted structured products, which generally have embedded derivative elements. Having reviewed overseas regulations and having regard to the structure of such products, we consider investors' knowledge of derivatives to be a crucial factor.
44. We therefore propose that it be explicitly required that intermediaries should seek, as part of the "know your client" process, client information including knowledge of derivatives. Intermediaries should then characterize those clients (other than professional investors) who have derivative knowledge as "clients with derivative knowledge". If a client is not characterized as a "client with derivative knowledge", the intermediary should not promote any unlisted derivative products to such a client in all circumstances. An intermediary can promote unlisted derivative products to a "client with derivative knowledge" provided that it complies with paragraphs 5.2 (reasonable advice) and 5.3 (derivative products) of the Code of Conduct and that the recommendation is suitable for the client.



45. References can be made to the section headed “Investor characterization” in Part III - Intermediaries conduct of this consultation paper.

Professional investors

46. We have previously committed⁸ to review the definition of “professional investor” in response to concerns expressed regarding the purchase of “accumulators” by individuals who had been classified as such. This was also included as a recommendation in our subsequent FS Report.
47. In the public debate on this issue there has been considerable focus on the minimum portfolio requirement (asset test), set out in subsidiary legislation, which requires that an investor has a minimum portfolio of HK\$8 million. There is a general market misconception that investors with a portfolio of this size will automatically be treated as professional investors under the Code of Conduct. In fact, the intermediary must establish that the investor has sufficient knowledge and experience in the relevant products and markets⁹. Even then an investor cannot be treated as a professional investor unless he formally agrees, in writing, that he wishes to be classified as such.
48. We believe that this test, as set out in paragraph 15.3 of the Code of Conduct, is the key test of whether or not an investor can be considered to be a “professional investor” and that this is where we need to take the most care to ensure that our criteria remain appropriate.
49. In considering the questions posed regarding the appropriate definition of professional investor it will be tempting to focus on the simple asset test and to suggest that the current hurdle is too low. However, consideration should also be given to legitimate concerns that if the asset hurdle is set too high this may adversely affect private placement activities in Hong Kong.
50. References can be made to the section headed “Professional investors” in Part III - Intermediaries conduct of this consultation paper.

Post-sale arrangements – cooling-off period

51. Our examination of Minibonds highlighted that a number of investment products have the effect of locking investors in for a considerable period of time. This is not only because of the maturity period of the investment but also because of the absence of a liquid secondary market in which they can sell their investment.
52. Overseas markets we have examined have various forms of “cooling off” periods where an investor can exit a transaction within a limited period after initially committing to it. In Hong Kong such a cooling off period already exists for ILAS products.
53. In considering the possibility of cooling off periods for other investment products we have considered carefully where a cooling off period could be said to be really needed and have also been conscious of the need to avoid the impression that, where investors do not need to take any responsibility for their decisions.

⁸ This commitment was made at the Financial Affairs Panel meeting on 7 July 2008.

⁹ Please refer to paragraph 15 of the Code of Conduct for full details of the criteria required and the procedures which need to be followed.



54. Our proposal is that a cooling off period should only be considered for products where the investment is long-term, and where there is no ready (and realistic) secondary market. If an investor buys a product which has a liquid secondary market e.g. most mutual funds, then if they decide that this was not an appropriate investment decision they can immediately exit by selling the product. In these circumstances a cooling off period may not be appropriate.
55. However, where there is no ready secondary market for a long-term investment, we believe that it would be reasonable to allow an investor to change their mind, within a short period after the initial investment decision, rather than lock them into a long-term investment which, they have determined is not appropriate. In these circumstances we believe that the appropriate response would be to refund their investment capital and the corresponding sales commission less a reasonable administration charge and less any legitimate market value adjustment.
56. We believe that cooling off periods determined in this way would be a win-win arrangement for both the investor and the intermediary who would not want to have a disgruntled customer for the entire period of the investment. Equally, under our proposals, we do not believe that an investor would change their mind lightly since they would be required to settle the legitimate costs of their decision.
57. Reference can be made to Part IV - Post-sale arrangements of this consultation paper.

Education

58. Greater awareness of risks, an increased understanding of the different investment products available and the availability of appropriate reference material, will all help to improve the quality of the investment decisions made by the public. While regulation surrounding the sale of investments is needed to protect the investing public this needs to be complemented by efforts to help individual investors make appropriate investment decisions. We have proposed a significant increase in the amount and scope of investor education made available to the Hong Kong public as part of a continuous programme that enables individual investors to address their investment needs in an informed manner. The Government will consult the public later this year on a proposal to establish an Investor Education Council.

Resolution

59. The recent Minibonds issue has highlighted the lack of an effective dispute resolution procedure for individual complaints against regulated entities. Regulatory matters will always require the involvement of the regulator. However, it is important that individuals should have a means of seeking redress in respect of their commercial disputes with financial service providers outside the regulatory regime. The Government will consult the public on the proposal to establish a Financial Services Ombudsman and will consult the public on this later this year.



Invitation for comments

60. In this consultation, we have posed 32 questions to interested parties to consider and provide comments on. These questions are categorized as follows for ease of reference:

Questions	Subject	Where to find the details in this paper?
1 to 17	The offer of investment products to the public in Hong Kong.	Part II
18 to 28	Intermediaries conduct in the sale of investment products in Hong Kong, whether to the public or not.	Part III
29 to 32	The feasibility of a cooling-off period for sales of investment products to the public in Hong Kong.	Part IV

61. We would like to seek comments on the proposals set out in this consultation paper. In determining our regulatory approach in the areas that we consult on, it is important that we take into account the views of those who will be affected by the implementation of these proposals, including market participants and investors. We have set up various ways for interested parties to provide comments. Please see the "Foreword" section at the beginning of this consultation paper. In view of the complexity of the proposals, we consider a three-month consultation period to be appropriate. We look forward to hearing from you by 31 December 2009. After the end of the consultation period, we will analyse the comments carefully and aim to adopt a balanced and pragmatic approach for the purposes of enhancing investor protection in Hong Kong.