

Hong Kong Securities Institute Roundtable Luncheon

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Introduction

Thank you for having me here today.

On 15 September 2009, during a speech event at the Brookings Institution, the Washington think tank, Ben Bernanke, Chairman of the US Federal Reserve, uttered words to the effect that the recession “is very likely over at this point” and that the recovery had begun.

With such glad tidings, I should perhaps wrap up my speech on this high note and say no more about regulation. However, despite the positive overtones, Mr Bernanke did not state that happy days are here again and actually believes that any recovery would be slow. I have lost track of the number of times people started having parties after Mr Bernanke or other well-respected personalities in the economics field would say something about the end of the crisis. Alas, at the end of the day, we are all still here. By now we should know it is going to be a long road back; and there’s no short cut this time.

As we have seen, this crisis has exposed most major economies in the world to financial downspin. Fortunately for us, there has not been any systemic failure in Hong Kong, and so naturally our primary focus has been reforming and strengthening our regulatory structure and investigating mis-selling complaints for products which had failed from the crisis. On the other hand, the regulators in the US and Europe have been busy ensuring stability of their own markets and their systemically important institutions in the past months.

Precisely due to the relative stability of our markets, we have not found it necessary to make knee-jerk reactions. For example, when the crisis first occurred, many jurisdictions were quick to impose temporary restrictive measures on short selling in the hope of preventing further market volatility. We in Hong Kong stood our ground because we recognised the importance of short selling as a mechanism in providing liquidity and its only very small role to play in creating market volatility back in September last year. The other jurisdictions had all subsequently lifted their measures after realising the limited effects they have on stabilising markets, hence vindicating our decision.

Another example is the latest EU’s proposal for new regulation to be introduced for alternative investment fund managers. Many have criticised the proposal to be far too restrictive for an industry that had only played a peripheral role in causing the financial crisis and also far too protectionist to retain investors from outside the region. We are already hearing that Sweden, the new EU rotating president, will be significantly amending the rules before they can be rolled out.



The lesson learnt from these examples is not to over-react. I have spent the past twelve months giving speeches and pre-warning everyone that we should absolutely expect more regulation out of this crisis. The key to all of this, however, is and always has been sensible regulation. I have recently learnt that the Chinese use the same word for crisis and opportunity. This crisis does bring about an opportunity for markets to review and enhance their regulatory systems. After the collapse of Lehman Brothers more than one year ago, both the Securities and Futures Commission (SFC) and the Hong Kong Monetary Authority have kicked into review mode and have subsequently issued official reports recommending specific measures to address the issues that we believed arose from the early termination of Lehman products. We have literally spent the past year researching and fine-tuning these proposals. Today I can firmly state that we have achieved sensible regulation.

By now you all should know that I have come here today just to explain the consultation which we rolled out at the end of last week. This consultation invites market comments on various proposals that aim to enhance protection for the investing public. The proposals are a result of extensive research, experience-sharing and soft-consultation with other major jurisdictions and local stakeholders. It can be broadly divided into three parts: the first part is in relation to the way in which disclosure on product risks and features should be enhanced and the obligations that the product issuer or arranger should bear; the second part is in relation to revisions to be made to the Code of Conduct which, as we all know, governs intermediary conduct and selling practices; the last part involved a newly introduced cooling-off concept for long term illiquid products.

Before I proceed into the key proposals, I should emphasise that these proposals do 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. This requires a much deeper policy considerations and involves discussions and co-operations at a much higher level, including governments and supranational organisations such as the G20.

This consultation is a start, in that it suggests new measures to strengthen our regulatory regime regarding the sale of investment products to retail investors and better protect the interests of investors. In case people carry the expectation that these proposals are a universal cure-all that will eradicate all kinds of misconduct and problems and ensure investors will never be mis-led or lose money, well, this consultation does not intend to achieve all that and I'm not sure if any regulator should even try.

Product

The most prominent feature about the product proposal is the convergence of rules and standards for all products that we authorise, whether they are under the Companies Ordinance (CO) or the Securities and Futures Ordinance (SFO). The Codes governing disclosures of various product types such as unit trusts, ILASs and unlisted structured products will be merged into one SFC Handbook (Handbook) on products, or a Consolidated Code. This will allow for consistent standards and principles to be applied across all products that we regulate. Noting the difference in structure for each product type, the way the Consolidated Code works is to firstly acknowledge the commonality and fundamental structures of all products to which an array of overarching principles should apply, and then



to be supplemented by specific provisions under each part of the Handbook that accounts for the differences in structure.

The more interesting part here is the introduction of an Unlisted Structured Products Code – a first for a major jurisdiction. Due to its unique structure, we are proposing to impose eligibility requirements on issuers and guarantors of unlisted structured products and to introduce the concept of a product arranger for issuers that are not immediately within our regulatory handle, such as SPVs. Under these arrangements, issuers and arrangers would be under ongoing obligations to fulfil certain regulatory requirements, including regular updating of pricing information and collateral safeguards.

We are working on further enhancing this exercise with the Government by way of merging the two product regimes under the CO and SFO so that all products can be authorised under the same legal framework, bringing additional consistency and commonality of standards.

I can't explain this point enough – mainly because I have been summoned to explain the same idea a number of times in front of the Legislative Council- that our primary role in relation to product authorisation is to ensure that the features and risks of the products are adequately disclosed in the product documentation, free from inaccurate or misleading information, so that investors relying on these offering documents can form an informed judgment.

For Collective Investment Scheme, because of an active management component, we also ensure that the manager of client assets and investments are properly qualified and that there is a certain level of safeguarding on the structure of the product being authorised.

In the past year, one of the messages we have obtained from the market is that not all investors read the product offering documents before making their investment decisions, because the documents are often too long and it is difficult to identify the important parts. Instead they rely on marketing materials which have the sole purpose of attracting investor attention to the products being featured and may not contain all the relevant risks associated with the product, simply because they are much briefer.

To cater for most investors' practice we have developed a Key Facts Statement. Its concept is very much akin to the proposal by the Committee of European Securities Regulators with respect to key information document. They are intended to be user friendly, standardised to the extent possible (to facilitate comparison between products), and be kept concise. In principle, this Key Facts Statement will comprise part of the offering documents of the product and have equal force as the prospectus – yet it will be limited to only a few pages in length so as to highlight and facilitate investors' appreciation of the key features and risks of the product.

Conduct

We now come to the part about conduct, which as we all know, has been an area of the biggest concern in Hong Kong. I would like to share with you 3 key messages on the proposals regarding the conduct regulation section of the proposals.



Key Message 1 - Existing regulatory framework is sound

The first point I would like to make is that we do not intend to make substantive changes to the Code of Conduct (Code). As you all know, the Code sets the benchmark for intermediary conduct and core requirements such as the need to ensure suitability. Although the current regulatory framework has served Hong Kong well and provides a sound basis for guiding intermediary business conduct, we believe that now is the right time for new regulatory requirements to be usefully introduced and to provide further guidance to the industry to cater for market developments over the years.

Key Message 2 - How the proposals would strengthen investor protection

The main objective of all the proposals that involve intermediary conduct is to strengthen investor protection.

Enhancing disclosure

Besides product disclosure, which we covered earlier, we believe it is also important to ensure a certain level of sales-related disclosure is made because some sales-related information may affect how investors make their investment decisions. One such information is the level of commission or other benefits that the distributor will receive from the issuer. We propose imposing requirements on pre-sale disclosure by intermediaries to their client regarding potential conflicts of interest (such as commission rebates) and providing each customer with a Sales Disclosure Document that contains useful information, including the disclosure of any benefits received by the intermediary. With a Sales Disclosure Document in hand, the customer would now have the information to make a better informed decision on whether or not to invest in a particular product, as compared to another product not recommended by the intermediary.

Ensuring investors have appropriate knowledge regarding their investments

The second way to protect investors is to make sure that they are armed with the knowledge to understand what they are investing in. We believe that investor's knowledge and experience regarding the investment or product in question is of vital importance.

There is a general concern that the average investor is often unable to understand the complex nature and features of certain unlisted structured products, especially those with derivative elements. There is evidence of this as a SFC investor survey that was carried out in December 2008 revealed that a good two-thirds of investors surveyed knew very little of at least one of the products they had invested in, such as unlisted equity linked products. It almost begs the question – why did they buy them? Was it the investor's own decision to invest in something that he did not understand but believed might generate handsome returns, or was it the intermediary who recommended an overly risky or complex product that was outright unsuitable for that investor?

We have always had a "Know Your Client" process requirement under the Code . We are now proposing that, as part of that process, intermediaries should seek information from clients in relation to their knowledge of derivatives. Intermediaries would then characterise those clients (other than professional investors) who have derivative knowledge as "clients with derivative knowledge".



If a client is not characterised as a “client with derivative knowledge”, the intermediary should not promote any unlisted derivative products to that client.

It follows that those clients that are assessed as being “clients with derivative knowledge” can be sold any kind of derivative product. But I must emphasise that intermediaries still need to comply with the suitability requirement whenever they make a recommendation or solicitation.

Although this appears to be an extra step, it is in fact not a new requirement. Intermediaries are already expected to know such details under the long established “know-your-client” procedures. However, we are trying to make this criterion more explicit by codifying it to help intermediaries determine whether a product is suitable for a client.

Professional investors

This emphasis on investor knowledge and experience continues on to professional investors. Many have put the sole focus of the professional investor definition on the portfolio threshold, which is currently set at US\$ 1 million. Indeed, in the current consultation we are seeking comments on the monetary threshold. However, we reiterate here again that it is not only about the threshold, it is also about having sufficient knowledge, expertise and investment experience in the relevant financial products under consideration. It is a whole package. Again, this works to the benefit of high-net-worth investors who should be qualified to understand what they are investing in before being treated as professional investors.

Reducing distractions

We also recognise that gifts, when used as a marketing tool to promote investment products, may distract investors from focusing on the features and risks involved and determining whether the product is actually suitable for them. Gifts should not compromise the basis of any recommendation made to the investor. As such we propose to restrict distributors from offering gifts to investors when promoting a specific investment product to investors.

Key Message 3 – Market participation

As I have mentioned before, the purpose of the consultation paper is to put forward measures to strengthen our regulatory regime. However, no amount of effort and persistence on our part is going to matter without support from the market and industry participants. Our intention is to put in place a regulatory system that strikes a good balance (it will never be perfect or please everyone) that provides enough flexibility for market players and sufficient investor protection. The financial crisis has done enough damage to investor confidence and we must restore that confidence for Hong Kong’s markets to prosper.

Before this consultation was rolled out, we have engaged in a series of soft consultation with some market participants which have resulted in invaluable feedback for us in fine-tuning these proposals. Now that the full consultation is rolled out, it goes without saying that everyone’s feedback and support for these initiatives is paramount. We therefore look forward to receiving your views and feedback on the proposals.



Cooling off

Many of you will know that the concept of cooling off is already applicable in the insurance industry, including for ILAS products – and one rationale for that is because insurance plans and products tend to be long termed and their exits can be difficult and costly. In the consultation we explore the idea of whether cooling off can also be applied to long term, illiquid products – mostly unlisted structured products.

Now, before we all jump up and rejoice at the opportunity of a possible free ride, let me assure you – exercising the cooling off right will come at a price. To account for fair market movement and administrative costs incurred, an investor will typically not be able to recover his entire principal investment amount or all of the commission paid. Either that or part of the costs would likely have been priced into the product in anticipation of the exercise of the right. How the arrangement is determined will likely depend on the product type and the ease of which a product or its position can be unwound.

I should stress that the concept of cooling off is meant to bring liquidity to products that are otherwise illiquid and not for speculation purposes. Therefore it is possible that we will cap the recovery of investment to the principal amount, but not more.

It is therefore crucial for everyone to think carefully whether cooling off is a suitable option for financial products, in general and for each individual case.

If we receive broad support for the concept, we will then consider implementation details. For example, the length of the cooling off period. Our research indicates that, where cooling off applies for products, the length of the period could range from a few days to a few weeks. If we are to introduce cooling off, one of the issues that we would expect and rely on feedback is the length of the cooling off.

Conclusion

I hope I have given you a reasonably thorough outline of our latest proposal today. It isn't meant to be a be-all-and-end-all solution to the concerns many have regarding our regulatory structure, but we believe the proposals should be able to adequately tackle most of the problems that have surfaced.

You will notice that some of the proposals have been left open-ended and there were a lot of questions prompted after each section. That was intentional. We welcome support for our work but we also expect feedback so we can tailor the proposals more to everyone's benefits. The consultation period is for three months.

This is only the start of our regulatory reform in Hong Kong. Going forward, we will continue to participate in global efforts to harmonise standards and approaches to financial regulation, as we have broadly seen for short selling, and co-ordinate our efforts locally to reflect that. There is still a long list of legislative amendments that we would like to effect, and many large projects that we have to provide support to and seek support from the Financial Services & the Treasury Bureau, like the Investor Education Council and Financial Ombudsman proposals.



Finally, we strive to provide a confident and efficient environment for markets to operate and we look to your contribution in helping us achieve that.

Thank you.