ISDA®

SIFMA®
Securities Industry and Financial Markets Association

Comments by the International Swaps and Derivatives Association, Inc. (**ISDA**) and the Securities Industry and Financial Markets Association (**SIFMA**) on (i) the Consultation Paper on Proposals to Enhance Protection for the Investing Public issued by the Securities and Futures Commission on 25 September 2009 and (ii) the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance

30 December 2009

CONTENTS

SECTION **PAGE**

Dear Sir/Madam,

The International Swaps and Derivatives Association, Inc. (ISDA) and the Securities Industry and Financial Markets Association (SIFMA) [1] appreciate the opportunity to collectively express our views on the Consultation Paper on Proposals to Enhance Protection for the Investing Public (the "**First Consultation Paper**") and the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance (the "**Second Consultation Paper**") issued by the Securities and Futures Commission (the "**SFC**") in September and October 2009 respectively.

Executive Summary

In the First Consultation Paper, the SFC puts forth a number of proposals aimed to enhance the regulation of the sale of retail investment products in Hong Kong and to restore investor confidence in the financial market. The First Consultation Paper follows the SFC's review relating to the sale of unlisted structured products highlighted by the collapse of Lehman Brothers Holding Inc.[2] The First Consultation Paper is "premised on Hong Kong continuing to adopt a largely "disclosure-based approach" coupled with conduct regulation on intermediaries who sell products"[3].

ISDA and SIFMA strongly support this undertaking and are committed to rebuilding confidence in the Hong Kong structured products market, including working with our respective members to assist in reviewing and, where necessary, reinforcing the existing regulatory regime. In addition, we strongly agree with the SFC's conclusion in favour of maintaining the existing disclosure-based approach, which we note is in line with the practice adopted by other major international financial centers.

We also appreciate and support the SFC's objective to harmonise the regulatory regimes under the Companies Ordinance ("**CO**") and the Securities and Futures Ordinance ("**SFO**"), as set out in the Second Consultation Paper.

We would take this opportunity to express our gratitude to the SFC for answering our members' queries at a meeting hosted by ISDA on 19 October 2009 (the "**October ISDA Meeting**"), and for hosting a number of briefing sessions for industry participants in early November and the forum on cooling-off and disclosure of benefits in December, which we found most helpful and informative.

The primary focus of this paper is our response to the First Consultation Paper, and we have set out our views on selected proposals therein. In particular, we have not addressed Questions (11) to (17) in the First Consultation Paper relating to the revised code on unit trusts and mutual funds and investment-linked assurance schemes respectively, which may be the subject of a separate response by market participants and the corresponding industry groups. We have also set out our views on a number of areas in the Second Consultation Paper.

Our comments in this paper represent our members' views primarily from the perspective of manufacturers of investment products; however some of our members have expressed views in relation to the requirements applying to intermediaries as well.

Individual members will have their own views on different aspects of both the First Consultation Paper and the Second Consultation Paper, and may provide their comments to the SFC independently.

In our comments, we will make frequent reference to applicable principles drawn from the following publications of the Joint Associations Committee (the "**JAC Principles**")[4]:

(i) Principles for Managing the Distributor-Individual Investor Relationship regarding Structured Products (*reproduced at Appendix 2*); and

[1] Descriptions of these associations are provided in Appendix 1.
[2] The First Consultation Paper, Part I, paragraphs 6, 9 and 11.
[3] The First Consultation Paper, Part I, paragraph 22.
[4] The Joint Association Committee is sponsored by five leading trade associations (International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), European Securitisation Forum (ESF), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA)).

(ii) Principles for Managing the Provider-Distributor Relationship regarding Retail Structured Products (*reproduced at Appendix 3*).

Hong Kong's market offers a wide range of investment products to investors to help meet their own unique financial objectives in light of their particular circumstances. The challenge in reviewing the regulatory regime in response to the recent events is to ensure that any new measures introduced do not have the unintended consequence of stifling the market as a whole and depriving investors of products which may be eminently suitable for them. To that end, the interests of the industry and of the regulators are aligned in ensuring that the lessons from this experience are well understood and serve to focus the review of the regulations, whilst being careful to preserve a regulatory framework that is conducive to product innovation and future growth. If the regulatory review is conducted with this in mind, investors will be better protected, but still have the opportunity to invest in an ever evolving suite of diverse and appropriate products to meet their particular investment needs.

A brief summary of our position on key proposals is as follows:

Disclosure Enhancements

- We largely support the codification of existing market practice for structured products in the form of Appendix C (which includes the introduction of a products key facts statement) and Appendix D to the SP Code. Our comments are primarily suggestions and requests for clarification in order to fine tune the proposals and ensure that the overall approach remains robust.

- We also agree that ongoing disclosure should be provided to investors to keep them informed throughout the tenor of their investments; however we believe this should be achieved in a manner that is consistent with the nature of unlisted structured products, in that they are "hold to maturity" investments and the primary concern for investors is whether an issuer of the product has the financial capability to fulfil its obligations. We have therefore made a number of suggestions to ensure ongoing disclosure is practicable for product providers and meaningful for investors. These include aligning certain requirements with those applicable to listed structured products, particularly in relation to the provision of financial reports in both English and Chinese within 4 months of the date to which they relate and disclosure of information that may have a material negative effect on the ability of an issuer to fulfil its commitments under a product.

Increasing product transparency

- We generally agree with the proposed eligibility requirements for issuers and guarantors, and the appointment of a Hong Kong product arranger for SPV issuers. Again, our comments on these issues seek mainly to clarify the requirements, such as making sure that eligibility requirements apply only at the time of a product's issue date.

- We acknowledge that the industry has to have processes in place to make sensible commercial decisions about what products should be sold to whom.[5] However, we have a number of concerns with the proposed measures relating to collateral and reference assets. We believe that the proposed eligibility criteria for collateral are overly restrictive and that the proposal to prioritise investors' claims to collateral proceeds is fundamentally inconsistent with the way products are currently structured. We also feel strongly that under a disclosure-based regime, reference assets should not be subject to eligibility criteria. We have therefore set out our comments and suggestions for a modified approach in these areas.

[5] This is reflected in Principle 6 (New Product Review) of the JAC Principles for Managing the Distributor-Individual Investor Relationship (which provides that "New structured products, whether developed by the distributor or developed by a third-party provider or manufacturer, should be subject to the distributor's product review and assessment process. This process should take into account the nature of the new structured product, the target investors, and an assessment as to whether the product is appropriate for its intended target market.") and Principle 3 of the JAC Principles for Managing the Provider-Distributor Relationship (which provides that "Product providers should consider what internal approval processes are appropriate for retail structured products; any such processes might address such issues as sign-off, product structuring, risk-reward and distribution."). See Appendix 2 and Appendix 3.

- We agree that it is important that investors should be able to assess the performance of their investments, and should be given a means to exit an investment before maturity, if necessary. However we believe it is important to again bear in mind that unlisted structured products are designed to be long-term investments and, on this basis, we have set out various recommendations regarding how, at what frequency, and for which products, indicative prices and liquidity should be provided.

- We strongly believe that product providers should be required to satisfy themselves (instead of confirming to the SFC) that a product, as at its issue date, is designed fairly and is appropriate for a generic class of investors, subject to the intermediaries' suitability checks.

Intermediaries' conduct

- In general, our comments in relation to investor characterisation and the client profiling process is that these processes should not be subject to an overly prescriptive or "box ticking" approach, but that intermediaries should be afforded discretion while being guided by clear principles in the conduct of their business. On this basis, we generally do not support the creation of a category of "investors with derivatives knowledge", mandatory audio recording, nor increasing the minimum portfolio threshold of HK$8 million for high net worth investors.

- We support pre-sale disclosure of benefits, as it is important that investors are made aware of any potential conflicts of interest before a decision is made to invest in a particular product. In general, we believe that the appropriate approach is specific disclosure by way of percentage bands or ceilings.

Cooling-off

- We generally support the introduction of an "option to unwind" (a term we suggest should be used in place of "cooling-off period") in certain limited circumstances. However, we believe that investors are better protected, and their confidence in investment products are better enhanced, through increasing their understanding of a product, and by ensuring proper suitability checks at the intermediary stage, as well as providing liquidity for investment products.

Second Consultation Paper

- We appreciate and support the SFC's effort to rationalise and harmonise the two existing offering regimes, but strongly believe that the replication of certain private placement safe harbours in the CO (in particular the HK$500,000 minimum denomination/consideration exemption and the "not more than 50 persons" bright line exemption) into the SFO is a fundamental and essential part of this exercise. We also feel that further consideration should be given to the proposed definitions of "structured product" and "securities", and have made a number of suggestions to ensure that the definitions do not inadvertently capture products that should not be subject to regulation under some or all parts of the SFO and the related subsidiary legislation.

Comments on specific proposals in the First Consultation Paper

We set out below our comments in relation to a number of selected proposals from the First Consultation Paper.

1. **Overarching Principles**

> "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."

1.1 Members welcome the SFC's efforts to standardise and codify requirements for the offer documentation and advertising of different investment products into a single Handbook as described in the First Consultation Paper, and support the SFC's objectives to enhance product disclosure and increase product transparency.

1.2 Members generally agree with the principles as set out in the Overarching Principles section. However, members would appreciate the SFC's guidance on the following matters.

1.3 *Paragraph 5.3 (Selection of distributors)*: Members would ask the SFC to clarify that this requirement may be satisfied through product providers having in place clear internal policies and guidelines on how to select and conduct due diligence on distributors as part of the selection process (for example, through assessing whether the distributor provides proper training for its sales staff), and that the intention is not to place the onus of ensuring distributor competence and/or ongoing compliance with the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the "**Code of Conduct**") onto product providers, as distributors are licensed by or registered with the SFC and are required to comply with the applicable requirements set out in the Code of Conduct. In light of this, members also submit that the reference to "due care and diligence" should be replaced by "reasonable care and diligence", as otherwise it will be unduly burdensome for product providers to comply with this requirement[6].

1.4 *Paragraph 5.6 (Language)*: Members express considerable concern on the requirement for the Chinese and English versions of the offering documents to be of equivalent standing, which is technically impossible to comply with as it is inconceivable that there will be no inconsistencies between the two language versions. This requirement may also provide an opportunity for arbitrage between the different language versions. In any event, issuers should be permitted to state that (i) in respect of financial statements and the legal terms and conditions of a product, one language version will prevail over the other in the event of inconsistency; and (ii) one language version of the offering document is a translation of the other (which is an approach consistent with prospectuses authorised under the Companies Ordinance). Members would also ask the SFC to clarify that the requirement for equivalent standing of Chinese and English versions only applies in respect of offering documents, and not in respect of any other ongoing disclosure information provided by product providers.

1.5 *Paragraph 7.2 (Issue of advertisements)*: Members would like clarification on the requirement that advertisements be authorised by a "delegate designated by the senior management of the issuer of the advertisement", and suggest that it should be made clear that such a delegate can be an employee of the issuer's group and not necessarily an employee of the issuer of the advertisement, and that the delegate will not assume personal liability to investors for the content of the advertisement.

1.6 **For the foregoing reasons, we largely support the proposed provisions of the Overarching Principles Section, but would appreciate the SFC's guidance on the points highlighted above.**

[6] A similar requirement is also included in paragraph 3.5(g) of the SP Code. Our comments here therefore also apply to that paragraph in the SP Code.

2. **Disclosure requirements**

> "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?"

Appendix C

Members agree with the general principle that "an offering document should contain the information necessary for investors to be able to make an informed judgment of the investment", [7] and therefore welcome codification of much of the existing practice for unlisted structured products in Appendix C. However, while the items contained in Appendix C should serve as a helpful checklist, in practice its application should be flexible and considered in light of the particular circumstances of each product. Members' comments on certain of the specific content requirements are set out below.

Para 2(f): Key components of the structure and any embedded derivatives

2.1 Members support a generic description in the offering documents that the relevant product involves derivatives. However, a detailed disclosure of the "key components of the structure and embedded derivatives" could be confusing to investors, as it involves technical concepts that cannot be easily explained comprehensively with a plain language approach.

2.2 A misguided assumption is sometimes made between product risk and product complexity. It is also sometimes suggested that products with complicated structures are not suitable for retail consumption as they cannot be easily understood. This is based on the fallacy that investors need to understand the details of the underlying structure of the products. We submit that what investors need to understand is not necessarily the detailed underlying structure of the product, but its potential returns and related risks. A detailed description of the components and derivatives underlying a product may distract investors from a proper assessment of the product, the focus of which should be the payout and risks.

2.3 Members therefore suggest that a more user-friendly approach to a retail investor should be that the technical and legal descriptions of the structure and embedded derivatives be as set out in the legal documentation for the product, which will be specified as display documents in the offering documents and are available for inspection to any interested parties.

Para 6: Product key facts statements

2.4 Members support the proposal for the inclusion of product key facts statements ("**Product KFS**") for unlisted structured products offered to the Hong Kong public and agree that it should be a helpful means to assist investors to understand the key features and risks of the products[8].

2.5 Members however believe that the Product KFS should not be subject to a prescribed "best practice" 4-page limit. It will also be difficult to implement in practice given that the template Product KFS for unlisted structured products is itself almost 4-page long before the product specific details are included. Whilst a suggested (rather than prescribed) format of the Product KFS is welcomed, the emphasis should be on the Product KFS being clear, concise and comprehensive in explaining the product's key features, possible investment outcomes and inherent risks, and with this in mind, there should be an element of discretion afforded to product providers in formulating the Product KFS. Limiting the Product KFS to 4 pages is no guarantee that it will be reader-friendly, and there is less need for a page constraint where the SFC is required to approve the Product KFS.

[7] This is reflected in Principle 1(Product Transparency) of the JAC Principles for Managing the Distributor-Individual Investor Relationship, see Appendix 2.

[8] While the Product KFS for unlisted structured products forms part of the offering document, members may have different views as to whether the Product KFS for unit trusts and mutual funds should form part of the offering document or be a standalone document, and individual members will submit their views to the SFC separately.

2.6 Members are concerned that using one template Product KFS to cover the wide spectrum of unlisted structured products (including equity-linked investments, equity/credit/commodity-linked notes, equity-linked deposits and collateralised structured products issued by SPV issuers) may oversimplify the differences amongst this diverse array of products and mislead investors. While members agree that comparability is desirable, a one-size-fits-all approach would not be practical. Different products warrant different considerations, and therefore the Product KFS should be principles-based and not overly prescriptive[9]. Members would appreciate the opportunity to work with the SFC to design further templates for different types of unlisted structured products.

Para 23 and 24(f): Governing law, conflicts of laws and recognition of judgments

2.7 Members would like to seek guidance on the extent to which issuers are expected to explain the choice of laws (other than Hong Kong law)[10], and issues relating to conflicts of laws and recognition of judgments in connection with a guarantee or enforcement of collateral. Members are concerned that the proposed obligation may potentially be too onerous given the complexity, uncertainty and the wide variety of circumstances involved. These are highly complicated areas of law, and therefore it is difficult, if not impossible, to include a meaningful summary in the offering documents. Members therefore suggest the obligations can be discharged by including a generic and brief description in the form of a risk factor.

Para 25: Credit ratings

2.8 Members suggest that it would be helpful if the SFC could work with the market participants to develop standard language on explanations of credit ratings to ensure consistency in the offering documents.

Para 26-30: Reports and accounts

2.9 Members consider that reproducing reports and accounts for two financial years in the offering documents would often result in very bulky documents (especially given that this obligation will now apply to the issuer as well as the guarantor and each key product counterparty where applicable). Members propose that incorporation by reference, which is a practice now adopted in most other major international financial centers, be permitted where the financial information of the issuer/guarantor/key product counterparty is readily available (for example, online or made available for inspection). Further, members also suggest that issuers be permitted to make the financial information available electronically (for example, online or by way of email or CD-ROM distribution), which is an efficient and environmentally friendly means of disclosure.

2.10 In respect of overseas issuers (such as US banks) that prepare their financial statements other than in accordance with Hong Kong accounting standards and the IFRS, the requirement under paragraph 28(b) to conform auditors' reports to either standard would be very costly. This would add to the overall cost of the products, which will ultimately be passed on to investors. Chapter 15A of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the "**Listing Rules**") applicable to listed structured products does not carry a similar requirement. To introduce it into the SP Code would create inconsistencies in the disclosure requirements for financial statements applicable to different products issued by the same product issuer in Hong Kong under the listed and unlisted platforms. Members therefore urge the SFC to expand the scope to include other internationally recognised accounting standards.

Para 34(b): Warnings/statements/legends to be included

2.11 Members generally welcome the introduction of standard responsibility statements. However, members suggest that such responsibility statements should be qualified so that they are made by

[9] The main content requirements of a prospectus prepared in accordance with the EU Prospectus Directive are that the summary of such prospectus ".shall, in a brief manner and in non-technical language, convey the essential characteristics and risks associated with the issuer, any guarantor and the securities…". Members consider that such a principles-based approach to the content requirement is preferable to any detailed prescribed content for the Product KFS.

[10] Similar requirements are also set out in paragraphs 5.6 and 5.17(d) of the SP Code. Please see also our comments in paragraphs 11.14 to 11.15 below in relation to choice of law and jurisdiction.

issuers, guarantors or product arrangers based on their knowledge and belief as at the date of an offering document. In addition, members seek clarification that paragraph 34(b) is not intended to change the current practice whereby a guarantor takes responsibility for information relating to itself, and an issuer takes responsibility for the rest of the document, subject to a carve-out for third-party information that has been properly extracted from public sources.

2.12 **For the foregoing reasons, we largely support the proposed requirements under Appendix C, but would appreciate the SFC's clarification and guidance on the points highlighted above.**

Appendix D

2.13 Members support the introduction of advertising guidelines for unlisted structured products and recognise that Appendix D substantially codifies the existing practice. Members, however, seek clarification on the following requirements.

2.14 *Applicability*: Appendix D states under "Application of advertising guidelines" that "advertisements" do not include general marketing materials "without reference to any particular product". Members would seek the SFC's clarification that this means that advertisements with references to a generic product type (as opposed to a specific series or stand-alone offering) can still be issued without authorisation, as is the case under the current practice.

2.15 *Note (1) to paragraph 1*: Instead of including a description of the derivative component as proposed, members suggest issuers of advertising materials should only be required to include a generic statement that the relevant product involves derivatives, particularly considering space limitations in most advertising materials. An investor's primary initial concern should be to understand possible investment outcomes together with the related risks, and not to have a detailed knowledge of the product's underlying structure and they can be directed to read the offering documents for a more detailed description of the product. Please also refer to our comments in paragraphs 2.1 to 2.3 above.

2.16 *Paragraphs 13 and 24:* Members consider the requirement to set out all the prescribed warning statements to be impractical and onerous where the advertising channel is radio, television, cinema or any other channel that is subject to time constraints (for example, limited air time) or space restrictions. Flexibility should be allowed for advertisements disseminated through these channels. In this context, we would highlight that the *Guidelines on Marketing Materials for Listed Structured Products* published by the SFC in September 2006 state that the level of detail required for disclosure of risks will depend on, among other things, the "nature and form of the marketing materials", and set out a list of "bare minimum" risks to be included in all marketing materials and a separate list of other risks to be included as appropriate. Members suggest the SFC should introduce a similar concept in Appendix D.

2.17 Members note that paragraph 6.7 of the SP Code provides that the SFC may review, and even withdraw, its authorisation for advertisements at any time. Members would like to seek clarification on the situations where the SFC would consider exercising such powers.

2.18 **For the foregoing reasons, we generally support the proposed advertising guidelines, subject to our two suggestions above.**

3. **<u>Ongoing Disclosure</u>**

> "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?"

3.1 Members agree that investors should be given a certain level of information about their products throughout their tenors. However, this requirement has to be considered together with the

fundamental nature of most unlisted structured products, being that they are designed to be held to maturity.

3.2 In principle, members believe that the information that will be most helpful to investors is the indicative bid prices of structured products, as factors affecting the price of the products should have been reflected in such indicative bid prices. In respect of indicative valuation and market making, please see our comments in paragraphs 8 and 9 below).

3.3 A balance also needs to be struck between protecting investors and overloading investors with too much information, in order to avoid the unintended result that the disclosure may trigger investor panic and precipitate panic selling by investors in cases where such selling may not be warranted.

3.4 The scope of information proposed to be disclosed must therefore be carefully considered and we set out below members' comments on the proposed requirements.

Financial information

3.5 *Paragraph 7.6(a)(i)*: Members urge the SFC to relax the time limit of 4 months after the date to which financial statements relate, and allow more time at least for the preparation of translations. Otherwise, it will be impossible for most issuers to comply with the proposed requirement, because in practice it takes considerable time to translate financial statements following publication. This is particularly onerous for issuers whose annual reports are officially published in neither English nor Chinese. Members note that Chapter 15A of the Listing Rules contains a similar requirement to deliver to the Hong Kong Stock Exchange annual reports within 4 months, but without the additional need for translations[11]; members therefore urge the SFC to adopt a similar approach in the SP Code, such that annual reports are required within 4 months only in their original language with English and/or Chinese translations (as the case may be) of the financial statements (instead of the entire annual report) to follow as soon as practicable. Alternatively, members suggest that issuers should be required to translate only the key items in the income statement and balance sheet within the 4-month timeframe.

3.6 *Paragraph 7.6(a)(ii)*: Again using Chapter 15A as a point of reference, the obligation to deliver any interim report should similarly be required within 4 months only in their original language, with the English and/or Chinese translations (as the case may be) of the financial statements (instead of the entire interim report) to follow as soon as practicable. Members also suggest that instead of translating the entire financial statements in the semi-annual report or quarterly report, only the key items in the income statement and balance sheet need to be translated. This would be similar to the practice for the level of information to be included in listing documents for Chapter 15A products. Further, as many issuers are not required to publish quarterly reports in their home jurisdictions, members urge that this requirement should be clarified by differentiating between half-yearly and quarterly reports, and by inserting "where published" to make it clear that quarterly reports will not have to be prepared solely for the purpose of satisfying the SP Code – such an approach would be consistent with the requirement applicable to listed structured products under Chapter 15A of the Listing Rules.

3.7 *Paragraph 7.6(a)(iii) and (iv)*: The scope of the information captured under these two paragraphs is potentially very wide, especially for issuers that make frequent filings in an overseas jurisdiction. While it is possible to deliver the relevant information in its original language, members suggest that these documents should not be required to be translated. Otherwise, flexibility should be built in for the translation to follow as soon as practicable.

In addition, the reference to information provided to "other securities or financial regulator" in paragraph 7.6(a)(iv) may capture sensitive information which has been provided to an overseas regulator in confidence and which is not in the public domain even in the relevant overseas jurisdiction. It would therefore not be appropriate for such information to be disclosed to investors in

[11] Rule 15A.21 of the Listing Rules requires an issuer to deliver its annual reports to the Hong Kong Stock Exchange within 4 months. It does not require a translation to be provided within such time limit. However, where an issuer wishes to continue offering listed structured products under its programme, it will have to translate the annual financial statements for inclusion in its updated base listing document. This practice is consistent with the practice currently adopted for unlisted structured products.

Hong Kong. Members note that there is no similar requirement for listed structured products under Chapter 15A of the Listing Rules and urge that a consistent approach be adopted.

3.8 *Note (2) to paragraph 7.6(a):* Members consider that the "best practice" to prepare and issue supplemental offering documents should only apply to the extent that products are continuously being offered under a programme. Where an issuer is no longer offering new products under a programme, it should be permitted to discharge the continuing disclosure obligations under this paragraph by delivering the relevant documents to the SFC and making it available to investors through the means of dissemination discussed in paragraph 3.10 below.

Material adverse changes and changes in circumstances

3.9 Members express considerable concern over the requirements set out under paragraphs 7.6(b) and 7.6(c) of the SP Code, and members are not aware of similar requirements currently being imposed in other major comparable jurisdictions on retail structured products and at present no international consensus has been reached on the need for such a requirement[12]. In particular, members would highlight the following major issues:

3.9.1 What amounts to a "material adverse change" that is "material to investors' interests" or an event having "a material negative effect on the ability of [a relevant party] to fulfill its commitments" is subject to different interpretations and covers too broad a range of circumstances.

3.9.2 It may not be possible to determine whether an event is "material" until some time after the event has occurred. Also, in view of the logistics of sending notices (e.g. translation requirements so that the notice is in both English and Chinese and the potential for delay by distributors to relay the notice to investors), it may take some time for the notice to ultimately reach the end investors. For these reasons, it may be difficult to notify investors in a "timely and efficient manner" (as required by General Principle 2 in the Overarching Principles section). There is therefore the danger for a conclusion to be drawn with hindsight that a certain event should have been disclosed to investors or that notice could have been administered more efficiently, giving rise to potential disputes between issuers and investors.

3.9.3 There is considerable overlap between the requirements set out in paragraphs 7.6(b) and 7.6(c), and having what is effectively two material adverse change requirements may lead to confusion. It is important to note that the primary concern of investors in structured products is whether an issuer and/or guarantor has the financial capability to fulfill its obligations under the product. Investors in equity shares have a different consideration, and their primary concern will be the business and profitability of the relevant company.

3.9.4 Members therefore suggest streamlining these two requirements by removing the requirement in paragraph 7.6(b) as any event affecting an issuer's ability to fulfill its obligations should have been covered by paragraph 7.6(c). This approach would be consistent with the standard applicable to listed structured products under Chapter 15A of the Listing Rules.

3.9.5 In the event that paragraph 7.6(b) is to be retained:

- The reference to "business" should be deleted as it can be subjective and as explained above, an investor's primary concern in the structured products is the ability of the issuer to fulfill its obligations, which is measured by its financial condition.

- The requirement should not cover the issuer's and guarantor's respective corporate groups as it is too wide for financial institutions that operate on a global basis and any

[12] We note that there is currently an ongoing enquiry in the EU of much more limited scope with regard to product transparency. For example, the Committee of European Securities Regulators (CESR) is currently conducting a consultation on the extension of MiFID post-trade transparency requirements to Asset-Backed Securities (ABS), Collateralised Debt Obligations (CDO), Asset-backed Commercial Paper (ABCP) and Credit Default Swaps (CDS), which have predominately been sold to institutional investors.

change in the corporate group may not necessarily impact the issuer's or the guarantor's financial condition, and to the extent that it does, it will be captured under paragraph 7.6(c).

3.9.6 In any event, the requirements in paragraphs 7.6(b) and (c) should be qualified by providing that:

- the assessment is to be in the reasonable opinion of the issuer or guarantor; and
- disclosure should only be required "to the extent permitted by applicable law, rules or regulations".

Means of dissemination

3.10 Members suggest that ongoing disclosure obligations should be capable of being satisfied by dissemination of the relevant information via intermediaries or by means of web-based disclosure through:

- the website designated by issuers; and
- a proposed "official SFC website" (members strongly support recent discussions urging the SFC to set up a website, similar to the stock exchange's website for ongoing disclosure, onto which all market participants may upload information as appropriate. Such a website would be beneficial to investors as it will offer them a central location to access all disclosure documents).

Trustee/custodian

3.11 *Paragraph 7.6(d)(ii)*: Given that product providers are already required to exercise due care and diligence in selecting the trustee and custodian under paragraph 5.4 and considering that the trustee/custodian is a separate entity from the issuer, members consider it is impractical, if not impossible, for product providers to continuously monitor and notify the SFC and all investors of any breach of the SP Code by a trustee or custodian of which it "ought to be aware after reasonable enquiry". Members therefore suggest that these words should be removed.

3.12 **For the foregoing reasons, we urge the SFC to modify the continuing disclosure obligations specified in paragraph 7.6 of the SP Code in light of our comments above.**

4. **<u>Eligibility Requirements for Issuers and Guarantors</u>**

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

4.1 In principle, members agree that the eligibility requirements for issuers and guarantors have been introduced to enhance product transparency and will help restore investor confidence. Members, however, suggest that certain requirements be clarified to facilitate a smooth implementation.

4.2 Members are concerned that the requirements under paragraph 3.3(a)(ii) of the SP Code in relation to good standing may in practice be difficult for most issuers to comply with if a literal interpretation is to be adopted. For example, there may be technical breaches and it is almost impossible for any major financial institution to confirm that it has "never been convicted of any offence under applicable securities or corporate laws or other laws involving fraud or dishonesty", especially if it has a long operating history in multiple jurisdictions. It is therefore necessary that these requirements should be qualified by a materiality test (for example, by reference to events having a material adverse effect on an issuer's ability to discharge its obligations under the structured product) and a time limit.

4.3 In addition, members consider that the eligibility requirements should only apply at the time of product's issue date. Issuers and guarantors should not be required to comply with the eligibility requirements throughout the life of the products as their ability to do so will depend on a variety of factors, many of which are beyond their control. Where there is a credit rating downgrade, for example, while we accept that the relevant issuer or guarantor may no longer issue new products, it would not be appropriate for it to cease to be eligible as an issuer or guarantor for products that have already been issued, nor should it be considered to be in breach of the SP Code. Please also see our comments in paragraph 11.16 below with regards to compensation to investors.

4.4 **For the foregoing reasons, we support the introduction of eligibility requirements on issuers and guarantors but urge the SFC to modify the requirements in light of our comments.**

General obligations of the issuer

4.5 Members also have the following comments on two specific requirements under paragraph 3.5 of the SP Code:

4.5.1 *Paragraph 3.5(e):* While issuers will have systems in place to disseminate ongoing disclosure information, members would appreciate if the SFC could clarify that the requirement in this paragraph does not have the effect of requiring them to continuously monitor their distributors or holding them responsible for events that are beyond their control, such as delay by distributors in relaying the information to investors. Issuers' obligations for ongoing disclosure should be considered discharged once the information has been provided to distributors for dissemination to investors. The requirement to notify investors in a "timely and efficient manner" under General Principle 2 in the Overarching Principles section should be construed accordingly.

4.5.2 *Paragraph 3.5(f):* Members seek clarification on the meaning and level of independence required in relation to systems for "independent valuation of the structured product or of any collateral". Issuers do not generally seek third party independent valuations of its structured products[13]. On this basis, members strongly suggest that this requirement for independence be removed or otherwise clarified (for example, by stating in the SP Code that this requirement can be satisfied by valuations done in-house by product providers, subject to proper internal controls over the valuation process). In any event, members would highlight that it is inevitable that there will be a certain level of information flow from one internal team to another within the issuer's organisation – for example, certain parameters required for valuation will need to be provided by the trading team to the team determining the valuation.

4.6 **For the foregoing reasons, we urge the SFC to clarify the requirements under paragraphs 3.5(e) and (f).**

5. **<u>SPVs and Product Arrangers</u>**

> "Question (5):
>
> (a) What are your views on the proposed requirements applicable to SPV Issuers?"

5.1 Members do not object to the proposed requirements applicable to SPV issuers.

> "Question (5):
>
> (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

[13] Please see also paragraph 8.3 below in relation to the difference between the valuation and price of structured products.

term of the structured product?"

5.2 Members do not object to the requirement to appoint a product arranger for SPV issuers.

5.3 However, members would make the following suggestions:

5.3.1 The eligibility requirements generally under paragraph 4.2 should only apply as at the issue date of a product and not throughout its tenor. (Please see similar comments in relation to issuers and guarantors in paragraph 4.3 above.)

5.3.2 The requirements under paragraph 4.2(b) should be qualified by a materiality test and a time limit. (Please see similar comments in relation to issuers and guarantors in paragraph 4.2 above.)

5.3.3 The requirement under paragraph 4.4 for product arrangers to "ensure that the Issuer at all times complies with the applicable requirements in the Handbook" may not be commercially feasible. At present, product arrangers are generally engaged to handle purely administrative matters. This reflects the fact that the products are often structured in a way that there is generally minimal or no financial reward for the product arranger. Requiring a product arranger to assume such an onerous responsibility under paragraph 4.4 is disproportionate in terms of risks and rewards, therefore in practice it would be almost impossible to find any party willing to take on such a role as a product arranger. Moreover, it would be unreasonable to hold a product arranger answerable for compliance of the Handbook by an SPV issuer when the SPV issuer is ultimately an independent legal entity over which the product arranger has no effective control. Members therefore urge that this requirement be removed, as the role of a product arranger should be to serve as a communication channel between an SPV and the investors and regulators in Hong Kong, similar to the role of a "representative" under paragraph 9.3 of the Code of Unit Trusts and Mutual Funds.

5.3.4 Members consider that a product arranger should not be required to be licensed or registered for both Type 1 and Type 4 regulated activities, given that the product arranger is not engaging in any advisory activity.

"Question (5):

(c) Do you think a Product Arranger should also be appointed for structured products issued by Issuers (whether SPVs 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)?"

5.4 Members believe that a product arranger should not be required to be appointed where the issuer or guarantor satisfies the requirement of being a "Regulated Entity" that is already subject to the regulatory oversight equivalent to that of Hong Kong.

"Question (5):

(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."

5.5 Members do not consider further obligations or requirements should be imposed on product arrangers.

5.6 **Subject to the foregoing comments to clarify the eligibility criteria for product arrangers, members do not object to the requirement to appoint a Hong Kong product arranger for SPV issuers.**

6. Collateral

> "Question (6):
>
> (a) What are your views on the proposed eligibility criteria for collateral in respect of structured products?"

6.1 While recognising that the eligibility criteria for collateral are introduced to enhance product transparency to better serve investors' interest, members are concerned that certain of the proposed criteria are overly onerous and difficult to comply with in practice. The requirements effectively limit the pool of qualifying assets to cash or an extremely narrow class of securities such as treasury bonds, which will have a significant impact on the structure of transactions and make it commercially unrealistic for issuers to come up with viable structures, with the undesirable effect of limiting the range of investment choices available to investors.

6.2 In order to uphold a disclosure-based approach, members suggest that the list should be used as a helpful starting point for issuers in their selection of collateral and to the extent that a collateral does not satisfy certain of the prescribed requirements, the use of that collateral should nevertheless be permitted so long as the associated risks are adequately disclosed in the offering documents. Flexibility should also be built into the SP Code (for example, by providing that the relevant criteria may be modified or dispensed with as the SFC deems appropriate in light of the circumstances of each transaction) to enable it to develop alongside the market as new products evolve.

6.3 Members note that a Product Advisory Committee will be set up to provide advice on policy and market trends across different product areas. As such, as an alternative to having a prescribed list of eligibility criteria in the SP Code (which may curtail market innovation), consideration can be given to leaving the evaluation of eligible collateral to the discretion of the Product Advisory Committee from time to time in order to enable the SP Code to develop alongside the market as new products evolve.

6.4 In addition, it should be made clear that the eligibility criteria are applicable only as at the date of issue of a product, and not during its tenor, as collateral can be affected by market events that are beyond the control of the issuers. Please see our related comment in relation to the application of eligibility requirements in paragraph 4.3 above.

6.5 Members have the following comments on certain of the specific requirements:

6.5.1 *Paragraph 5.13(a)*: Given that much of the instruments used for collateral are bonds which are normally traded over the counter, it is not possible to assume that prices for collateral will be continuously available. The requirement for the collateral to be liquid and tradable may in practice preclude instruments such as money market funds from being used (which in the professional market are considered as cash equivalents). Members would therefore appreciate guidance on the types of collateral that would be considered to be "liquid and tradable" and that would satisfy this requirement.

6.5.2 *Paragraph 5.13(j)*: Given that collateral is generally ring-fenced to each issue of notes, it is not clear whether the requirement for collateral to be "appropriately diversified" would require each batch of collateral to contain a mixture of assets; as presently drafted, it is unclear whether collateral comprising solely of different series or tranches of US treasury bonds will satisfy this requirement. Members suggest that diversification should be left to the discretion of issuers on a case-by-case basis, rather than through codification.

6.5.3 *Paragraph 5.13(k)*: The obligation to ensure collateral does not subject investors to "undue risk" is a very subjective and vague concept. This requirement should be removed unless objective standards are included to clarify it.

6.5.4 *Paragraph 5.14*: Other than cash and certain highly liquid securities (for example, US treasuries) which may be marked-to-market on a daily basis under normal market conditions, the valuation process of collateral often takes a couple of days to complete. Members suggest that collateral should be marked-to-market at the same frequency that indicative pricings are required to be provided – please see our comments in paragraph 8 below. It is also difficult to disclose valuation policies in offering documents as it could involve disclosure of sensitive proprietary information.

Members also note that the valuation of collateral is required to be independently conducted, and suggest that the SP Code should be revised to clarify that the requirement for independence can be satisfied by the establishment of proper internal controls over the valuation process, coupled with appropriate checks and balances.

6.5.5 *Paragraph 5.17(d)*: Please refer to our comments in paragraph 2.7 above in relation to the requirement relating to conflicts or cross-border insolvency issues.

6.5.6 *Paragraph 5.19:* Issuers should not be required to make a confirmation to the SFC that the collateral "adequately protects the interests of investors", given that there are factors affecting the security arrangement that are outside the issuer's control and the interests of different investors may vary. There is also the danger for a conclusion to be drawn with hindsight that a certain collateral was inappropriate at the outset in the event that the proceeds from such collateral fail to meet the claims of all investors due to such factors which are beyond the control of the issuer.

6.6 **For the foregoing reasons, we strongly urge the SFC to adopt a flexible approach to the use of collateral and to clarify or modify the eligibility criteria and requirements applicable to collateral; in particular we suggest that the proposed confirmation under paragraph 5.19 of the SP Code should be removed.**

"Question (6):

(b) Do you think that collateral should be subject to any additional eligibility criteria? If so, what criteria?"

6.7 Members do not think that collateral should be subject to any additional eligibility criteria.

"Question (6):

(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?"

6.8 Members consider that the proposal for prioritisation of investors' claims to the collateral proceeds is inconsistent with the very nature of structured products and marks a significant departure from international market practice. Members therefore strongly object to this proposal.

6.9 According priority to investors' claims is a significant deviation from current market practice, as one of the fundamental premises for a swap counterparty agreeing to a limited recourse arrangement in a collateralised SPV issue is that it would have a secured claim over the collateral, with priority over the investors. It is precisely because of the risk allocation in such a structure that the swap counterparty is prepared to perform its obligations and assume the associated risks under the swap, and that investors are able to enjoy higher potential returns on their investments as a result of their

bearing the risk of being subordinated to claims of the swap counterparty. Without such priority, it would be difficult in practice to engage any swap counterparty who would be willing to participate in a subordinated arrangement or to maintain comparable returns to investors, given the disproportionate risk and reward allocation for the swap counterparty. Adopting a structure that gives investors priority as proposed would therefore decrease the potential return of the relevant products to a level that such structured products would be unappealing and ultimately unmarketable.

6.10 Members, however, would consider it acceptable, and note that it is not uncommon, for documentation to provide for the priority between the swap counterparty and the investors to be reversed in the event that the swap counterparty is in default or insolvent (although the enforceability of such a provision is currently the subject of litigations in the UK and the US arising from the collapse of Lehman). In those circumstances, the investors will have priority over the swap counterparty.

6.11 Members therefore strongly urge that the correct approach is not to prioritise investors' claims to collateral proceeds, but for the associated risks to be brought to investors' attention by means of appropriate risk disclosures in the offering documents.

6.12 **For the foregoing reasons, we strongly oppose the proposed requirement for investors' claims to collateral proceeds to be prioritised and urge the SFC to modify the proposed measures to take into account the above comments.**

7. **Reference assets**

> "Question (7): Do you believe that 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 for a structured product? If so, please list such additional criteria / factors and give an explanation for each."

7.1 Members consider that the requirement under paragraph 5.7 for reference assets to be "acceptable to the Commission" is tantamount to introducing a merit-based regime through the backdoor. Members believe that under a disclosure-based regime, any reference asset should be eligible as long as it can be properly disclosed.

7.2 Similarly, members believe that reference assets should not be subject to eligibility criteria. A key feature of structured products is the wide range of assets that can be referenced. It should also be borne in mind that in practice product design is often driven by and tailored to investors' and market demands. To subject selection of reference assets to eligibility criteria would significantly reduce the number of products available to the Hong Kong market and curtail product innovation.

7.3 If reference assets are to be subject to eligibility criteria (to which members object), members strongly urge that flexibility should be built in so that issuers will be permitted to use a reference asset notwithstanding that it does not fully satisfy certain of the prescribed eligibility criteria, so long as the associated risks are adequately disclosed in offering documents.

7.4 Members would also highlight the following specific concerns in respect of the factors that the SFC proposes to take into account under paragraph 5.8 of the SP Code:

7.4.1 *Note (2)*: The requirement for the information on reference assets to be made available in English and Chinese may preclude the use of a large number of non-Hong Kong related reference assets (such as well-known overseas stocks and indices) and may otherwise place considerable burden on issuers to translate information which is not available from public sources. Further, a key design consideration and appeal of structured products linked to overseas reference assets is their ability to offer Hong Kong investors exposure to assets to which they would not otherwise have access. This requirement will restrict product innovation and deprive investors of investment opportunities that would otherwise

be available. It is also contrary to the practice for retail investment funds where an investment manager may invest in non-Hong Kong underlying assets. Further, Chapter 15A of the Listing Rules does not have a similar requirement for overseas reference assets.

7.4.2 *Note (4)*: Clarification is needed on the criteria to determine whether the number of reference asset in a basket is "reasonable in light of the product strategy or objective and the intended target market", and that issuers will not be required to provide ongoing disclosure in relation to any change in index methodology or composition unless such change gives rise to an adjustment (in which case the issuer will notify the investors in accordance with the terms and conditions of the product).

7.4.3 *Note (5)*: Shares of most listed companies are to a certain extent controlled by the controlling shareholders. We understand that this requirement relating to "control or influence by one party or a group of parties" is primarily intended to apply to proprietary indices. Members would therefore appreciate the SFC's clarification in the SP Code.

7.5 **For the foregoing reasons, we urge that reference assets should not be subject to eligibility requirements, but to the extent they are, they should be modified in light of our comments above.**

8. **Indicative valuations**

> "Question (8):
>
> (a) Should indicative valuations of structured products be required to be provided 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."

8.1 Members agree that it is important to provide investors with regular performance information in relation to the structured product they hold[14] and consider that the indicative bid price (and not valuations) is the best measure for investors to assess the performance of their investments and the impact of any market events.

8.2 Members are, however, mindful that most unlisted structured products are designed as "hold to maturity" instruments and care must be taken to ensure that investors are not inadvertently misled or confused into thinking that unlisted structured products are traded products or that there is an active secondary market for them.

8.3 It is important to draw a distinction between a valuation and a bid price of a product. Valuation entails a measure of the "value" of a product determined in accordance with the product provider's internal valuation policies. On the other hand, a bid price represents the price at which an issuer will be prepared to buy back the product at a given time, and will have taken into account factors such as break funding costs, unwind costs and the quantity of the product to be bought back (which will not necessarily be reflected in a valuation). Members therefore believe that indicative bid prices instead of valuations should be disseminated to investors, as it is a more accurate measure of the potential amount which investors will get if they wish to sell their products at a given time.

8.4 Members believe that daily provision of indicative bid prices as proposed is neither practicable nor desirable as it would create a false impression that there is an active secondary market for the structured products or that investors may profit from trading structured products. Members however understand the importance of providing investors with regular price information in relation to the structured products which they hold and generally support the SFC's proposal in this regard. In relation to the frequency at which indicative bid prices should be provided to investors, currently there is no consensus among members. Some members suggest that the provision of indicative bid

[14] This is reflected in Principle 7(Liquidity/Secondary Market), 7a(Client Valuations) and 12(Post Trade Follow-up/Product Life Cycle Issues) of the JAC Principles for Managing the Distributor-Individual Investor Relationship, see Appendix 2.

prices should be done on a monthly basis and believe that such requirement would be consistent with the existing practice of intermediaries to provide monthly statements of investment products to investors; whereas other members have indicated that they are prepared to provide indicative bid prices for certain products on a weekly basis. In any event, members suggest that the requirement to provide indicative bid prices should only be applicable to products with a tenor of over one month.

8.5 Members submit that issuers should not be required to provide indicative bid prices where there is a market disruption event, extreme market volatility or other similar circumstances, and would appreciate if the SFC can provide for exemptions under such circumstances in the SP Code.

8.6 In addition, members seek clarification on the following requirements:

8.6.1 Indicative valuations (or preferably indicative bid prices as noted above) are required to be determined on an "independent basis". Pricing is usually done in-house by a team within the issuer or its affiliate and it is generally not possible to obtain third party pricing for certain proprietary products. Members therefore urge that the requirement for independence should be removed. If this is not possible, then the requirement should be clarified by providing that it can be satisfied by valuations done in-house by product providers, subject to proper internal controls over the valuation process.

8.6.2 In addition, members are concerned with the obligation for an issuer to "provide a timely and effective explanation to investors" where there is a "material fluctuation in the indicative valuation". Members do not believe that it can be feasibly carried out in practice, for the following reasons:

- Issuers will take different views on materiality, resulting in inconsistent disclosure for similar products in the market or possibly a deluge of warnings to investors by issuers concerned to guard against liability arising from this requirement.

- Interpretation of the reasons for any fluctuation is subjective. Factors affecting prices of structured products are diverse, many of which are beyond the control of the issuers and may involve unsubstantiated market rumours (such as events or rumours relating to underlying assets), which may in turn lead to the creation of false markets. To the extent that any fluctuation results from an event relating to an issuer, the relevant information will in any event be disclosed as required by the applicable ongoing disclosure obligation. In this context, please see our comments in paragraph 3.9 above.

- Issuers will receive, in the course of their banking and investment banking activities, confidential and market-sensitive information, and an open-ended obligation to explain to investors any material fluctuation on the indicative valuation of a product may well conflict with confidentiality obligations.

8.7 **For the foregoing reasons, we submit that indicative bid prices (and not indicative valuations) should be provided no less frequent than monthly, and only for products having a tenor of over one month. Further, the requirement for independent pricing should be clarified, and issuers should not be required to explain material fluctuations in indicative bid prices.**

9. **<u>Liquidity provision</u>**

"Question (8):

(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?"

9.1 Members again highlight that structured products are designed to be held to maturity, but recognise that it is important to provide investors who wish to exit their investment with a means to do so.

9.2 Members would ask the SFC to consider that firm bids cannot be quoted in all circumstances. Certain structured products are forward priced, and as such any firm bid price is time sensitive and can quickly "go stale" even with normal market movements. Therefore any bid price offered will depend upon a number of factors, including the unwind costs, break funding costs and prevailing market conditions. These considerations together make it impossible to provide firm bids for these products that are meaningful to investors until a sell order is confirmed. In this respect, members would draw an analogy with the practice for the redemption of mutual funds, where the actual executed price is available only on the next business day after a redemption request is executed.

9.3 To the extent that it is possible to provide firm bids for certain products, such firm bids can only be given on request, as a firm bid is dependent on, among other factors, the quantity of the product to be bought back and the market conditions at the relevant time. It should be noted, however, that depending on the nature of the product, a firm bid may only be valid for a very short period of time.

9.4 Members therefore respectfully submit that:

9.4.1 The SP Code should provide an exemption to the obligation to provide liquidity for products with a tenor of less than six months, because (i) short-term products expose an investor to the possibility of market risks for a shorter period of time, and (ii) it is rare in practice for investors to request early redemption of short-term products given that investors will usually have formed a view on the trend of the underlying.

9.4.2 For products with tenor of at least six months, liquidity can be provided subject to the following:

- liquidity should be provided by means of firm price quotations upon request, provided that to the extent it is not practicable to provide firm price quotations, indicative price quotations can be substituted;

- any obligation to provide liquidity should be on a best efforts basis only and subject to market conditions: members propose that the SFC should specify the circumstances under which issuers are not required to provide liquidity, for example, where trading in the reference asset is suspended or there is a market disruption event or extreme market volatility. Reference can be made to the exceptional circumstances when liquidity providers are not required to provide liquidity for listed structured products; and

- product providers should be permitted to specify the minimum trade size below which, and/or a maximum trade size above which, a request for a bid price will not be accommodated, so long as such thresholds are clearly disclosed in the offering documents.

9.5 **For the foregoing reasons, we propose that firm bids should be provided on request only, provided that if that is not practicable, indicative bids may be given instead. Any liquidity provision should be on a best efforts basis and subject to market conditions.**

10. **<u>References to annualised returns in advertisements</u>**

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

10.1 Members agree that the use of annualised returns should be subject to appropriate disclosure as proposed by the SP Code.

10.2 **We support the SFC's proposals relating to annualised returns.**

11. **Other comments on the SP Code**

Pursuant to paragraph 124 of Section 1 of the First Consultation Paper, we set out below members' comments on other parts of the SP Code.

Para 1.5: Nomination of an individual as an approved person

11.1 In relation to paragraph 1.5 of the SP Code, members recommend that the scope of persons eligible to be appointed as an approved person pursuant to section 105(2) of the SFO be broadened to include persons other than the directors (e.g. members of senior management), particularly in light of the requirement that such persons must also ordinarily be resident in Hong Kong. Members would ask the SFC to clarify that no additional personal liability (other than any liability under existing law) will attach to a person acting as an approved person. In addition, members consider that the approved person should not be required to be licensed or registered for both Type 1 and Type 4 regulated activities, given that the approved person is not engaging in any advisory activity in performing its functions.

Para 5.1: "Fair design" and "appropriate"

11.2 Paragraph 5.1 of the SP Code requires issuers and product arrangers to "confirm to the Commission that a structured product is designed fairly and is appropriate for the market(s) for which it is intended". Members strongly consider such a confirmation to be inconsistent with a disclosure-based regime. Under a disclosure-based regime, the focus should be that the disclosure is true, accurate and complete, and the task of ensuring suitability for individual prospective investors is necessarily for the intermediaries to determine.

11.3 We note that representatives from the SFC clarified at the October ISDA Meeting that the intention behind this requirement is not to replace the intermediaries' obligations and suitability checks required under the Code of Conduct and the focus is on whether the structure and pricing of the products are fair for the market as a whole. In this context, members emphasize that the retail market in Hong Kong embraces a diverse range of investors with different education backgrounds, investment experience, investment objectives, and degrees of sophistication. It is therefore extremely difficult to conclude whether a product is "fair" or "appropriate" for the market as the interests of different investors are not necessarily aligned and what may be fair and appropriate for one group of investors may not be so for another. There is also the danger for a conclusion to be drawn with hindsight that a product could not have been fair and appropriate at the outset in the event that a product does not perform optimally. Therefore, instead of referring to the "market" as a whole, members believes that consideration should be made on the basis of a particular "market segment" comprising investors with a particular investment strategy, investment objective and risk appetite for which the relevant product is designed.

11.4 Members are also concerned about the liability that may be attached to such a confirmation, particularly considering that it is a criminal offence under section 383 of the SFO to make a false or misleading representation in applications to the SFC.

11.5 However, members recognise that issuers should be guided by a principles-based approach in the structuring of products for distribution to retail investors.[15] Therefore, instead of requiring issuers and product arrangers to make a confirmation to the SFC that "a structured product is designed fairly and is appropriate for the market(s) for which it is intended", members suggest that issuers and product arrangers should only be required to satisfy themselves that they have given due consideration to the principles in relation to fairness and appropriateness, provided that the criteria for "fairness" and "appropriateness" are set out in an objective and clear manner. Members would

[15] This is reflected in Principle 3 of the JAC Principles for Managing the Provider-Distributor Relationship, see Appendix 3.

welcome the opportunity to work with the SFC to develop the relevant standard criteria regarding product fairness and appropriateness.

11.6 Members submit that it should be made clear that (i) the issuer's assessment of the principles above is only made on the issue date of the relevant product on the basis of a generic investor base, without regard to individual investors' particular circumstances; and (ii) whether the product is suitable for a particular investor is to be determined by the intermediaries in compliance with any applicable requirements under the Code of Conduct.

11.7 **For the forgoing reasons, we are strongly opposed to the requirement for the issuers and products arrangers to confirm to the SFC that a structured product is designed fairly and is appropriate for the market(s) for which it is intended.**

Para 5.2 and 5.5: Key Product Counterparties

11.8 Members seek clarification on the scope of "Key Product Counterparty" as defined in paragraph 5.5 of the SP Code. Representatives of the SFC clarified at the October ISDA meeting that the intention is to cover SPV issues or repackaging transactions in which investors' return will be affected by (and their recourse are typically limited to, among others) payments under the underlying hedging transactions, but it will not apply to other hedge providers in 'balance sheet' transactions with whom issuers transact to hedge their obligations under their investment products. Whilst the verbal clarification is most helpful, the existing definition is not clear and will give rise to confusion. We therefore urge the SFC to clarify this point in the SP Code.

11.9 Members seek clarification on the meaning of "independent" as used in paragraph 5.2 of the SP Code, and in particular, whether it means "unconnected". It is very common, and may in fact be desirable from a risk management perspective, for issuers or product arrangers to belong to the same group of companies as key product counterparties. Members would highlight that in practice there would be little incentive for an unaffiliated key product counterparty to execute a swap or enter into a transaction with a SPV issuer (in part because the SPV is bankruptcy remote and such key product counterparty cannot sue it for payment but must seek redress through the trustee).

11.10 Members again appreciate the SFC's clarification at the October ISDA Meeting that key product counterparties may be an affiliate of the issuer or arranger, and an independent team in the issuer's organisation or internal information barriers, coupled with proper checks and balances, would be considered satisfactory. Members believe that such clarification should be expressed in the SP Code.

11.11 **For the forgoing reasons, we respectfully urge that the reference to "independent" in paragraph 5.2 of the SP Code be clarified.**

Para 5.3: Conflicts of interest

11.12 Members are concerned that the requirement that an issuer should "avoid situations where conflicts of interest may arise…between different parties involved in respect of the structured product" may not be feasible (for example, conflicting interests of the issuer and the calculation agent). It is not uncommon for a number of entities within the issuer's group to assume various roles in a product, and as such a certain degree of conflict inevitably exists. Members suggest that the practical solution is the disclosure of the existence of any conflicts of interest upfront to investors in the relevant offering document. Members therefore seek clarification on whether appropriate risk disclosures and the existence of internal procedures and measures to manage such conflicts would satisfy the requirement under paragraph 5.3.

Para 5.5: "best available terms"

11.13 Members note that it may not be practically possible to ensure that transactions are entered into "on the best available terms" as required by this paragraph, on the basis that there may not be total transparency for pricing of certain derivative transactions, in particular in respect of those involving

proprietary strategies and methodologies. Members urge that "at arms' length" should be the more appropriate test.

Para 5.6: Governing law and jurisdiction

11.14 Members respectfully submit that (i) the expectation for all agreements, guarantees and arrangements to be governed by Hong Kong law, and (ii) the obligations on issuers and product arrangers to ensure that they and their counterparties (e.g. guarantors, paying agents or custodians under medium term note programmes or key product counterparties) submit to the non-exclusive jurisdiction of the Hong Kong courts may in certain instances be impracticable and amount to a fundamental deviation from international market practice.

11.15 This is particularly relevant for issuers that use their global issuance programme with a Hong Kong retail wrapper to make offerings to the public in Hong Kong. To revamp global programme documents to comply with such proposed requirements would be extremely difficult (for example, it is impracticable for a US issuer's guarantee to be governed by Hong Kong law). Too rigid an approach may deter issuers from offering products in Hong Kong, thereby limiting investors' product choices.

Para 7.8: Compensation to investors

11.16 Members are concerned about the effect of paragraph 7.8 of the SP Code, which requires issuers to compensate investors for failure to continue to meet applicable requirements under the Handbook. This will cover an array of events that are beyond the issuer's control as such a downgrade in the issuer's credit rating or a reference asset or collateral ceasing to meet relevant eligibility criteria. Members believe that it would be unreasonable for issuers to compensate investors in such circumstances, or where there is technical non-material breach of the SP Code.

11.17 In any event, members do not believe that the SP Code should require product providers to compensate investors without any due legal process of handling and settling disputes. Investors' right to be compensated should continue to be dealt with under the existing avenues provided by our legal system. Members therefore strongly urge the SFC to remove this provision.

11.18 **For the forgoing reasons, we strongly urge that paragraph 7.8 of the SP Code be removed.**

12. **Transition period**

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

12.1 In principle, members do not object to the SFC's proposal on the transition period. However, members suggest that in respect of programmes existing as of the effective date of the SP Code, the requirements of the SP Code should only come into effect at the time of the next annual update of the relevant programme.

12.2 **For the foregoing reasons, we support the SFC's proposal on the transition period.**

13. **Scope of application of Part III of the First Consultation Paper**

> "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."

13.1 Members agree that some proposals in this part of the First Consultation Paper should only apply to unlisted investment products, as listed products are already subject to oversight of the relevant exchange and are often transacted on an execution basis with no solicitation from the sales staff of

intermediaries. In addition, listed products tend to be highly standardised. It follows that certain proposals are not relevant to listed products, including investor characterisation, pre-sale disclosure of benefits, the use of gifts, sales disclosure document and audio recording.

13.2 However, members note that certain proposals relating to intermediaries' conduct may nevertheless not be appropriate for unlisted investment products either. Please see our comments in relation to Questions (19) to (28) below.

13.3 **For the foregoing reasons, we agree that some of the proposals in this part of the First Consultation Paper should only apply to unlisted investment products, but would draw the SFC's attention to our responses to questions below.**

14. **Investor characterisation**

> "Question (19): Do you think that 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 in ensuring that the investment advice and products offered in relation to unlisted derivative products are suitable?
>
> Please give your views on the contents of the proposed measures for intermediaries to assess whether investors have knowledge of derivatives."

14.1 Members acknowledge the SFC's aim of enhancing investor protection and the need for intermediaries to seek information from investors about their knowledge of derivatives as part of their suitability assessment process.[16] However, intermediaries are already required to seek the relevant information under the existing Code of Conduct and in particular, paragraph 5.3 of the Code of Conduct requires intermediaries to ensure that investors understand the nature and risks of derivatives products. Members therefore do not believe the creation of a separate category of "clients with derivative knowledge" is necessary.

14.2 An overly prescriptive approach of classifying investors into different categories risks turning suitability assessments into a "box-ticking" exercise which undermines the proper process of the intermediary arriving at an informed judgment. Members are of the view that the existing framework to determine suitability is sufficient. Intermediaries should be allowed to tailor their own procedures to discharge their functions under the current requirements, subject to the supervision of the SFC and the Hong Kong Monetary Authority.

14.3 Members would add that derivatives are often embedded in investment products as mechanisms for the allocation of risk. As such, they may be useful for the portfolio diversification and risk management strategies of investors. A misguided assumption is sometimes made between product complexity and product risk, which leads to the illusion that complexity and risk are synonymous. This is clearly not the case – for example, principal protected products may be highly complex in structure precisely because they are structured to reduce risk.

14.4 Provided that the investment recommendation and sale processes are appropriately carried out, embedded derivatives in a structure do not seem a legitimate reason to preclude investors from being introduced to structured products which may otherwise be suitable for their investment objectives and risk profiles. The provisions currently drafted may discourage issuers from creating, and intermediaries from selling, structured products and reduce their availability to the market, possibly to the detriment of investors, and it may in turn have a negative impact on Hong Kong's position as a leading financial center.

14.5 In any event, members believe that the list of criteria under the proposed paragraph 5.1A(b) to the Code of Conduct is too restrictive, with the effect that only a small segment of the public would qualify as having derivatives knowledge and be eligible to purchase the relevant structured

[16] This is reflected in Principle 8 (Client Appropriates and Suitability) of the JAC Principles for Managing the Distributor-Individual Investor Relationship, see Appendix 2.

products. Requiring investors to attend courses is impractical as many would be unwilling to do so. These criteria also presume that course attendance will result in a genuine understanding of derivatives by all attendees, and ignores the fact that investors may gain knowledge in derivatives through other means.

14.6 **For the foregoing reasons, we generally do not support the introduction of a separate category of "clients with derivative knowledge" and suggest that the intermediaries should be given flexibility to assess suitability under the current requirements in the Code of Conduct.**

15. **Professional Investors**

> "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 studied courses which are related to the relevant product?
>
> Do you have any other suggestions?"

15.1 Similar to the comments in paragraph 14 above, members are concerned that the criteria for determining whether a high net worth investor has specific knowledge and expertise may be too restrictive with the result that only a small segment of investors can be classified as high net worth investors, which may have an adverse impact on Hong Kong's private placement market.

15.2 Members suggest that instead of prescriptive criteria, the considerations proposed should only be non-exhaustive examples to assist an intermediary to determine whether a high net worth investor has the requisite knowledge and expertise.

15.3 Members note that the requirement for an intermediary to reassess an investor's knowledge and expertise if he or she has ceased trading for two years (the proposed new paragraph 15.3B of the Code of Conduct) may be unrealistic for certain products or markets and urge that such requirement be removed.

15.4 **For the foregoing reasons, we generally do not support the proposed amendments to the Code of Conduct, and suggest that intermediaries should be given flexibility to assess whether a high net worth investor should be considered to have the requisite knowledge and expertise.**

16. **Minimum portfolio requirement**

> "Question (21): What amount should the minimum portfolio requirement be set at? Please give your reasons."

16.1 Having considered the threshold for private placements in other major international financial centers, the members' view is that the current minimum portfolio requirement in Hong Kong should remain at the existing level of HK$8 million in order to maintain its competitiveness as an international financial center. Raising this minimum portfolio requirement will adversely affect the private placement market in Hong Kong.

16.2 **For the foregoing reasons, we suggest the minimum portfolio should be maintained at the current HK$8 million.**

17. **Pre-sale disclosure of benefits**

Business model 1 – Where a distributor distributes a product and it or any of its associates explicitly receives monetary benefits from that product issuer (directly or indirectly)

> "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 disclosure options would be more appropriate? Please explain your views.
>
> Option 1.1 – Disclosure of dollar amount or percentage
>
> Option 1.2 – Disclosure of percentage bands or ceiling (i.e. "x% to y%" or "up to y%)
>
> Option 1.3 – Generic disclosure

17.1 Members recognise that it is important for intermediaries to disclose any actual or potential conflict of interest to investors as required by the Code of Conduct and therefore agree that commissions and/or benefits received by an intermediary in the sale of a structured product should be disclosed to investors, as this is an important way to mitigate against any conflicts of interest and enhance transparency.[17]

17.2 Members believe that the appropriate approach for disclosure under business model 1 should be option 1.2 (disclosure of percentage bands or ceiling), as members consider this option provides more transparency to investors than generic disclosure under option 1.3, while option 1.1 would not be practicable because many structured products are sold over a marketing or offer period, during which market parameters affecting how commissions are determined (such as, where applicable, prevailing interest rate, credit spreads, dividends and forward contract prices) will fluctuate, which would in turn make it extremely difficult to quantify and disclose a fixed dollar amount or percentage at the pre-sale stage.

17.3 Members' support for option 1.2 is subject to the following suggestions:

17.3.1 Distributors should be given the flexibility to choose whether to disclose a percentage band or a ceiling for a particular product.

17.3.2 Specific disclosure (by way of a percentage band or a ceiling) should be limited to those monetary benefits which are quantifiable at the point of sale.

17.3.3 In respect of any non-monetary benefits or monetary benefits which are not quantifiable at the point of sale, only generic disclosure of the existence and nature of the relevant benefits should be required.

17.4 Members also recommend that it would be helpful if the rules concerning disclosure of benefits in connection with all unlisted investment products were harmonised, for example, the standard of disclosure for funds should be similar to that for other investment products.[18]

> Question (23): Do you have any suggestions as to how the percentage bands referred to in

[17] This is reflected in Principle 3 (Fees and Costs) of the JAC Principles for Managing the Distributor-Individual Investor Relationship, see Appendix 2

[18] Although we support harmonisation of the rules regarding disclosure of commission, we would like to point out that the harmonisation should only be done in respect of equivalent things. In this respect, we believe that a distinction should be drawn between the profit or loss made by the issuer of a structured product and the management fees charged by a fund manager. The profit or loss which may be made by the issuer of a structured product is not analogous to the fees charged by a fund manager, since management fees are deducted from the return which the investor would otherwise have received, whereas product profits made or losses suffered by the issuer are not. For detailed discussions on this point, see paragraphs 33-38 of the JAC Submission to EU Commission in relation to PRIPS dated 17 November 2009 (http://www.isda.org/uploadfiles/_docs/JAC_Letter_17_November_2009.pdf).

Question 22 should be set (e.g. up to 1%, over 1% to 2%, etc)?"

17.5 Members suggest that the range of any percentage band should be set by the distributors depending on the type of products being distributed, and any ceiling should be rounded to the nearest percentage point.

Business model 2 – Where a distributor does not explicitly receive any monetary benefits for distributing an investment product issued by itself or any of its associates

"Question (24): Where a distributor does not explicitly receive any monetary benefits for distributing an investment product, which of the following disclosure options would be more appropriate? Please explain your views.

Option 2.1 – Specific disclosure of distribution reward

Option 2.2 – Generic disclosure"

17.6 For similar reasons to those explained under business model 1 above and subject to our suggestions in paragraph 17.3 above, members generally believe that the appropriate approach for disclosure under business model 2 should be option 2.1 specific disclosure by way of percentage bands or ceilings (as opposed to dollar amounts or percentages).

17.7 Members consider that disclosing a fixed dollar amount or percentage would not be realistic or meaningful under business model 2, as product providers themselves may only be able to estimate how much an external distributor might be paid for.

17.8 Despite members' general support for option 2.1, a number of members are of the view that there may be circumstances where specific disclosure is not practicable under business model 2 because (i) in a case where a product provider only distributes its product in-house, it is extremely difficult, if not impossible, to determine and quantify how much an external distributing firm may otherwise be paid for distributing the same or a similar product; and (ii) product providers/distributors have varied practices in terms of how they account for and allocate internal costs and profits in distributing products. The circumstances surrounding the issue and distribution of products may also be very different for each product provider/distributor. Any estimate may be artificial and based on arbitrary assumptions that cannot be easily compared among different issuers and therefore will be of little value to investors.

Business model 3 – Where a distributor makes a trading profit from a transaction

"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"

17.9 Members submit that a distinction should be drawn between the different types of profits that a distributor may make from a back-to-back transaction. Not all such profits represent "commission" in the form of an incentive. Members agree that if a distributor receives a fee or some other monetary benefit, or purchase a product at a discount from a product provider, as an incentive for the distributor to sell the product, such benefit or discount is similar to a commission and hence should be disclosed. For similar reasons to those explained under business model 1 above and

subject to our suggestions in paragraph 17.3 above, members believe that the appropriate approach for disclosure in such a case should be option 3.1 specific disclosure by way of percentage bands or ceilings (as opposed to dollar amounts or percentages).

17.10 There are, however, certain circumstances where the profit that a distributor makes from a back-to-back transaction is not an incentive received from the issuer and therefore should not be categorised as a "commission". For example, a distributor may make a profit from market movements in its favour during the period between its purchase and sale of a product, or it may be rewarded by the additional risks which it has taken on in a principal-to-principal transaction (such as the assumption of counterparty risk). There is a considerable difference between profits earned by distributors and inducements paid to distributors. This is because the latter are capable of creating conflict or bias and thus the possibility of such bias should be disclosed to the client, whereas the profits that a distributor makes under these circumstances are not inducements and therefore should not be subject to any disclosure requirement.[19]

17.11 Members also agree with the SFC's observations in the First Consultation Paper[20] that in the case where a distributor sources an investment product from its inventory, it will be impossible to provide any meaningful specific disclosure of any trading profit that investors can compare on a like-with-like basis, given that different distributors may have acquired the investment products at different times.

17.12 **For the foregoing reasons and subject to our suggestions above, we generally support disclosure of a percentage band or ceiling in the case of business models 1, 2 and (to the extent that the trading profit is in the form of an incentive offered by product providers) 3.**

18. **<u>Use of gifts</u>**

> "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?"

18.1 Members do not have a strong view on the use of gifts so long as there is a level-playing field for all investment products.

18.2 **For the foregoing reasons, we are neutral on the proposal to restrict distributors from offering gifts to promote investment products to retail investors.**

19. **<u>Sales disclosure document</u>**

> "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 of fees and charges available to investors?"

19.1 Members do not see a compelling reason for having an additional sales disclosure document. Under the current practice, the four categories of information listed are already contained in documents of the intermediaries (such as account opening documents and subscription forms) and/or otherwise captured in the subscription process through audio recording. Members are concerned that too many documents with similar contents may distract investors' attention and discourage them from reading any of them.

19.2 In the event that the sales disclosure document is mandated, members would submit that for products which are frequently purchased on a repeated basis by investors, intermediaries should

[19] See paragraphs 33-38 of the JAC Submission to EU Commission in relation to PRIPS dated 17 November 2009 (http://www.isda.org/uploadfiles/_docs/JAC_Letter_17_November_2009.pdf).
[20] Paragraph 68 of Part III of the First Consultation Paper.

be permitted to provide the sales disclosure document on a one-off basis (for example, at the account opening stage or the first time an investor purchases a specific type of product).

19.3 As members generally express little support for the requirement for an additional sales disclosure document, they do not have any comments on the proposed information content.

19.4 **For the foregoing reasons, we generally do not support the introduction of an additional sales disclosure document which may result in an information overload to investors.**

20. **Audio recording**

> "Question (28): Do you think audio recording of the client risk profiling 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."

20.1 Members believe that the current market practice level of record keeping to be sufficient and are generally of the view that the audio recording should not be made mandatory. This is because audio recording entails significant costs which members believe are not sufficiently outweighed by the benefits accruing to investors. In this context, members would refer to the investors' experience and dissatisfaction as reported by the media in their subscription of the Renminbi bonds issued by Bank of East Asia (China) Limited in June 2009, which demonstrated that overly cumbersome regulatory procedures can be counterproductive.

20.2 Particularly in the context of private banking clients, audio recording is impractical. Given the nature of private banking relationships, the assessment of a client's risk profile and the advising or selling of a product is unlikely to be captured in a single conversation or meeting but may involve numerous discussions over a period of time with not just the client but often also their financial or legal advisors as well as the relevant banker and investment specialist. Furthermore, many discussions take place outside an office environment, making audio recording impractical.

20.3 Members therefore believe that audio recording should be optional, and not mandatory, as the risk profiling and selling process can equally well be controlled and recorded by means of proper documentation and record keeping (pursuant to the current requirements) and internal controls.

20.4 **For the foregoing reasons, we urge against making audio recording a mandatory requirement.**

21. **Cooling-off period**

> "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?"

21.1 Members acknowledge the SFC's remarks during the forum on cooling-off and disclosure of commissions on 7 December 2009, that cooling-off is one of a series of measures proposed to rebuild and enhance investor confidence.

21.2 Members generally support the introduction of a cooling-off period (or preferably an "option to unwind" as explained below) in certain limited circumstances. Members consider that the following factors should be considered in determining whether a cooling-off right should be available:

21.2.1 If the objective is rebuild investor confidence through addressing mis-selling and high pressure sales tactics by intermediaries, then a cooling-off period should not be seen as a primary means to achieve this, as mis-selling will occur regardless of the existence of a

cooling-off period. The focus should instead be on the regulation of intermediaries' activities by the application of the Code of Conduct and the suitability requirements thereunder.

21.2.2 If the objective is not to address mis-selling but to enhance investors' confidence by assisting them to avoid being locked into a long term investment, the solution is already provided by way of mandatory liquidity provision (please refer to our comments in paragraphs 8 and 9), which provides investors with an exit.

21.2.3 Members welcome the SFC's remark that cooling-off period will not come without a cost to investors[21]. Indeed, the introduction of a cooling-off period will necessarily increase product prices, as distributors and issuers will take into account the additional cost in providing investors with the right to unilaterally cancel their orders, despite the fact that not all investors necessarily need or want such a right.

21.2.4 Members also agree with the potential negative effects summarised in paragraph 13 of Part IV of the First Consultation Paper (such as the moral hazards and impact on remaining investors).

21.2.5 Members are concerned that the term "cooling-off period" will mislead investors into thinking that they will be able to receive the full amount invested, and consider that if a mechanism is to be introduced to allow investors to exit their investments, the term "option to unwind" will be more appropriate.

21.3 Having considered the above, members suggest that an "option to unwind" can be introduced in certain limited circumstances, subject to the following:

21.3.1 Any option to unwind should only be available for unlisted retail structured products which:

- have a tenor of at least 3 years; and
- are relatively illiquid with no regular liquidity provision[22].

This should be in line with the SFC's stated position that any cooling-off right (or preferably "option to unwind") should only be available (i) where there will be a relatively long lock-up period for the investment; and/or (ii) where there will not be dealings in the product or other liquidity provision on a frequent basis[23].

21.3.2 The length of any period for an option to unwind should not be the same across all products but should generally correlate with the tenor of a particular product, and in any event should be no more than 7 calendar days.

21.3.3 The option to unwind should only be available to retail investors and not professional investors.

21.3.4 Issuers should be able to account for the cost to unwind any hedging transactions and adjust for any market movements[24]. In any event, the maximum amount refunded by the issuer should be capped at the principal amount originally invested, less any unwinding costs and adjustment for market movements.

[21] Paragraph 13 of Part IV of the First Consultation Paper.
[22] Please see our comments on liquidity provision in paragraph 9 above.
[23] Paragraph 11 of Part IV of the First Consultation Paper.
[24] While there will be unwind costs related to trades that have already been executed, it is also possible, for example, in respect of certain fixed income and credit linked products, that the hedging transactions are entered into at the beginning of the offering period, i.e., before the trade date. Product providers for such products would therefore incur unwind costs upon an exercise of an option to unwind prior to trade date, and should be permitted to take into account such unwind costs so long as that fact is disclosed in the offering documents.

21.3.5 Intermediaries should be able to account for reasonable administrative costs and disbursements, and should be given a reasonable period of time to calculate the amount to be refunded and to carry out the refund process. Please also see our comments in paragraph 21.7 below.

"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."

21.4 Members would highlight that it is not feasible to delay the execution of the trade for certain structured products (such as equity linked investments) that are time-sensitive and require the trade to be executed at the time an order is received. In respect of these time-sensitive products, to delay trade execution in order to accommodate a pre-trade option to unwind would mean that investors will face uncertainty on the price of their investment during the interim period, and (i) will lose out on any rise in value during the interim period, and (ii) any fall in value or change in sentiment may cause investors to cancel regardless of the underlying merits. Investors are therefore ultimately worse off than in the absence of such an option to unwind.

21.5 Therefore, in respect of these time-sensitive products, members believe that a pre-trade option to unwind would not be feasible. In relation to investors' option to unwind in respect of these time-sensitive products after the trade is executed and other products for which it may be possible to delay the trade execution, please see our suggestions in paragraph 21.3 above.

"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."

21.6 In relation to investors' option to unwind after the trade is executed, please see our suggestions in paragraph 21.3 above.

"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."

21.7 Members agree that investors should receive the full amount of refund (including the sales commission) received from the product issuer determined pursuant to paragraph 21.3.4 above, less a reasonable administrative charge, as we mentioned in paragraph 21.3.5 above.

21.8 **For the foregoing reasons, we support the introduction of an option to unwind in certain limited circumstances as set out in our suggestions above.**

22. **Second Consultation Paper**

22.1 Members generally support and are grateful for the SFC's effort to rationalise and harmonise the two existing offering regimes, and transferring the regulation of structured products in debenture form from the CO to the SFO. We would like to take this opportunity to set out below members' comments on the following areas in the Second Consultation Paper.

Definition of "Structured product"

22.2 While members agree that the definition of "structured product" should be flexible, it is equally important to ensure that the new definition is as clear as possible and does not inadvertently capture products that are not intended to be brought within the proposed regulatory changes.

22.3 The meaning of the word "instrument" in paragraph (a) of the proposed definition of structured product should be clarified. As currently drafted, it is unclear whether "instrument" is meant to cover both derivatives in securitised form as well as derivatives which are traded over-the-counter ("**OTC derivatives**").

22.4 The underlyings applicable to an "instrument" in the proposed definition of structured product (which includes any securities, commodity, index, property, interest rate, currency exchange rate or futures contracts, as well as the occurrence or non-occurrence of certain events) is much broader than the underlyings applicable to a "regulated investment agreement" (which covers only "property"). Therefore, if "instrument" is intended to cover OTC derivatives, it will include a wide range of OTC derivatives which were previously not regulated by the SFO.

22.5 Members submit that OTC derivatives are generally private, bilateral contracts entered into by sophisticated market participants, and such private agreements should not be subject to securities regulation, as market standard documentation for OTC derivatives has been effective in documenting contractual obligations and resolving issues between counterparties to OTC derivatives. Regulatory oversight of OTC derivatives would render the market overly restrictive and may have a significant negative impact on Hong Kong's competitiveness as a financial center. Members therefore believe that OTC derivatives should only be regulated to the extent that they fall under the current definition of "regulated investment agreement" and excluded from the meaning of "instrument", and the definition of "structured products" should be confined to products in securitised form.

22.6 If "instrument" is intended to cover only products in securitised form, then this should be made clear in the legislation. On the other hand, if, despite our comment in paragraphs 22.4 to 22.5 above, the intention is for "instrument" to cover not only products in securitised form but to also cover OTC derivatives, then there would seem to be considerable overlap between the products falling under the scope of "instrument" in paragraph (a) and the products falling under the scope of "regulated investment agreement" in paragraph (b) in the definition of "securities", which renders the term "regulated investment agreement" superfluous.

22.7 Further, members urge that the definition of "structured product" should be amended to include the following carve-outs:

- There should be a carve-out for currency-linked instruments and money market instruments issued by financial institutions. While members welcome the exemption for these instruments from section 103(1) under the new section 103(3)(ea), members agree with the SFC's observation that these instruments are general banking transactions and treasury instruments of financial institutions and are therefore typically not regulated by the SFO[25]. These instruments are relatively simple and readily understood by investors. Given the wide scope of products covered by the proposed definition of "structured products", these currency-linked instruments and money market instruments should be excluded from the SFO entirely by providing a carve out in the definition of "structured products" as well as "securities" to ensure that they are not regulated under other parts of the SFO (such as the licensing requirements under Part V of the SFO).

- There should also be a carve-out for convertible bonds, exchangeable bonds and subscription warrants. While members note the SFC's intention that these products should be regulated as "structured products" under the SFO[26], members submit that these products are generally issued for capital fund-raising purposes, and an investor's exposure in these products is akin to that of an investor in the shares and debentures of the underlying company. Therefore it would be more appropriate for these products to continue to be regulated under the CO prospectus regime. If the SFC is concerned that this exemption may be abused by issuers issuing

[25] Paragraph 28 of the Second Consultation Paper.
[26] Paragraph 24 of the Second Consultation Paper.

structured products in these forms, perhaps a solution would be to provide that the carve out only applies to products issued for capital raising purposes.

Classification of all structured products as "securities"

22.8 While members generally welcome the regulation of structured products under Part IV of the SFO (subject to our comments above), members are concerned that a wholesale classification of all structured products as "securities" will have far reaching results, with the effect that all other provisions in the SFO (including the licensing requirements under Part V and the requirements under related subsidiary legislations such as the extensive administrative requirements pursuant to the Securities and Futures (Contract Notes, Statements of Account and Receipt) Rules), which were designed to apply to securities (under the existing definition)), will also apply to structured products [27]. This will require a substantial system and operations overhaul on the part of intermediaries. Given the extensive impact of the proposed change, members submit that this should be the subject of a separate consultation that requires a thorough consideration.

22.9 Specifically, members object to OTC derivatives being included in the definition of "securities" and thereby subject to licensing and other regulatory provisions and subsidiary legislations under the SFO. Please also see our comments in paragraphs 22.4 and 22.5 above.

22.10 Members also submit that currency-linked instruments and money market instruments should be excluded from the definition of "securities". Please see our comments in paragraph 22.7 above.

Safe harbours

22.11 Members are deeply concerned about the unavailability of a number of safe harbours for the offer of products under CO prospectus regime as a result of the transfer of regulation of certain products from the CO regime to the SFO regime, in particular the HK$500,000 minimum denomination/consideration and "not more than 50 persons" private placement safe harbours. Members urge the SFC to replicate these safe harbours into the SFO, as members believe that their continued availability for the distribution of structured products is key to Hong Kong's continual success as a major financial center.

22.12 These safe harbours were included in the CO after due consideration by the regulators and market participants throughout the 2004 CO amendment and consultation process. They are premised on the rationale that the cost of regulation of these private placements for a small group of investors or investors who can afford to make certain amount of investment (and therefore should reasonably be expected to understand and assume the related risks or obtain independent professional advice where necessary) outweighs any potential benefit that such regulation may bring.

22.13 In addition, members consider that there is no logical reason for different treatments of private placements under the CO regime and those under the SFO regime and believe that replicating the same safe harbours into the SFO regime is a fundamental and essential part of the exercise of rationalising and harmonising the two regimes. Members therefore urge the SFC to seize upon this opportunity to align the CO and SFO offering regimes by importing the CO safe harbours into the SFO.

22.14 Whilst members acknowledge that the "professional investor" exemption will continue to be available under the SFO (although the HK$8 million portfolio requirement for high net worth investors is a subject of the First Consultation Paper), members note that this exemption is not often relied upon in practice, due to the difficulty in satisfying the requirements under the Securities and Futures (Professional Investor) Rules relating to documentary evidence and certification of a high net worth investor's portfolio. In practice, most market participants rely on the other safe harbours available.

[27] We understand, however, that the SFC intend to retain the current definition of "securities" under Part VIII and XIV of the SFO and therefore the provisions under those parts will not apply to "structured products".

22.15 Members would also stress that the sale of any investment product is in any event subject to compliance with the Code of Conduct and therefore it should address any concern for any potential mis-selling.

22.16 Therefore, the unavailability of these safe harbours would substantially impair the ability of product providers and intermediaries to provide a wide range of private placement products and thereby limit the investment options available to potential investors. It will also have the unfortunate result of adversely affecting Hong Kong's competitiveness as an international financial center, as robust private placement regimes are available in other financial centers such as Singapore[28], Australia[29] and the EU[30].

HK$500,000 minimum denomination/consideration

22.17 Given the difficulty in relying on the "professional investors" exemption (please see our comment in paragraph 22.14), members would highlight that in practice, the HK$500,000 minimum denomination/consideration safe harbour is currently an important and commonly relied upon safe harbour for the distribution of non-SFC authorised structured products by market participants.

22.18 Members therefore strongly urge the SFC to replicate the HK$500,000 minimum denomination/consideration safe harbour into the SFO. If the SFC's concern is that the threshold is too low, members would like the opportunity to work with the SFC to revise the threshold to a level that is appropriate.

22.19 Members understand that the SFC is concerned that there may be potential abuse if this safe harbour is introduced, and submit that as explained above, the sale of any investment product is subject to compliance with the Code of Conduct and this concern should be addressed by the regulation of intermediaries' conduct. Members would like the opportunity to discuss with the SFC whether this concern can also be addressed by the introduction of anti-avoidance measures (which may be provided in the form of guidance notes) should the SFC consider necessary.

22.20 However, if, despite our comments, this safe harbour is not to be introduced in the SFO, members urge the SFC to relax the requirements under the Securities and Futures (Professional Investor) Rules (in particular the requirement for certification of an investor's portfolio by an auditor or a certified public accountant) so that market participants can avail themselves of the high net worth "professional investors" exemption in practice.

"Not more than 50 persons"

22.21 The "not more than 50 persons" exemption was introduced in the 2004 CO amendment to clarify a legal uncertainty that the market had considered long overdue, given that there was previously no clear definition of "public" in the CO (which is still absent in the SFO). Without this bright line definition, market participants will be exposed to the same uncertainty surrounding the meaning of "public" once again. It will also have a significant impact on the way private placements are conducted in Hong Kong.

22.22 Members strongly believe that it is in the interest of both the industry and investors for there to be certainty in the legislation and therefore urge the SFC to introduce this safe harbour into the SFO. However, should that not be possible, members would greatly appreciate if the SFC can provide some guidance on the interpretation of the term "public" in the SFO and confirm that it considers that an offer to no more than 50 people will not constitute a public offer.

22.23 Members understand that the SFC is concerned that there may be potential abuse if this safe harbour is introduced, and submit that:

[28] In Singapore, exemptions apply to offers to no more than 50 persons, and to offers with consideration not less than SGD200,000 (and it is expected to be reduced to SGD100,000 by the end of 2009).
[29] In Australia, exemptions apply to offers to no more than 20 persons with no more than AUD2 million being raised in any 12 month period.
[30] In the EU, exemptions apply to offers to 100 persons per state, and to offers with denomination/consideration of not less than EUR50,000.

22.23.1 Where the existing "not more than 50 people" is relied upon, members have internal policies to ensure that the requirements of this safe harbour is strictly complied with, including that the limit of 50 is determined by the number of people to whom an offer is made (and not merely those who have accepted the offer) and restrictions are imposed on recipients on distributing any offer document to third parties.

22.23.2 Members understand that the SFC is concerned that this safe harbour may be abused by product providers by issuing similar products with slightly different terms. Members would like to explain that what may appear to be similar products with variation in terms are in fact different products. For example, where the tenor is different (albeit, say, only by one day), other parameters of the products (such as the strike price and barrier price that are dependent on the initial spot price) will also be different. The economic terms of the products will therefore be effectively different. Members however understand the SFC's concern and members would like the opportunity to discuss with the SFC whether this concern can instead be addressed by the introduction of anti-avoidance measures (which may be provided in the form of guidance notes) should the SFC consider necessary.

23. **Conclusion**

We fully support the initiatives of the SFC to review and, where necessary, enhance the existing regulatory regime for unlisted investment products offered to retail investors set out the First Consultation Paper. We also support the SFC's efforts in harmonising the existing two regulatory regimes under the CO and the SFO. We are grateful for the opportunity to present our views on the First Consultation Paper and the Second Consultation Paper, and are committed to working with the SFC in this endeavour to help to re-build confidence in the structured products market in Hong Kong.

Appendix 1

The International Swaps and Derivatives Association, Inc. (**ISDA**) has over 840 member institutions from 58 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective, both in terms of the depth of representation across the derivatives industry and in terms of international representation and understanding of the regulatory arrangements in other jurisdictions.

The Securities Industry and Financial Markets Association (SIFMA) brings together the shared interests of more than 650 securities firms, banks and asset managers. SIFMA's mission is to promote policies and practices that work to expand and perfect markets, foster the development of new products and services and create efficiencies for member firms, while preserving and enhancing the public's trust and confidence in the markets and the industry. SIFMA works to represent its members' interests locally and globally. It has offices in New York, Washington D.C., and London and its associated firm, the Asia Securities Industry and Financial Markets Association, is based in Hong Kong.

Appendix 2

Joint Associations Committee (JAC)

Structured Products: Principles for Managing the Distributor-Individual Investor Relationship[31]

The distributor-individual investor relationship should deliver fair treatment of the individual investor. Individual investors need to take responsibility for their investment goals and to stay informed about the risks and rewards of their investments. Distributors can play a key role in helping them achieve these objectives. In this document, an "investor" means a retail investor who is not an institution, a professional, or a sophisticated investor, and a "distributor" refers to any institution or entity that markets or sells retail structured products directly to an individual investor. This will include an issuer of a retail structured product that markets or sells the same directly to individual investors.

In light of the increased interest in structured products as part of individual investors' investment and asset allocation strategies, it is important for firms to keep these principles in mind in their dealings with individual investors in structured products. These principles complement and should be read in conjunction with our recently released, "Retail Structured Products: Principles for Managing the Provider-Distributor Relationship," available at the websites of the five sponsoring associations[32], which focus on the relationship between manufacturers and distributors. These principles apply to the relationship between the distributor and the individual investor.

Although these principles are non-binding (being intended primarily to help inform firms' thinking) and do not create enforceable obligations or duties, firms involved in the distribution of structured products to individual investors are encouraged to reflect these principles in their policies and procedures. Further, each firm is encouraged, given differing regulatory environments and both cultural and client base differences, to consider the extent to which the firm should adapt these principles to its particular circumstances. As stated in the related Provider-Distributor Relationship Principles noted above (Principle 7), "no party takes on the regulatory obligations of another or the oversight of that other party's compliance with those obligations.".

For the avoidance of doubt, these principles are intended primarily to apply in the context where structured products are actively marketed and/or recommended by distributors to individual investors, and not where distributors are merely executing transactions for investors on a non-advised, non-discretionary basis. Where distributors are executing on this basis, those parts of these principles that are not appropriate to such relationships (for example, those relating to secondary market making and client appropriateness and suitability) shall not apply.

Overview

The term "structured products" refers to a variety of financial instruments that combine various cash assets and/or derivatives to provide a particular risk/reward profile that allows investors access to broader investment opportunities. The return of a structured product is usually derived from the performance of one or more underlying assets. Examples of underlying assets include, but are not limited to: interest rates; a particular equity or debt instrument; a basket of securities; a securities index or indices; an individual commodity or commodities; a commodities index; an individual currency or currency basket; creditworthiness of a security or basket of securities; or any combination thereof.

Some structured products offer full or partial principal protection, while others have no principal protection. Some offer a yield; others do not. It is possible that the value of an individual structured product may not increase as much as the underlying asset, or may decrease more than the underlying asset. Some structured products offer individual investors access to new asset classes that may otherwise be difficult to access through other investment alternatives and which can help with portfolio diversification.

---

[31] Published in July 2008

[32] European Securitisation Forum, International Capital Market Association, International Swaps and Derivatives Association, London Investment Banking Association, Securities Industry and Financial Markets Association

Structured products can be more or less risky than other investment products such as equities, fixed income products, or mutual funds: there is no necessary link between product complexity and investment risk - complex products may be low risk, and non-complex products may entail high risk. It is important that an investor understands the role in an investment strategy that can be played by any particular structured product in light of the investor's specific investment objectives, risk tolerance, and investment horizons.

Principles

These Principles should be read in conjunction with the Overview and Introduction section set out above, which contains important overarching comments to the nature and scope of the Principles. Moreover, the Principles are to be taken collectively, rather than viewing any one Principle in isolation from the others.

1. Product Transparency

The party who is primarily responsible for the creation of marketing materials,[33] or is responsible for a prospectus, or other offering memorandum, should, to the extent permitted by applicable laws and regulations[34], use reasonable efforts to ensure that the material features of the particular structured product are clearly articulated and delineated in such marketing materials or prospectus in a way that enables individual investors to evaluate the investment from a risk/reward perspective. Such party should also ensure that structured product descriptions in client materials and prospectuses are clear and not misleading. This will be helpful to both individual investors' and financial advisors'[35] understanding of the product. Further, to the extent that a distributor is primarily responsible for the creation of marketing materials, such materials should be adapted to, and reflective of, the knowledge and sophistication of individual investors in the target market. For example, it should be clearly disclosed how returns on a structured product are linked to an underlying asset.

Marketing materials that are distributed to, or intended for distribution to, individual investors should be subject to review by the distributor's appropriate supervisory staff, as well as other internal processes, such as compliance or legal, as appropriate.

2. Risk Disclosure

Risk disclosure is important to an investor's understanding of structured products and should be made available to investors before a decision to invest is made. Investors should understand the risks inherent in the product before investing in it. Investors should be informed of the general types of risks associated with structured products, subject to individual regulatory standards as to the specific language required. Particular prominence should be given to any risk not usually associated with a given product, for example, risk of loss due to any sale of the product before maturity, as well as any material product-specific risk that may apply, such as risks arising from the underlying asset, liquidity and market risks in relation to the product itself, or specific tax considerations. Where information on past performance is given, the presentation should be fair and not misleading, and, in particular, should acknowledge any limitations in available data.

3. Fees and Costs

Investors in a structured product should be informed of the existence of fees, costs, commissions, discounts, and any other sums paid to the distributor for acting as such over the life of that product. Distributors should have internal processes and controls in place to consider the appropriateness of fees and other incentives given local market conditions and regulatory requirements. A distributor's internal processes and controls should also consider the level of disclosure regarding such fees and costs in light of

---

[33] The relationship between providers and distributors is specifically addressed in "Retail Structured Products: Principles for Managing the Provider-Distributor Relationship," Principle 5, Joint Trade Associations, July 2007.

[34] In some jurisdictions, law and regulation may specify or limit the form, the content or the presentation of material which may be given to investors. These principles do not require such rules to be disregarded.

[35] "Financial advisor" refers to the firm's employees, or independent contractors, who interact directly with individual investors and who are registered to solicit trades and effect transactions. The formal term may vary significantly by firm and/or jurisdiction.

their possible impact on the secondary market of the structured product concerned.[36]

4. Potential Conflicts Management

Distributors should have internal processes and controls in place to consider potential conflicts issues and identify measures designed to mitigate, manage, or disclose material conflicts of interest arising from the sale of structured products. Such processes should, where necessary or appropriate, provide timely, adequate, and clear disclosure related to conflicts of interest or potential conflicts of interest that may exist or arise in connection with the distributor's sale of the structured product, or as a result of the business they conduct.

5. Credit Ratings

Credit ratings of issuers or, where applicable, guarantors, may not represent a rating of the potential investment performance of the individual structured product itself. Credit ratings, however, should be taken into account to the extent that it affects the terms of the product. If credit ratings are provided, the related disclosure should make clear the significance of the rating. Distributors should use credit ratings accordingly.

6. New Product Review

Distributors should understand the products they distribute. New structured products, whether developed by the distributor or developed by a third-party provider or manufacturer, should be subject to the distributor's product review and assessment process. This process should take into account the nature of the new structured product, the target investors, and an assessment as to whether the product is appropriate for its intended target market. Distributors should also have a process for determining what generally constitutes a "new product." It is not sufficient for a distributor to accept a third-party manufacturer's assessment regarding appropriateness of structured products for individual investors who are ultimately customers of the distributor and not the manufacturer. Distributing firms should conduct an independent assessment.

7. Liquidity/Secondary Market

Investors should be informed before investing of the likelihood of their being able to sell a particular structured product prior to maturity, and of the ways in which this might be done. Any secondary market to be provided by the distributor itself or through an exchange, or otherwise, should be disclosed. If there is little likelihood of such sale or other liquidation being possible, that fact should be clearly disclosed. Investors should be made aware that sales in the secondary markets, even where possible, may be at prices that are below the amount payable on the product at maturity, the original offering price, or the price at which they acquired the product. In addition, distributors should make a clear distinction between an investment in the structured product and a direct investment in the underlying asset, and that the return on the structured product may not reflect the return of a direct investment in the underlying asset, noting in particular that these respective returns may not necessarily move in tandem. For principal-protected products, it should be made clear to investors that the principal protection applies only at maturity, and the costs of unwinding the product mean that an earlier redemption value may differ materially from the potential value at maturity.

7a. Client Valuations

Structured products should be valued on a regular basis and disclosed to the investor through the distributor's normal client statement process or otherwise.

8. Client Appropriateness and Suitability

Where a firm actively markets a particular product, as opposed to merely executing transactions on clients'

[36] Insofar as a secondary market exists for the product. See Principle 7.

instructions, it should determine which particular types of clients the product could properly be sold to (appropriateness) and may also be required to determine whether the particular product is right for a particular client (suitability). Methodologies and standards for making these determinations should be developed by the distributor and adequately communicated to the distributor's financial advisors. Liquid net worth, degree of sophistication, risk profile, age, and investment experience are several variables that may be relevant to such an assessment. Also, financial advisors should consider how a specific structured product would fit into an individual's portfolio. These standards should be reviewed periodically and amended, as needed.

9. Financial Advisor and Supervisor Training

Structured products vary a great deal as to their terms, risk/reward profile, liquidity/availability of a secondary market, underlying asset, and a variety of other factors. As such, it is important that financial advisors interacting with individual investors have an adequate understanding of structured products in general as well as an understanding of the characteristics of the individual structured products being offered. The financial advisor should be able to clearly explain the product's features to an individual investor. Distributors should provide their financial advisors with the necessary training, or access to training, in structured products, including both the benefits and risks of the products, and should consider providing educational materials on structured products generally, in a suitable form (including one-on-one meetings, written materials, class-based training, desktop training, or other forms, as appropriate). Such training should also be provided to those responsible for supervising financial advisors.

10. Oversight and Compliance

Structured product sales to individual investors should be subject to the distributor's internal legal, compliance, and supervisory review processes, policies, and procedures. Distributors should have such supervisory procedures in place covering transactions in structured products, which should involve supervisory staff of appropriate seniority in light of the nature of the particular product and investor target market. Supervisory responsibilities may encompass sales practices, reasonableness of profit/loss potential, fees, and adequacy of training. Managers performing such supervision should have access to appropriate legal and compliance department support.

11. Tax Implications

Investments in structured products may have tax consequences for individual investors depending on their personal circumstances and jurisdiction of residence. Although certain tax implications may be highlighted in product documents, investors should be encouraged to discuss the specific tax implications of structured products with their accountant, tax attorney, or other tax professional.

12. Post-Trade Follow-up/Product Life Cycle Issues

Distributors should provide financial advisors with the necessary information to help their clients monitor performance of any structured product in which they have invested, and provide access to information regarding the terms of that structured product, including its maturity, pay-out details, secondary market price,[37] and other pertinent information.

[37] Insofar as a secondary market exists for the product. See Principle 7.

Appendix 3

Joint Associations Committee (JAC)

Retail Structured Products: Principles for Managing the Provider-Distributor Relationship[38]

A. Introduction

These Principles seek to address issues that financial services firms have in practice found helpful to consider when performing the function of either provider or distributor in connection with the process of delivering structured products to retail investors.

It should be noted that **the Principles are non-binding and, as such, intended purely to help inform firms' thinking**. The sponsoring associations believe market participants should be free to agree their relationships and relative responsibilities on a case-by-case basis, to the extent these are not prescribed by local law or regulation. The Principles are intended to be sufficiently broad in their applicability to provide a reference framework for managing the provider-distributor relationship in retail structured products markets globally.

The Principles are the product of a global working group of firms, taking in the views of both distributors and providers and supported by a coalition of trade associations: European Securitisation Forum (ESF), International Capital Market Association (ICMA), International Swaps and Derivatives Association (ISDA), London Investment Banking Association (LIBA) and Securities Industry and Financial Markets Association (SIFMA). Furthermore, the associations issued the Principles for public comment, obtaining constructive feedback from other trade associations and market participants.

Structured products include a variety of financial instruments that combine various cash assets and/or derivatives to provide a particular risk-reward profile that would not otherwise be available in the market. The exact risk-reward profile varies from instrument to instrument.

The arrangements between the parties, the applicable regulatory regime and the fact that structured products combine various components may in practice result in different financial services parties being responsible for different aspects of the related regulatory obligations (even though the universal-bank model may entail a 'proprietary product distribution' arrangement). In particular, it is common for the distributor to have a direct interface with the retail investor while the provider does not. These Principles therefore particularly focus on how to address this issue, wherever it arises, given that all parties within this distribution 'chain' have a common interest in ensuring that investors obtain satisfaction with regards to their legitimate expectations as to the nature of the investment.

Retail investors in this context will mean natural persons and may include high-net-worth individuals. The Principles do not, unless otherwise indicated, address the role of entities acting solely as issuer of a product.

The Principles are drafted with no single jurisdiction in mind; they are, on the contrary, intended for global use, at a high level. The specific and possibly more detailed procedures that any firm might in practice (and subject to appropriate cost-benefit analysis) adopt to help it manage provider-distributor relationships with regards to retail structured products will be a function of factors such as the jurisdiction or jurisdictions involved, the distribution channel(s) utilised, the precise nature of the products and the nature of the relationship between the parties.

Regulatory treatment may depend on the nature of the component instruments; for instance, depending on the jurisdiction, structured deposits or exchange-traded notes acquired by investors via brokers on a 'reverse-enquiry' basis may each require separate analysis. Among other matters, due consideration will need to be given to post-sale arrangements such as secondary market-making activity and information provision. The sponsoring associations invite industry to consider adapting the Principles, as appropriate, to take account of such specific factors.

B. Principles

[38] Published in July 2007

These Principles should be read in conjunction with the Introduction above, which contains important overarching comments on the nature and scope of the Principles. Moreover, the Principles are to be taken collectively, rather than viewing any one Principle in isolation from the others.

1. Distribution to the retail investor in structured products in many, though not all markets, is effected through intermediaries, e.g. private banks, rather than directly by the product 'provider' (sometimes referred to as 'manufacturer').

2. Where a product provider and a private bank (or other retail-facing business) operate within the same institution, they may operate quite distinctly; they may even be subject to different regulation; or have different reporting and management structures. Any such formal separation is generally robust and will be driven by legal, compliance, confidentiality and other requirements. Thus, even where a product is originated and distributed by the same institution, there can, in practice, be a separation between the manufacturing and distribution functions to which these Principles refer.

3. Product providers should consider what internal approval processes are appropriate for retail structured products; any such processes might address such issues as sign-off, product structuring, risk-reward and distribution.

4. The distribution structure means that it is often the distributor who interfaces with the individual investor and whose client that investor is. In such circumstances, investor suitability (as determined in the local market) is accordingly exclusively an issue for distributors, since it must be considered in the context of confidential information provided by the client to the distributor.

5. Distributors must understand the products they distribute. In jurisdictions where distributors provide not only the issuer's prospectus document but also term-sheets or other marketing material (such as brochures) to their clients, the distributors take responsibility for the accuracy and completeness of those marketing materials, even if they incorporate material provided by the product provider; in these circumstances, a distributor must be satisfied with and take responsibility for such materials and their compliance with local law and regulation.

6. Product providers should ensure that their term-sheets are accurate, fair, balanced and clear (respecting, as appropriate, jurisdiction-specific regulation to this effect); and that they are presented in a way which is consistent with their agreed obligations to the distributor. (For example, where the parties understand that the product will be distributed by the distributor to high net worth individuals, the termsheet should not contain rubric that the product is not suitable for retail investors.) Where providers agree to assist the distributor by supplying information, this should be clear and of the kind requested by the distributor in preparing its own term-sheet or product description for its client; this may include scenario analyses and relevant-to-product risk factors.

7. When commencing dealings with a distributor, product providers should consider whether the distributor is an appropriate distributor for the placing of particular types of products and, where they consider it necessary, practical and appropriate to do so, should conduct a "know your distributor" approval process. There is no fixed form for this process, which can vary according to the circumstances, and there are a number of means by which a provider can gain comfort as to the integrity of a distributor's processes. Issues which may typically be considered include a distributor's typical client type (and whether the distributor deals directly with them or via sub-distributors), suitability determination processes, regulatory status, reputation and compliance with selling laws; though the specific details considered will vary widely depending on the distribution, the particular product and the relevant jurisdiction or jurisdictions. Each party does, in any case, retain its own regulatory obligations; no party takes on the regulatory obligations of another or the oversight of that other party's compliance with those obligations.

8. Distributors should also evaluate product provider counterparties ("know your product provider"), particularly as regards the product provider's performance with respect to those items mentioned in 6 above.

9. To the extent that law and regulation may not distinguish sufficiently between the roles of product providers and distributors, this may create points of uncertainty as to where legal or regulatory liabilities may fall. Providers and distributors should be aware of this and its consequences.

10. Product providers and distributors should seek to agree and record their respective roles and responsibilities towards investors.