

Legislative Council Panel on Financial Affairs

Regulation of sale of structured investment or derivative products

Follow-up to Meeting on 7 July 2008

Background

1. At its meeting on 7 July 2008, the Panel discussed the regulatory requirements for the sale of financial products such as “accumulators” to professional investors. As a follow-up action, the SFC was requested to consider whether the licensed and registered intermediaries should be required, under the Code of Conduct for Persons Licensed by or Registered with the SFC (the “Code”), to disclose to their potential customers that such products had not been approved by the SFC, given that the SFC would review the existing definition of “professional investor” and some financial products such as “accumulators” sold by private banks to professional investors are not required to be approved by the SFC under the existing regulatory regime.
2. This paper sets out the responses of the SFC to the Panel’s request.

Authorization under a disclosure-based regime

3. The authorisation status of a financial product should be put into context by explaining the implications of SFC’s authorisation.
4. Under the Companies Ordinance, the SFC is empowered to authorize the registration of a prospectus offering shares or debentures to the public.
5. Separately, under the Securities and Futures Ordinance (“SFO”), the SFC is also empowered to authorize collective investment schemes (“CIS”) pursuant to various CIS codes so that they can be offered to the public¹; and the issue of any advertisement, invitation or documents that offer securities or other investment agreements to the public of Hong Kong².
6. When the SFC considers whether authorisation should be given in relation to an application, the role of the SFC is essentially to assess whether adequate information is disclosed in compliance with the relevant CIS codes or the Companies Ordinance. Under the current regulatory regime, the SFC is not expected to examine and consider the merits of each product and it is therefore explicitly stated in all SFC-authorized documents that SFC authorisation does not imply its recommendation or endorsement of the offer or the product.
7. The reasons for this regulatory approach are that any regime that required the SFC to endorse an offer or product would delay the ability of issuers to make such offers or products available to the market as quickly as they would want

¹ Section 104 of the Securities and Futures Ordinance

² Section 105 of the Securities and Futures Ordinance. Pursuant to the section, the Commission has so far authorised the issue of offer documents of two accumulators structured as equity linked investments for marketing to the public

to. Moreover, any endorsement that the SFC might issue in any particular case could not adequately reflect the fact that for some investors a particular offer or product might be suitable, but that for other it might not be. Furthermore, such endorsement might lead investors to believe that the offers or products in question are free of risk and result in reduced investor vigilance, when each and every investor should constantly be reminding himself that all investments carry a degree of risk.

Appropriateness of products for investors

8. Investors must assume a level of responsibility to ensure that their investments are appropriate bearing in mind their own particular circumstances (such as investment objective, investment horizon and risk tolerance). In making an investment decision, it is of great importance for investors to consider the product features and its related fees and charges and match the risk return profile of the product with their circumstances. All the information about the product (in particular, that the product has been authorised by the SFC) is clearly set out in the prospectuses and other offering documents for their review.
9. The current regulatory regime requires the SFC to license appropriately qualified intermediaries and imposes on them an onus to ensure that only appropriate investment advice will be given to the investors. To this end, the SFC is continuously making efforts to raise standards amongst intermediaries and to raise awareness and vigilance amongst investors by means of ongoing investor education. This approach is consistent with those adopted in other sophisticated and well regulated jurisdictions and is considered by the SFC to strike an appropriate balance.

Business Conduct of Intermediaries

10. Both licensed and registered intermediaries are governed by the Code in the way they conduct their business activities. The Code, which is principle-based, contains 9 General Principles and a number of more specific requirements. In particular, a licensed or registered intermediary should, inter alia:
 - (a) Act with due skill, care and diligence, act in the best interests of its clients;
 - (b) Make adequate disclosure of relevant material information in its dealings with its client;
 - (c) Ensure that the suitability of the recommendation or solicitation made to a client is reasonable in all the circumstances³; and
 - (d) When providing services to a client in derivative products or any leveraged transaction, assure itself that the client understands the nature and risks of the products and have sufficient net worth to assume the risks and bear the potential losses of trading in the products.
11. If intermediaries fail to observe these regulatory obligations, they may well face disciplinary action, which in serious cases can result in the termination of their licences. For this reason, there is a strong incentive for intermediaries to act appropriately.

³ This may be waived for professional investors subject to conditions.

Investor Education

12. The SFC recognises the importance of investor education. Apart from product education, we also place considerable emphasis on educating investors to ask the right questions as they have the right to know the features and risks of the product to be invested while licensed / registered intermediaries have the obligation to make full disclosure of risks and product information. In this way, investors can make sure that they fully understand the features and downside risks of a product recommended before making an investment decision, and get suitable advice.
13. The approach taken by the SFC is both proactive and innovative. We have and will continue to bring across our messages through a wide array of channels including our InvestEd website (www.InvestEd.hk), radio, TV, broadcast media on buses, newspapers and free investor leaflets. Our outreach programmes include public seminars and educational talks in universities and schools. Moreover, we have organised various kinds of competitions, such as TV quiz shows, story telling competition to improve the appeal of our investor education initiatives.
14. Our education efforts have always kept pace with the product development in the market. We are active in educating investors about the key features and risks of complex products, particularly when they are new to the retail market, such as equity-linked instruments, credit-linked notes, hedge funds, warrants, callable bull bear contracts, futures and options.

Conclusion

15. We consider our existing regulation (in the form of the disclosure-based authorisation regime and the Code requirements governing the business conduct of intermediaries) effective and that it enables investors to have access to all relevant information and advice from intermediaries to help them make a balanced investment decision. However, we are grateful for the Panel's proposal as it serves as a reminder concerning intermediaries' disclosure obligations. Since the Code is principle-based and the licensed and registered intermediaries have the obligation to disclose relevant material information under the Code, it is unnecessary for us to amend the Code as currently drafted. In light of the Panel's proposal, we intend to give further guidance to the industry by issuing a circular and/or FAQ, explaining our expectations that intermediaries should, in appropriate cases, disclose the non-authorisation status of products to their clients rather than amending the Code.
16. At the same time, the SFC would also continue with its effort in investor education and seek to reinforce the importance of complying with the relevant code requirements by taking forceful disciplinary actions in appropriate cases.