SECURITIES AND FUTURES COMMISSION

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Date:	10/11/2004 06:20 PM		
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Subject: Re: Phase 3 CO Prospectus Regime Reforms - Draft Consultation Paper for your comments

I am writing on behalf of IIP in response to your email.

I am copying this email and the attached paper, which sums up IIP's concerns, to everyone on the circulation list as we believe that the CFD paper raises very key policy and operational issues that would affect all other divisions so we would like them to be aware as well.

You will note that we have reservations about some of the proposals (and arguments offered) in the CFD paper. The proposals have significant implications both on our work, and on the market. We should form an internal work group among different divisions to examine the issues and their implications.

We are extremely pressed for time. Our paper may still has typos and presentational problems. I apologize. But we felt that it is very important that we at least get out these views and issues before the tight deadline given.

(See attached file: IIP paper 041110final.doc)

aIIP's response to CFD's draft consultation paper on Phase 3 of the CO Prospectus Regime Reforms

1. This response paper sets out IIP's preliminary comments on CFD's draft consultation paper on Phase 3 of the CO Prospectus Regime Reforms ("the draft paper") which was sent to the divisions by email on 26 October 2004.

Summary of IIP's views

2. It is premature to table the draft paper in its current form for the Board's discussion. Proposals submitted to the Commission for consideration should only be made when consensus on the principal aspects of the reform is reached amongst the divisions.

3. The proposals set out in the draft paper are new initiatives that are much wider than reform of company law provisions. They impact on the SFO regulatory regime. Market impact analysis and comprehensive benchmarking of international standards should be provided in the draft paper.

4. The disclosure regime is inadequate in dealing with regulatory concerns including conduct issues. There are merits in relying on the existing mechanisms under SFO Part IV for product regulation than undertaking a revamp of the entire CO regime, but these options have not been thoroughly examined. The SFO Part IV provides the flexibility to ensure structural safeguard, corporate governance and continuous compliance of the products and intermediaries involved.

5. We support the objective of moving towards a post-vetting regime. However, it does not appear to us, at least not from the paper, that CFD has considered the dimensions and implications of the necessary structural reforms, both in the regulatory framework that SFC now administers and Hong Kong market operations, that would be required in order for a post-vetting regime to function. Unless and until we have made these assessments and are satisfied that they are appropriate and manageable, we should not push any post-vetting proposals.

6. The adoption of post-vetting should be carefully considered, in particular, whether it is appropriate for secondary market sales where the merits of the product should also be considered.

7. It is recommended that a working group comprising representatives from the divisions whose work will be affected by the proposals be set up to thoroughly consider the full impact of the proposals to the market, and on the work and regulatory approach of the Commission.

8. If CFD were minded to table the draft paper to the Board without properly addressing our concerns set out in this memo, we would request that CFD's paper be tabled in tandem with a copy of this paper to the Board so that the Board is given a different perspective to assist it in its discussion. The proposals in the CFD paper have far reaching implications for the market. If we issued it without thorough assessment of its implications, we could be faulted in the same way that we faulted in the Penny Stock incident.

Overview of the draft paper

9. The draft paper contains complex and substantive issues about the entire regime concerning the offer of securities and the way intermediaries conduct is involved in securities offerings in Hong Kong. It is incumbent on the part of IIP to devote sufficient time to examine them in detail. Unfortunately, IIP has not been engaged in the policy development stage, and was only given two weeks to review the draft paper. We are only able to highlight in this response fundamental problems about the draft paper and potentially industry provocative issues for the consideration of all the divisions.

10. In general, IIP shares the regulatory mission that a regulator should strive to ensure that investors' interests are protected and it is the regulator's responsibility to ensure that reforms are undertaken to enhance the quality of the market. As a regulatory body, we must identify "the most important problems", fix them and tell

the world. The Commission has been adopting a "risk based approach" both in its implementation of rules and the promulgation of new policies. We believe new policy proposals, while can be bold in making, should nonetheless be able to:

- identify the key risk areas;
- examine existing regulatory tools that may be able to fix those risks;
- where new tools are needed, justify the need for the new tools; and
- assess the impact to the market and investors as a whole via a cost and benefit analysis.

11. In previous Board meetings of the Commission, the Board advised that staff should carefully consider and structure their proposals. It was commented that the proposals should not only represent the individual division's aspiration towards a particular regulatory regime, but also be well-thought through measures so that only mature ideas (rather than half-baked ones) are presented to the Board for meaningful discussion.

12. We feel that the draft paper contains proposals that are more than a Phase 3 reform of the Companies Ordinance because a significant number of proposals therein are not necessarily natural development from the proposals made in the Phases 1 and 2 of the Companies Reform. Instead, each of the principal proposals represents a distinct topic on securities under the SFO; and the scale of public consultation on each of them could be as extensive as a stand-alone project in light of the recent scale of policy consultations by the Commission since SFO.

13. The proposals also change the Commission's regulatory philosophy. If changes are made for the better, IIP would give its support. But this cannot be ascertained until careful consideration and discussion take place internally (and soft consultation if need be). Is there a need to change the way we regulate? What is gained by the changes? Would the negative impact on the market and the relationship between the regulators and the industry outweigh the perceived gain? Can the perceived gain be achieve by other ways?

14. The draft paper has not identified the problems to the current regime that warrants such fundamental changes. Some of the proposals are presented as if they were unrelated to and independent from each other. IIP questions whether the right tools are used for the current problems, and whether consideration is given as to whether the tools under the SFO can be used to tackle the issues.

15. Without going into the specifics of each of the proposals, we would like to highlight areas that would raise major concerns because of the lack of:

- Clear presentation of the key regulatory problems and risks faced by the regulator.
- Comprehensive picture about the pros and cons of the overhauls of the current regulatory frameworks under the SFO and the CO.
- Technical and market impact analysis taking into account the regulatory principles underpinning the SFO and the unique features of the Hong Kong market.

As stated above, due to time constraints, we do not intend to set out exhaustively the fallacies in some of the proposals. However, we would present our key observations with the use of appropriate examples.

16. IIP considers that all divisions should come to agreement on changes of this scale. The work of various departments will be affected by the proposals significantly, not to mention their impact on the industry. A cross-divisional working party should be set up to study all the proposals and a detailed impact analysis should be conducted with proper liaison with all the divisions whose work will be affected by the proposals.

17. We believe that proposals submitted to the Commission for consideration should only be made when consensus on the principal aspects of reform are reached amongst the divisions. Given the gravity of the reforms proposed, and the inadequate internal discussions and consultation conducted to date, we are concerned that the serious regulatory and conduct issues are not properly assessed.

18. IIP also wishes to emphasise the importance of market consultation. IIP has conducted extensive soft consultation in the recent analyst conflicts of interest rules. For a relatively straightforward exercise (amendment to the Code of Conduct) where the proposed rules are very much in line with the international standard, IIP had to meet over 40 related parties in order to ensure all the issues were thoroughly considered and discussed in the context of how the proposals will work in the industry. Each proposal in the CFD draft paper deserves serious consideration in its own right. Soft consultation should be conducted before the proposals are issued for consultation formally.

19. While our position is neutral on all the proposals, the draft paper fails to discuss with appropriate reference to existing provisions in the SFO and the related subsidiary legislation that may be implicated in the proposal to abolish the public offer concept. Under the SFO, the conduct of intermediaries and their compliance standards and systems have been founded on the concept of public offers, which is in turn pervasive throughout the SFO. Without an appropriate examination of possible impact to the industry and the SFO framework, we have concerns that the Board of the Commission is not given a comprehensive picture.

Key reforms underlying the draft paper and principal fallacies

20. As the draft paper now stands, its approach is to disperse various serious issues belying several key projects in the form of questions posed in connection with the reform of individual CO provisions. We are mindful of the need to put the issues in an integral perspective so that readers of the draft paper could have an overview of the thrust of various key regulatory reform initiatives.

Replacement of the document based approach for offers of securities

21. The draft paper stated that whenever offers of securities are made, the obligation of issuance of a disclosure document is triggered unless the offer falls within a specified exemption. The reason given in the draft paper was to *"provide for greater certainty in the law by regulating the act of offering rather than the*

document containing the offer". It is not clear from the draft paper what kind of regulatory risks and problems in "the act of offering" the proposal is meant to fix. Would the intention be to deal with the key issues of product disclosure and mis-selling of products by distributors?

22. On the point of mis-selling, it is worthwhile to point out that Ian Johnston, Executive Director of ASIC, in the earlier discussions and sharing session with the Commission, pointed out that the issues about mis-selling in the Hong Kong market revolve around conduct issues. The draft paper did not cover how Australia has dealt with product disclosure in the so-called "transaction based" regime. A close look of the Australian regime reveals that the product disclosure requirement is in fact part and parcel of the conduct requirements imposed on intermediaries. The Australian Corporations Law places the obligation of producing a product disclosure document on the "regulated person" rather than the issuer. The draft paper fails to highlight the differences between the overarching framework of the Australian system for offers of financial products and those in HK.

Fallacy that the CO is a better avenue to regulate offers of non-ordinary course capital raising activities

23. The proposal that the CO regime should be transferred to the SFO regime and thereby allowing "exotic financial products" to be regulated under the new CO regime under the SFO has overlooked the scope of the SFO and how in practice the SFO has been applied to facilitate market development while ensuring investor protection in a structured manner.

24. It is a misnomer in the draft paper to call the regime under SFO Part IV an "investment advertisement regime". The operation and mechanics of SFO Part IV should be understood properly.

25. When financial products are authorised under SFO Part IV, be they structured as a corporate share or debenture or contractual arrangement, the offerors of the products have to ensure that there are sufficient structural safeguards such as

operators' eligibility. The criteria for authorisation of a product is clearly spelt out in various codes and guidelines communicated to the public.

26. Product codes and guidelines have the merit of being flexible and are efficient in administration. They provide for specific but flexible requirements and are employed to assist the market in meeting the required standard and obtaining authorization. These requirements do not only cover disclosure matters but also structural matters, such as imposing capital and competence requirements on the operators/guarantors involved in the product. Such flexibility and ease of administration is not available in the CO regime as the rigid contents requirements are set out in the Third Schedule. It also fails to provide any safeguarding guidelines or measures.

27. The CO prospectus regime including the Third Schedule is outdated and out-moded by the SFO, and the disparity problem mentioned in the draft paper can be solved by removing the CO prospectus regime altogether.

28. In our view, SFO Part IV is already broad enough to cater for CO-prospectus type requirements. There is no need to retain the CO prospectus regime as it can be replaced by the combined use of the SFO statutory power to grant authorisation and the issue of relevant product codes and guidelines.

29. Currently, the SFO empowers the SFC to authorise "regulated investment agreement" and "collective investment schemes". The former is close to a catch-all phrase and pursuant to which the Commission has already authorised ELDs. In fact, the definition of these categories of products is, unlike the CO which is tied solely to corporate form, based on the nature of the investments.

30. What the draft paper has not highlighted in relation to the use of the SFO Part IV authorisation powers is that other than IPD, CFD has in fact already relied on the SFO powers (under section 105) to authorize equity-linked instruments. The anomaly of CFD instead of IPD invoking the power under section 105 arose from

the "distinction" that lies in ELNs' legal form, being considered by CFD as "debentures".

31. Another major advantage of SFO Part IV is that IIP, through the codes and guidelines issued and regular inspection, continues to regulate the conduct of the intermediaries after the product is offered. The CO however is simply a disclosure regime that confers no regulatory handle over the governance of the operators and any continuous compliance after the products are sold.

32. One should also bear in mind that Hong Kong is an international financial centre, and we have witnessed tremendous growth of foreign issuers wishing to launch their investment products in Hong Kong. Hence product authorisation under SFO Part IV based on a merits approach will be able to ensure investment products, local or foreign, are reaching the market on the same basis. When authorising the products, IP also performs a gate-keeping function.

33. Most major jurisdictions adopt a similar authorisation approach for investment products. Even in Australia, product guidelines are issued in the form of policy statements, rather than rigid legal requirements under the CO.

34. In light of the above discussion, we believe that a suitable clarification of our internal procedures for authorisation of new financial products by issuing clear guidelines and communicating one standard for investment products having substantively the same risks and rewards would already serve the purpose of ensuring a fair and level playing field for all product authorisation. Concerns about the incidental application of the CO to products that appear in corporate form could be addressed in a number of ways, including the exemption of SFO authorised products from the net of the CO or have the CO provisions removed accordingly.

35. IIP is happy to share our experience in product authorisation under the SFO which is built up since the launch of Protection of Investors Ordinance (the predecessor of the SFO) and the industry's views about this procedure.

36. As a matter of interest and for better understanding of the international regime on how the sales and offers of financial products are regulated, it would be useful to examine rules and practices of other leading financial centres like the UK and the US. As far as we are aware through working contacts with the NASD and the FSA, both regulators provide detailed and specific requirements for disclosure documents and product promotional materials. These are implemented by way of conduct rules. Similar to the approach under Part IV of the SFO, NASD pre-vets relevant investment advertisements. With respect to the FSA, it seems that the breach of Financial Promotion Rules results in licensing and disciplinary consequences to the intermediaries who authorise the publication of such materials.

Post-vetting regime and use of Stop Notices

37. We welcome proposals that would streamline current vetting processes, and the standard of disclosure documents in relation to offers of financial products. However, we believe it is overly simple and inappropriate to consider the so-called "post-vetting" regime in isolation from the other key components to this regime.

38. In addition, we feel that it is a misnomer to call the proposed regime a "post-vetting" one with a shift of emphasis on "vetting". In fact, the proposal that the CO provisions should be transferred to the SFO is in a way acknowledging that the authorisation mechanism under the SFO has done more than simply "vetting" of disclosure documents.

39. We speak from our past working experience with our fellow regulators regarding the "post-vetting regime". Take the example of Australia, Ian Johnston openly admitted that were ASIC given another chance to consider the notion of "post-vetting", they might not have done it in the way it is now.

40. In our interaction with the product disclosure team in ASIC, we note that their "post-vetting regime" entails a chain of reforms in the securities and corporate regulations and structural changes within the regulatory body. To name but a few:

- Public offering process (for securities or other financial products) is now contained in the law: in particular, proceeds raised have to be kept in a trust account until the stop notice procedure is cleared.
- The industry demands (and the regulator needs to issue) clear guidelines on specific products as well as accounting and financial reporting requirements to complement the "post-vetting regime". This embodies the principle of natural justice as it would be unfair for a person to be given a stop notice on unclear disclosure if he does not even know what the benchmarks are.
- ASIC maintains a significant number of highly qualified and senior lawyers to review legal proceedings and possible administrative appeals and waiver applications in connection with the "post-vetting regime".
- ASIC has faced severe industry criticisms on "selective post-vetting" as this gives the impression that large firms are favoured. Demand on resources of AISC has not been reduced. There have also been market requests to ASIC to revert to the "pre-vetting" regime given the uncertainty that might impact on the commercial operation of a securities offering.
- Industry seeks to exploit this mechanism to sabotage deals of their competitors. This is already seen in the case of pre-vetting regime in Hong Kong where industry people file complaints in order to delay the launch of new products by their rivalries.

We don't think it would be meaningful to discuss the Singaporean approach given that it follows the model of Australia and the industry generally believes that the administration there has overriding powers over regulatory requirements where circumstances require.

41. Given the importance of the topic and for the sake of completeness, we suggest that the approach adopted in the US and the UK markets should also be examined in the consultation paper, and an explanation should be given as to why we consider the Australia/Singapore post-vetting approach is to be preferred and more suitable for the Hong Kong market. If we understand it correctly, the "post-vetting" regime affects both listed and unlisted securities and it is unclear from the draft paper how this ties in with the rest of the listing regime.

42. As part of the global market, Hong Kong cannot ignore the importance of two leading financial centres, London and New York and how our regulations have to interact with these two jurisdictions. Since early 1990s, Hong Kong has been the prime choice for H-shares listing and a significant number of Mainland Chinese enterprises are dual listed as well. Both the US and our regime share the common philosophy of regulatory oversight of the prospectuses before they are issued to the public, and this common approach in fact makes dual listing on the US and Hong Kong markets possible as it eliminates the possible "call back" effect due to the stop notice regime.

43. In terms of the relationship/interaction between the regulator and the intermediaries (sponsors), the post-vetting approach may discourage dialogue due to the possibility of the issue of stop orders and any subsequent legal proceedings. The issue of a stop order and the subsequent hearings put the regulator and the industry in a highly contentious atmosphere and inevitably in such an environment, both sides are expected to incur substantial legal costs in contentious proceedings.

44. Moreover, given the financial interest at stake for issuers and intermediaries, the industry will require clear guidelines from the regulator in relation to both the general principles for disclosure and when stop notices are issued. In this regard, we should also bear in mind that the Commission is under a duty to consult the market before guidelines are issued. We should be realistic as to how much resources can be saved by switching to the post-vetting approach.

Post-vetting – secondary market sales

45. It is not clear whether secondary market sales are also subject to post-vetting. Reference was made to "prospectus" throughout the discussion on post-vetting (paragraphs 45 to 47 of the draft paper). Under the proposal to adopt the "transaction-based regime", prospectuses are required to be issued for all offers of shares or debentures (paragraphs 4 to 6 of the draft paper). It is further proposed that the prospectus regime will only cover "non-ordinary course capital raising"

activities, which is not defined (paragraphs 10 to 12 of the draft paper). The overall impact of these proposals to the market, the regulators and the practitioners, is not clear.

46. IIP considers that secondary sales should not be caught under post-vetting because the merits of the product should also be considered. Unlike IPOs, secondary market products can be complicated. The prospectus offer regime does not offer sufficient protection to investors because as long as the disclosure requirements are met, the product can be offered. The structure and the merits of a product are not considered. IIP considers that for secondary market sales, IP's current practice in administering SFO Part IV should be adopted. Please see paragraphs 25, 26 and 31 for details.

IPO process/parties' responsibilities

47. CFD also proposed changes to be made to the IPO process and impose civil and criminal liability to various parties involved in the IPO process. IIP considers issues like pre-deal research and parties' responsibilities are cross-divisional. Input from related divisions (IS/LIC/ENF/CFD) should be obtained.

48. On the issue of pre-deal research, no proposal was made in the draft paper and respondents are invited to express views on the issue in relation to the current regime. IIP considers that it would be better to set out a broad stance in the paper rather than leaving it wide open which gives the impression that the Commission has no idea, albeit preliminary, on how to address the issue.

49. Separately, we note that since various incidents involving the process of initial public offerings, the market and investors have an expectation of the governance of IPO process. Since the draft paper touches on a key aspect of the IPO process in terms of pre-deal research, the market is likely to expect a review of the existing IPO process, including the roles of the regulators in this regard.

Other Comments

Proposals are not ready for discussion at the Commission

50. IIP has reservations about whether the proposals as set out in the draft paper are ready to be discussed by the Commission. Two examples are set out below.

51. Paragraph 25.7 – *"Proposals to impose civil and criminal liability on particular persons will need to be revisited in light of conclusions to be reached in due course on proposals to be contained in an SFC consultation paper relating to statutory listing rules and in a Securities and Futures (Amendment) Bill introducing the framework for SFO enforcement action in the event of breach of the statutory listing rules, both proposed to be issued in [December 2004]."* It seems that it is more appropriate to wait till the two policies are finalised before the Commission is asked to consider the issue of liability of persons involved in the IPO process.

52. Paragraph 37.5 - The respondents are asked to comment on whether the IOSCO International Disclosure Standards serve as a useful model for Hong Kong. The current standards were issued in September 1998, and according to the draft paper, there is a new set of principles being developed. Which one are we asking the respondents to comment on? Is it meaningful to ask them to comment on the 1998 version? It would be useful to summarise the principles (from the 1998 version, the IOSCO draft if it is available and the principles adopted overseas) for the purpose of consultation.

Some proposed changes do not seem to be supported by sufficient reasons/justification

53. For example at paragraph 28.1, it was stated that "[t]he SFC does not see any reason why a secondary market purchaser who suffers loss as a result of a misstatement in a prospectus should not be entitled to compensation and accordingly propose that they also have the benefit of section 40 of the CO." The fact that we do not see any reason why certain things are not done is not a good explanation as to why we make certain proposals. Positive reasons should be given for our proposals.

Unclear definition of critical terms in the draft paper

54. Certain key terms and phrases used in the draft paper are not clear. In absence of clear definitions/scopes of such terms and phrases, readers are unable to have sufficient understanding to comment on the full scale of the proposals. For instance, the invented jargon of "non-ordinary course capital raising activities" and "ordinary course revenue generating activities" are used frequently in the context of one of the more controversial proposals in the draft paper – the re-juggling of the regulation of these two types of activities under the prospectus and the SFO Part IV regimes. The scope of these two phrases is however not set out in the draft paper. In absence of this information, readers of the draft paper will not be able to assess the feasibility of the proposals. It is unclear what "capital raising activities" mean.

Proposals to amend SFO

55. IIP suggests that when proposals are made to amend the SFO, detailed explanation/justifications should be set out taking into account the Commission's position when the Securities and Futures Bill was discussed at Legco. For instance, respondents to the SF Bill consultation had commented that the phrase "invitation to the public" should be more precisely defined. The government and SFC did not take on board the comment because "proper investor protection requires a broad notion, and that the notion is essentially a question of fact and should, in the case of dispute, be decided by the Courts".[1]

10 November 2004

Intermediaries and Investment Products Division

[1] Legco Bills Committee on Securities and Futures Bill and Banking (Amendment) Bill 2000 Paper No. 4B/01.