THE HONG KONG ASSOCIATION OF BANKS
香港銀行公會

Room 525, 5/F., Prince's Building, Central, Hong Kong
Telephone: 2521 1160, 2521 1169 Facsimile: 2868 5035
Email: info@hkab.org.hk Web: www.hkab.org.hk

香港中環太子大廈5樓525室
電話：2521 1160, 2521 1169 圖文傳真：2868 5035
電郵：info@hkab.org.hk 網址：www.hkab.org.hk

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Hon CHAN Kam-lam, SBS, JP
Chairman of Financial Affairs Panel
Legislative Council of Hong Kong
Legislative Council Complex
1 Legislative Council Road
Central, Hong Kong

By fax and email: panel_fa@legco.gov.hk

Dear Chairman

Securities and Futures (Professional Investor) (Amendment) Rules 2011 ("PI Amendment Rules")

The Hong Kong Association of Banks ("**HKAB**") understands that the Subcommittee on Securities and Futures (Professional Investor) (Amendment) Rules 2011 ("**Subcommittee**") has examined the PI Amendment Rules, which were submitted by the Securities and Futures Commission ("**SFC**") to the Legislative Council ("**LegCo**") for negative vetting in September 2011.

In addition, it has come to our attention that a motion may be put forward during LegCo's forthcoming meeting to be held on 30 November 2011 to further amend the Securities and Futures (Professional Investor) Rules (Cap 571D) ("**PI Rules**"), including shifting the qualitative accreditation requirements ("**Qualitative PI Requirements**") presently housed in paragraph 15.3 of the Code of Conduct for Persons Licensed by or Registered with the SFC ("**SFC Code of Conduct**") and/or adding further qualitative requirements to the PI Rules.[1]

HKAB is concerned about this proposal, and urges LegCo to consider the motion carefully. HKAB is of the view that the current regulatory framework, as reinforced by recent regulatory changes (including the changes to the PI Rules proposed by the SFC), is robust and has been effective in protecting investors' interests, and believes that the proposed changes are neither necessary nor desirable. We have come to this conclusion on the basis set out below.

1 Role of the SFC Code of Conduct and the Qualitative PI Requirements

The SFC Code of Conduct is an important regulatory code that governs the relationship between a licensed corporation or registered institution[2] ("**Regulated**

[1] As foreshadowed in paragraph 1(b) of the "*List of follow-up actions arising from the discussion at the meeting on 11 November 2011*": LC Paper No. CB(1)344/11-12(02), available on the Legislative Council website.

[2] Each as defined in Part 1 of Schedule 1 to the SFO.

Institution") and its clients. It sets down a broad range of know-your-client ("**KYC**") and selling procedures that apply to dealing with clients in regulated products.

The importance of this document is emphasised by the fact that many of the prudential changes that have been implemented by the SFC since the global financial crisis in 2008 have been implemented in the SFC Code of Conduct. This includes the new derivatives knowledge requirements,[3] new mandatory pre-sale disclosure of monetary and non-monetary benefits[4] and enhancements to the existing knowledge, experience and expertise requirements for high net worth professional investors.[5] These have, of course, also been accompanied by fundamental changes to the statutory framework for securities, structured products and (in the near future) over-the-counter derivatives.

The SFC Code of Conduct does not technically have the force of law. However, failure to comply with it can have significant impacts on a Regulated Institution, because a failure would impact its status as a "fit and proper" person and therefore its ability to continue operating a regulated business in Hong Kong.

The non-legislative status of the SFC Code of Conduct also enables the SFC to:

(a) respond quickly to challenges. This is evident from the post-2008 reforms, which were implemented through a combination of statutory amendments and progressive regulatory enhancements; and

(b) provide interpretative guidance to Regulated Institutions on novel and difficult factual scenarios, through supplementary guidelines and circulars. The SFC is not in a position to do this in relation to legislation - only the Hong Kong Legislative Council can provide a binding interpretation of legislative provisions.

A similar "tiered" approach to regulation that is adaptive to change and recognises the vital role of regulators is adopted in comparable jurisdictions all around the world.

The Qualitative PI Requirements sit within this framework. They require a holistic and documented assessment of a client based on a number of factors. Their role is to ensure that Regulated Institutions are only entitled to an exemption from certain selling procedures in the SFC Code of Conduct in appropriate circumstances. That is, they help to define the client relationship and the selling process - precisely the role of the SFC Code of Conduct. To mirror the Qualitative PI Requirements into the PI Rules would take away the flexibility and the benefits of this unique role played by the SFC Code of Conduct.

[3] Paragraph 5.1A, SFC Code of Conduct.
[4] Paragraph 8.3, SFC Code of Conduct.
[5] Paragraph 15.3, SFC Code of Conduct. By "high net worth professional investors", we refer to "professional investors" as defined in the PI Rules.

2 Public support for the existing framework

The SFC Code of Conduct has been the subject of extensive public consultation since 2009. The SFC also consulted the public on the PI Rules specifically in late 2010.

The results of these consultation processes demonstrate public support for the overarching regulatory framework in Hong Kong. Although improvements can always be made to the content of that framework, the quality of its structure has not been challenged.

3 Negative consequences of codifying the Qualitative PI Requirements

HKAB believes that codifying the Qualitative PI Requirements (that is, so that they sit within the PI Rules) and introducing further qualitative requirements are not necessary for the following reasons.

(a) ***Tick-box approach*** - First, it will transform the assessment process for high net worth professional investors into a "tick-box" exercise. This is because the Qualitative PI Requirements will need to be adjusted into more formulaic requirements to meet the test of legislative certainty. This will erode the value of the current approach, which requires a more nuanced client assessment based on a wide range of factors and a practical review of the totality of the circumstances.

(b) ***Constraints on regulators*** - Secondly, the SFC will have very limited power to give guidance on the Qualitative PI Requirements and to clarify standards and procedures in novel scenarios. Interpretation will be reserved to the Courts, as described in paragraph 1. The SFC may therefore be severely hamstrung in its efforts to respond efficiently and effectively to those circumstances.

(c) ***Slower reform*** - Thirdly, legislation takes longer to change. This means that any updates that are required to be reflected in the Qualitative PI Requirements will not be able to respond to new challenges as rapidly as needed.

(d) ***Loss of competition*** - Fourthly, Hong Kong has some of the very stringent regulatory standards in Asia. This must continue to be balanced against the need to be competitive for financial institutions and therefore, to offer choices for investors. Migrating the Qualitative PI Requirements to the PI Rules would alter well-accepted procedures for accrediting high net worth professional investors and limit the range of tailor-made investment products that may be made available to these investors via private placement routes.

(e) ***Lack of consultation*** - Finally, the proposed amendments to the PI Rules as set out in the SFC's Consultation Conclusions on the Evidential Requirements under the PI Rules in February 2011 were the result of a one-month public consultation, during which submissions from 16 respondents have been received and considered by the SFC. Those amendments did not include the migration of the Qualitative PI Requirements or introduction of further qualitative requirements. To introduce any such amendments to the PI Rules without a consultation would deprive the public and the banking industry of the benefit of an open and transparent consultation in the lawmaking process of a material legislation that has a profound impact on the operation, development and sustainability of the market.

4 Minimal benefit for the Hong Kong public

Finally, we believe that moving the Qualitative PI Requirements into the PI Rules would not necessarily increase the degree of investor protection for the Hong Kong investing public.

Specifically, an investor (including a person who meets the asset and portfolio tests in the PI Rules) who does not meet the Qualitative PI Requirements is currently already protected by the stringent KYC selling procedures in the SFC Code of Conduct, which include the suitability assessment process under paragraph 5.2 of the SFC Code of Conduct. Whether a person qualifies as a "professional investor" under the current PI Rules will only grant the person access to a wider range of products, so the individual may consider an investment product. The investor is currently protected by the safeguards already put in place which are designed to ensure suitability. HKAB believes that this approach works extremely effectively. It protects investors, it recognises the distinct roles of legislation and the SFC Code of Conduct and it allows the SFC to respond quickly when new challenges arise.

We therefore strongly urge LegCo to protect the current structure of the Hong Kong regulatory framework for professional investors.

As always, HKAB would be pleased to elaborate upon and discuss these issues further with LegCo. Should you have any queries in relation to our response, please contact our Manager Ms Heidi Hung on 2537 3220.

Yours sincerely

Eva Wong
Secretary

cc. Hon Jasper Tsang Yok-sing, GBS, JP, President, Legislative Council
Professor K. C. Chan, Secretary for Financial Services and the Treasury Bureau
Mr. Norman Chan, Chief Executive, the Hong Kong Monetary Authority
Mr. Ashley Alder, Chief Executive Officer, Securities and Futures Commission
Dr. the Hon David K.P. Li, GBM, GBS, JP, Member of the Legislative Council