

**Bills Committee  
Securities and Futures and Companies Legislation (Structured Products  
Amendment) Bill 2010**

**Submission of The Hong Kong Association of Banks**

**30 November 2010**

**Introduction**

This paper sets out the views of The Hong Kong Association of Banks (“**HKAB**”) in relation to the proposed amendments to the Companies Ordinance (Cap 32 of the Laws of Hong Kong) (“**CO**”) and the Securities and Futures Ordinance (Cap 571 of the Laws of Hong Kong) (“**SFO**”), in relation to the regulation of publicly offered structured products.

Assisted by Mallesons Stephen Jaques, we have examined the changes proposed in the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010 (“**Bill**”) and identified the areas of concern that we wish to raise with the Bills Committee. These are set out in the “**HKAB’s response**” section of this written submission.

We would be pleased to engage in further discussions with the Bills Committee in relation to the proposed changes and to provide further industry input where necessary.

**Executive summary**

HKAB and its members understand the policy intent of harmonising the offering regime for investment products and the proposed transfer of the regulation of publicly offered structured products in debenture form from the CO prospectus regime to the SFO.

In summary, HKAB suggests the following key refinements to increase market certainty, consistency and transparency in relation to product regulation:

- 1 If the Bills Committee pursues the proposal to disapply the CO safe harbour for offers to no more than 50 investors from the Part IV SFO authorisation regime, the change should be accompanied by regulatory guidance in relation to the meaning of an “offer to the public” for the purpose of section 103 of the SFO. This is important because:
  - (a) the Securities and Futures Commission (“**SFC**”) and the Hong Kong Legislative Council (“**Legislative Council**”) appear to have different views about the implications of this change;
  - (b) the Hong Kong financial services industry needs to understand how section 103 of the SFO will be interpreted and enforced by Hong Kong regulators, and a court in Hong Kong is likely to take into account the policy intention of this change; and
  - (c) the common law does not recognise a numerical limit to determine whether an offer is made “to the public”. Case law suggests that the number of offers is a relatively minor part of the equation.
- 2 All currency and interest-rate linked products issued by authorised financial institutions should be regulated uniformly, irrespective of their form. To achieve this, the proposed exemption in section 103(3)(ea) for such products should be moved into the definitions of “securities” in Part 1 of Schedule 1 to the SFO and “structured product” in Part 1A of Schedule 1 to the SFO, and the word “instrument” should be replaced with “product”. Currency-linked products should include those that are linked to the price of gold or silver.

- 3 Similarly, debentures and subscription warrants issued for capital fund raising purposes that are convertible into shares of the issuer or a related corporation should also be excluded from the definition of “securities”, to ensure that those products are regulated exclusively under the CO.
- 4 The exemptions for listed products from offer authorisation in sections 103(3)(h) and (i) of the SFO should be expanded to cover structured products.
- 5 More clarity is required about the function and operation of the proposed section 104A of the SFO, to resolve uncertainty caused by comments made in Legislative Council papers about this section. The drafting of that section should also be adjusted to mirror section 104 (with necessary changes), to eliminate the risk that unintended distinctions are drawn between the two provisions.
- 6 The definition of “securities” should not be expanded until the implications of that expansion are reviewed holistically. This requires closer examination, further consideration and separate market consultation, to ensure that any necessary adjustments to subsidiary legislation and regulatory codes, guidelines and circulars can be made in parallel to the changes made to this definition.
- 7 The concept of “regulated investment agreement” should be removed from the SFO regime to avoid duplication and confusion. Historical reasons should not be the determining factor in deciding how products should be regulated in Hong Kong and any concerns about the market understanding that these products are still regulated should be addressed either by adjusting the definition of “structured product” or through non-statutory guidance.
- 8 Futures contracts should be expressly excluded from the definition of “structured product” to avoid overlap and unintended regulatory consequences.
- 9 Exemptions for employee incentive schemes in sections 103(2)(e) of the SFO and in the definition of “structured product” should have a consistent scope and mirror the existing exemption for employee incentive schemes under paragraph 8 of the Seventeenth Schedule to the CO.
- 10 Deposits should be expressly carved out from the definitions of “debenture” in the SFO and the CO, and from the definition of “specified debt securities” in the SFO.
- 11 Additional non-statutory guidance should be provided about:
  - (a) the features of a currency and/or interest-rate linked product issued by an authorised financial institution that are acceptable and will not alter the exemption of such products from the SFO offer authorisation regime;
  - (b) the “widely quoted” reference rates that can be used for a floating rate debenture to qualify for the proposed exclusion in paragraph 2(e) of the definition of “structured product”; and
  - (c) the regulatory treatment of shares, repackagings and securitisations that could be interpreted as “structured products” in certain circumstances.
- 12 The proposed transitional provisions in Schedule 10 to the SFO should be enhanced to ensure that there is adequate time to prepare for, and implement, the changes described in the Bill. In particular, HKAB requests that:
  - (a) legitimate product offers made before the implementation of the Bill be appropriately grandfathered, even if they have not been authorised and registered under the CO. The suggested period is no more than 6 months; and

- (b) a 12 month grace period be allowed for licensing, to reflect that:
    - (i) the application process can take over four months from the date of application, plus preparation time (for example, to ensure that appropriate compliance procedures are in place); and
    - (ii) HKAB expects that the SFC cannot issue a licence in relation to structured products that do not currently fall within the definition of “securities” in advance, before the commencement of the Bill.
- 13 Parallel legislative changes should be made to complement the consolidation of product regulation that is proposed in the Bill. In particular:
- (a) amendments to the evidentiary requirements under the Securities and Futures (Professional Investor) Rules (Cap 571D of the Laws of Hong Kong) (“**Professional Investor Rules**”), which are the subject of a separate consultation process, should be implemented at the same time as the Bill comes into effect;
  - (b) section 404 of the SFO should be amended to clarify that products regulated under the SFO are excluded from the Betting Duty Ordinance (Cap 108 of the Laws of Hong Kong) (“**Betting Duty Ordinance**”); and
  - (c) structured products should be carved out from the definition of “deposit” in the Banking Ordinance (Cap 155 of the Laws of Hong Kong) (“**Banking Ordinance**”) and from the types of loans caught by the Money Lenders Ordinance (Cap 163 of the Laws of Hong Kong) (“**Money Lenders Ordinance**”).

These suggestions are described in more detail on the following pages, together with a small number of technical drafting adjustments and clarifications.

## Structure of our response

Our comments are grouped into the following thematic categories:

- Part A** - The expanded offer authorisation requirements
- Part B** - The proposed product authorisation requirement
- Part C** - Existing key concepts in the SFO
- Part D** - The new concept and definition of “structured product”
- Part E** - Other definitions
- Part F** - Implementation matters

HKAB would be pleased to discuss any of these matters further with the Bills Committee.

## HKAB's response

HKAB understands the policy intent of harmonising the offering regime for investment products and the proposed transfer of the regulation of publicly offered structured products in debenture form from the CO prospectus regime to the SFO.

In connection with these proposals, we have identified the following areas of concern that we wish to raise with the Bills Committee.

### Part A - The expanded offer authorisation requirements

#### 1 The meaning of an "offer to the public"

1.1 The Bill proposes to disapply the safe harbours available under the CO to the sale of structured products and securities under the SFO.

1.2 HKAB expressed its significant concern about this development in our response to the SFC's consultation in December 2009 ("**2009 Response**"). HKAB reiterates this concern, while acknowledging the efforts that are currently being made to improve the evidentiary requirements under the Professional Investor) Rules.

1.3 HKAB is particularly concerned about the uncertainty that will arise by the removal of the "not more than 50 investor" exemption that was introduced in 2004. We understand that there are strong policy grounds for this change. However, we suggest that this change must be accompanied by regulatory guidance in relation to the meaning of an "offer to the public" for the purpose of section 103 of the SFO, in order to give certainty to, and enhance consistency within, the industry.

1.4 The SFC's new handbook<sup>1</sup> does not contain this guidance. The SFC stated in its Consultation Conclusions that the concept was "well understood by the market" and that a "bright line test" or "guidance on the matter is unnecessary".<sup>2</sup> The SFC also appeared to imply that this is not a change in approach - that the CO adopted the number 50 because "many local market practitioners have been using the numerical limit of 50 persons as a benchmark for private placements" and that while the SFO does not set a similar bright line exemption, "the concept is retained in the SFO".<sup>3</sup>

1.5 In contrast, the Legislative Council has indicated that:

*"[f]rom the perspective of investor protection and in light of [the] development of the structured products market in the past few years, we consider it inappropriate to relax the public offering regime in the SFO by replicating these CO safe harbours. The safe harbours will be retained in the CO for shares and debentures issued for equity or debt capital-raising purpose[s], i.e. not for structured products."<sup>4</sup> (emphasis added)*

1.6 The SFC and Legislative Council therefore appear to have different views about whether the SFO will retain (in substance) an exemption for offers with a low distribution, even if the precise number is not explicitly stated.

1.7 This conflict is important to resolve, because:

- (a) the Hong Kong financial services industry needs to understand how section 103 of the SFO will be interpreted and enforced by Hong Kong regulators;

<sup>1</sup> SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, dated June 2010.

<sup>2</sup> Paragraph 22, Consultation Conclusions on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance, April 2010 ("**Consultation Conclusions**").

<sup>3</sup> Paragraph 22, Consultation Conclusions.

<sup>4</sup> Paragraph 11, Legislative Council Brief issued on 30 June 2010 (ref SUB/12/2/2/1).

- (b) a court in Hong Kong is likely to take into account the policy intention of this change, because section 103 of the SFO leaves ample room for interpretation and is not sufficiently clear on its own; and
  - (c) the common law does not recognise a numerical limit to determine whether an offer is made “to the public”. Case law suggests that the number of offers is a relatively minor part of the equation.
- 1.8 If the Legislative Council chooses to pursue the removal of the “not more than 50 person” safe harbour, HKAB requests that further guidance be provided as to the meaning of an “offer to the public” for the purpose of section 103 of the SFO. We suggest that this guidance take the form of (in decreasing order of preference):
- (a) subsidiary rules;
  - (b) non-statutory guidelines issued by the SFC that make clear that an offer to not more than 50 persons is not an offer to the public; or
  - (c) a clarification by the Legislative Council as part of the passage of the Bill, to the same effect.

## **2 Currency-linked and money market products issued by banks**

- 2.1 HKAB agrees that “currency-linked instruments”, “interest rate-linked instruments” and “currency and interest rate-linked instruments” issued by authorised financial institutions should be excluded from the proposed offer authorisation regime for structured products.
- 2.2 We note that in its Consultation Conclusions, the SFC agreed with industry feedback that these products should not be regulated by the SFO and recommended that section 103 contain an exemption for currency and interest rate linked instruments issued by authorised institutions. The SFC said that this would achieve the “same result” as putting the exclusion into the definition of “structured product”.<sup>5</sup>
- 2.3 However, while inserting this exclusion into section 103 means that these products will fall out of the proposed paragraph (g) of the definition of “securities”:
- (a) they will continue to be “securities” if they fall within the existing paragraphs (a) to (f) of that definition; and
  - (b) they will also continue to be “structured products”, which means that they may be unintentionally regulated in future.
- 2.4 HKAB suggests that all currency and interest-rate linked products issued by authorised financial institutions should be regulated uniformly, irrespective of their form. This will clarify the regulatory treatment of these products. It will also avoid the need to structure a product in a particular way to achieve a particular regulatory result (even though the fundamental nature of the product is the same) and help achieve the original goal of removing regulation of these types of products from the SFO, with which both the Hong Kong financial services industry and the SFC have agreed.
- 2.5 To achieve this, we suggest that:
- (a) the proposed exemption in section 103(3)(ea) be moved into the definitions of both:
    - (i) “securities” in Part 1 of Schedule 1 to the SFO; and
    - (ii) “structured product” in Part 1A of Schedule 1 to the SFO. In this case, paragraph 2(e) of that definition, which proposes to exclude debentures

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<sup>5</sup> Paragraph 54, Consultation Conclusions.

that only come within that definition by virtue of having a variable interest rate, could be expanded to deal with this; and

- (b) the word “instrument” be replaced with “product” in each of the terms “currency-linked instrument”, “interest rate-linked instrument” and “currency and interest rate-linked instrument” (and their respective definitions), to clarify that these products are exempt, irrespective of their form. We suggest that this adjustment is required to avoid an unintentionally narrow interpretation of these concepts, in light of the SFC’s stated view that an “instrument” is a “written document”.<sup>6</sup>

- 2.6 Please also refer to our comments about the definitions of “currency-linked instrument”, “interest rate-linked instrument” and “currency and interest rate-linked instrument” in paragraphs 17 and 18.

### **3 Listing exemptions**

- 3.1 HKAB requests that sections 103(3)(h) and (i) of the SFO, which exempt listed products from the offer authorisation regime, be amended to include a reference to “structured products”. In particular, we note that the SFC indicated in its Consultation Conclusions that section 103(3)(h) would be expanded to cover all structured products.<sup>7</sup>

- 3.2 We suggest that these changes are important to ensure that products are consistently regulated. For example, under the current drafting of these provisions, a structured product that falls within paragraphs (a) to (f) of the definition of “securities” would be exempt, but any other type of structured product would not. We suggest that this results in an anomalous and unsatisfactory regulatory approach. We would be pleased to discuss these provisions further with the Bills Committee, if required.

### **4 Carve out for structured products**

- 4.1 The proposed new section 103(11A) of the SFO contains a carve out from the exemption from authorisation provided in section 103(2)(i) of the SFO for persons who are in the business of buying and selling property other than securities or structured products (while acting in the ordinary course of that business). The proposed carve out says that this exemption does not apply to any structured products that:

- (a) are not authorised by the Commission under section 104A; or
- (b) are not listed securities.

- 4.2 We ask that the second limb in section 103(11A) (“are not listed securities”) be amended to state “*are not listed securities or structured products*”. The reason for this request is that the definition of “securities” for the purposes of Part IV of the SFO (which is set out in section 102) will capture some, but not all, structured products. HKAB suggests that this exemption should apply to all types of listed products.

- 4.3 As an ancillary matter, HKAB respectfully wishes to draw the Bills Committee’s attention to an oversight in Legislative Council papers describing this provision. These papers stated that section 103(11A) required authorisation under section 105 (rather than section 104A) and omitted to mention the exemption for listed products in section 103(11A)(b).<sup>8</sup>

<sup>6</sup> Paragraph 42(a), Consultation Conclusions.

<sup>7</sup> SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, dated June 2010.

<sup>8</sup> Page 3, “Replies to LegCo Secretariat’s Questions of 11 August 2010 (Batch 1)” issued on 25 October 2010 (ref CB(1)199/10-11(02) (“**Batch 1 Replies**”) (response to question on Clause 4(9)).

## Part B - The proposed product authorisation requirement

### 5 Interaction with the offer authorisation regime

- 5.1 HKAB is concerned about statements made by the SFC and the Legislative Council during the Bill's development about the nature and practical role of the proposed section 104A of the SFO. We wish to understand how this new section is intended to operate.
- 5.2 Specifically, we note that while describing the issue of product authorisation, Legislative Council papers state that:

*"[a]uthorization of a structured product under the SFO would normally be granted together with the authorization of its offering document under section 105 of the SFO. It is the general policy of the SFC not to consider authorizing a product under the SFO without a concurrent authorization of its offering document(s)".<sup>9</sup>*

- 5.3 This statement is inconsistent with the distinction made in the SFO between offer authorisation under section 105 and product authorisation under the existing section 104 and the proposed section 104A. Furthermore, section 104A is only relevant to the exception in section 103(11A)(a). That is, as currently proposed, product authorisation under section 104A is only required where a person wishes to:
- (a) offer a structured product that is not a listed security; and
  - (b) rely on the exemption from *offer* authorisation in section 103(2)(i).

If the "general policy" is that the offer needs to be authorised anyway, section 103(2)(i) becomes meaningless for any structured product that is not a listed security. HKAB therefore wishes to clarify if this is indeed the policy intention of the Legislative Council and the SFC.

- 5.4 We also request greater clarity about the intended purpose and function of the proposed section 104A to address the SFC's comments in its Consultation Conclusions that "*this enhanced approach should not be equated with "product" or "merit" regulation*".<sup>10</sup> If this is the case, we would be grateful for guidance on what authorisation under section 104A means.

### 6 Authorisation process for structured products

- 6.1 The proposed section 104A of the SFO (regarding the authorisation of structured products) replicates the substance of section 104 (which concerns collective investment schemes).
- 6.2 However, the two sections use different language, as shown in the comparison provided in the annexure. We expect these differences are largely for plain language drafting purposes (for example, to simplify sentences and use "must" rather than "shall" etc). The only substantive differences between sections 104 and 104A appear in the opening words of paragraphs (1) and (3) and are shown in tracking as follows.

*"On an application ~~to the Commission~~ by any person, the Commission may, ~~where it considers appropriate,~~ authorize..."*

- 6.3 HKAB supports the movement toward using plain language drafting. However, to ensure consistent product regulation and authorisation procedures, we suggest that either:
- (a) section 104A use the same language as section 104, with necessary changes to reflect that section 104A concerns structured products; or
  - (b) section 104A be consolidated into section 104.

<sup>9</sup> Page 3, Batch 1 Replies (response to question on Clause 5).

<sup>10</sup> Paragraph 63, Consultation Conclusions.

- 6.4 This will demonstrate that the authorisation regime for collective investment schemes and structured products is the same in principle. Otherwise, there is a risk that unintended distinctions are drawn between the two approaches. In particular, we expect that possible reasons might be inferred in future as to why the SFC need not “consider appropriate” the authorisation of a structured product under section 104A, but needs to do so in relation to authorising a collective investment scheme.

## Part C - Existing key concepts in the SFO

### 7 The expanded definition of “securities”

- 7.1 HKAB has significant concerns about the expanded definition of “securities” in Part 1 of Schedule 1 to the SFO.
- 7.2 We acknowledge that the SFC has already narrowed its original proposal to expand this definition, such that the definition proposed in the Bill only extends to structured products that require authorisation under section 105 of the SFO. We also acknowledge that the SFC indicated, in its Consultation Conclusions, that it will also review relevant requirements in the Code of Conduct for Persons Licensed by or Registered with the SFC and subsidiary legislation, and make any appropriate adjustments to reflect this expansion.<sup>11</sup>
- 7.3 However, we are concerned that this review process is not (to our knowledge) proposed to be undertaken before the implementation of the Bill. This raises a real risk of unintended, and currently unverified, consequences when the changes to the SFO come into effect.
- 7.4 HKAB strongly suggests that the proposed expanded definition of “securities” requires closer examination, further consideration and separate market consultation. There are currently 33 pieces of subsidiary legislation under the SFO, as well as a very large number of codes, guidelines and circulars that apply to the regulation of dealing and advising on securities in Hong Kong.
- 7.5 We urge the Bills Committee to pursue an holistic review of these materials before the implementation of the Bill. This will help ensure that any necessary adjustments to subsidiary legislation and regulatory codes, guidelines and circulars can be made in parallel to the changes made to the SFO. HKAB would be pleased to assist in this review process.
- 7.6 We also observe that the Bill contains a change to paragraph (vi) of the definition of “securities”. This paragraph excludes non-negotiable and non-transferable debentures from the definition of the “securities”. The Bill proposes to change that exemption to read:

*“(vi) any debenture that specifically provides that it is not negotiable or transferable (excluding a debenture that is a structured product);”*

- 7.7 The SFC seemed to indicate, in its Consultation Conclusions, that it would not pursue this proposed amendment.<sup>12</sup> HKAB therefore wishes to understand the reasons why this amendment is being pursued in the Bill and we suggest that it be reconsidered. As an alternative, we request that the exemption be refined so that it does not cast an unnecessarily wide net over structured products that do not require authorisation under the SFO.

- 7.8 In this case, our suggested changes to this exclusion are shown in tracking, as follows:

*“(vi) any debenture that specifically provides that it is not negotiable or transferable (excluding a debenture that is a structured product in respect of which the issue of any advertisement, invitation or document that is or contains an invitation to the public to do any act referred to in section 103(1)(a) of this*

<sup>11</sup> Paragraph 72, Consultation Conclusions.

<sup>12</sup> Paragraph 67, Consultation Conclusions.



[Ordinance is authorized, or required to be authorized, under section 105\(1\) of this Ordinance](#));”

- 7.9 This adjustment would mean that a non-negotiable, non-transferable structured debenture that is not authorised, and does not require authorisation, under section 105 of the SFO will not be caught by the definition of “securities”. We suggest that it is necessary because a “structured product” could fall within any of paragraphs (a) to (g) of the definition of “securities” and that such products should not be regulated as “securities”.

## **8 Regulated investment agreements**

- 8.1 HKAB asks that the concept of “regulated investment agreement” be removed from the SFO regime to avoid duplication and confusion.
- 8.2 While we understand that the concept has been in the SFO since its inception (as described by the SFC in its Consultation Conclusions),<sup>13</sup> we suggest that historical reasons should not be the determining factor in deciding how products should be regulated in Hong Kong. Instead, we suggest that the interests of clarity, efficient regulation and certainty should prevail.
- 8.3 The concept of “regulated investment agreement” overlaps with the proposed concept of “structured product”. Retaining that concept when the Bill is implemented will therefore unnecessarily complicate the SFO and raise the possibility of product distinctions being drawn where none were intended or required. We are aware that members of the Legislative Council raised similar concerns about this overlap in August 2010.<sup>14</sup>
- 8.4 We suggest that the current statutory reform process presents an ideal opportunity for this consolidation to take place. We expect that it will be difficult, time consuming and costly to revisit this issue in future.
- 8.5 HKAB acknowledges that the SFC wishes to “ensure market participants understand that regulated investment agreements are to be treated as structured products”.<sup>15</sup> Accordingly, we suggest that if there are concerns about coverage, either:
- (a) the definition of “structured product” should be adjusted to address these concerns; or
  - (b) the Legislative Council or the SFC should express their policy intention about the regulation of “regulated investment agreements” through non-statutory guidance.

## **Part D - The new concept and definition of “structured product”**

### **9 Futures contracts**

- 9.1 HKAB asks that futures contracts be expressly excluded from the definition of “structured product” to avoid overlap and unintended regulatory consequences.
- 9.2 In its Consultation Conclusions, the SFC relies on the exemption from offer authorisation in section 103(2)(b) for “offers made by or on behalf of an intermediary licensed or registered for Type 2 or Type 5 regulated activity (whether acting as principal or agent) in respect of futures contracts” to argue that the definition of “structured product” does not need to specifically exclude “futures contract”.<sup>16</sup>
- 9.3 However this exemption only relates to authorisation - this raises a risk of unintentionally regulating futures contracts pursuant to special requirements that may be imposed on structured products in future. In this regard, we suggest the SFO should clearly distinguish between futures contracts (which are already regulated and subject to market

<sup>13</sup> Paragraph 40, Consultation Conclusions.

<sup>14</sup> Page 5, Batch 1 Replies (paragraph (b)(i) of questions on Clause 15(8)).

<sup>15</sup> Paragraph 40, Consultation Conclusions.

<sup>16</sup> Paragraph 42(e), Consultation Conclusions.

rules) and the new types of regulated structured products. This is also consistent with the distinction made in respect of collective investment schemes, in paragraph 2(c) of the proposed definition of “structured product”.

## **10 Floating rate debentures**

10.1 We appreciate the SFC’s description, in its Consultation Conclusions, of the kinds of reference rates it considers acceptable for floating rate debentures to qualify for a proposed exemption from the definition of “structured products” (paragraph 2(e)).

10.2 Specifically, the SFC clarified that “widely quoted” money market reference rates are:

*“rates that are widely used by banks in borrowing funds from other banks in the interbank market and as reference rates for financial instruments. Examples include the London Interbank Offered Rate (i.e., LIBOR) and the Hong Kong Interbank Offered Rate (i.e., HIBOR).”<sup>17</sup>*

10.3 HKAB welcomes these examples of “widely quoted” rates, because they provide useful practical guidance. In the interests of further enhancing market certainty, we suggest that the SFC expand upon this guidance and provide a non-exhaustive list of other types of reference rates that it considers to be acceptable. To confirm, we wish to preserve flexibility and do not think that a prescriptive list (in statutory or non-statutory form) is appropriate or necessary.

10.4 We also request that the Bill be refined to clarify that a floating rate debenture that falls within paragraph 2(e) of the proposed definition of “structured product” is also an “interest rate-linked instrument”. While the two concepts have different fields of operation, we suggest that the clarification is important for banks that will rely on the exemption for “interest rate-linked instruments” and secondly, that it does not alter the apparent policy intention behind the proposals.

10.5 We suggest that this refinement can be achieved by amending the proposed definitions of “interest rate-linked instrument” and “currency and interest rate-linked instrument” in Part 1 of Schedule 1 to the SFO to refer to paragraph 2(e) of the definition of “structured product” in Part 1A of that Schedule. Please also refer to our suggestions in relation to those definitions in paragraph 17.

## **11 Shares**

11.1 HKAB appreciates the comments made by the SFC, in its Consultation Conclusions, that ordinary shares and preference shares should not be “structured products”, but only “to the extent that these products have no derivative element attached to them”.<sup>18</sup>

11.2 We suggest that the SFC formalise these comments in the form of non-statutory guidance (using examples), to give members greater certainty about the regulatory treatment of ‘vanilla’ products (such as convertible preference shares) that could be interpreted as “structured products” as a result of their changeable nature.

## **12 Debt capital fundraising products**

12.1 HKAB welcomes the exclusion, from the proposed definition of “structured products”, of debentures and subscription warrants issued for capital fund raising purposes that are convertible into shares of the issuer or a related corporation.

12.2 However, we are concerned that these products have not been excluded from the definition of “securities” in Part 1 of Schedule 1 to the SFO. This has the potential to result in the regulation of these products under both the SFO and the CO in certain circumstances (namely, where the product falls within any of the existing paragraphs (a) to (f) of the definition of “securities”).

<sup>17</sup> Paragraph 42(f), Consultation Conclusions.

<sup>18</sup> Paragraph 41(b), Consultation Conclusions.

- 12.3 HKAB reiterates the view expressed in our 2009 Response that these types of products should be regulated exclusively under the CO.<sup>19</sup> Accordingly, we request that the definition of “securities” be amended to include an exemption that mirrors paragraphs 2(a) and (b) of the proposed definition of “structured products”.
- 12.4 If this proposal is not adopted, we request that the SFC clarify that in reviewing applications for the authorisation of such products, it will refer to the disclosure requirements in the Third Schedule of the CO.

### **13 Employee incentive schemes**

- 13.1 HKAB welcomes the exclusion of employee incentive schemes from the definition of “structured product” in the proposed new Part 1A of Schedule 1 to the SFO. This is an important and practical exemption in the CO and we appreciate that the SFO and CO regimes will therefore be broadly consistent in the regulatory treatment of these types of schemes.
- 13.2 To increase consistency further, we request that this exemption in the definition of “structured products” be adjusted so that it more closely aligns with the existing exemption for employee incentive schemes under paragraph 8 of the Seventeenth Schedule to the CO (which is proposed to be disappplied from the SFO).
- 13.3 In particular, HKAB asks that the exemption for employee incentive schemes in paragraph 2(f) of the definition of “structured product” be amended to allow the product to be offered not only by the corporation in question or a related corporation, but also by the trustee of a trust established by one of those corporations and which holds the product that is the subject of the relevant offer.
- 13.4 For regulatory consistency, we also ask that the exemption for employee incentive schemes in section 103(2)(e) of the SFO be refined:
- (a) to mirror the scope of the exemption in paragraph 2(f) of the definition of “structured product” (with the adjustment we proposed in paragraph 13.3), so that employee incentive schemes are treated in a consistent manner, irrespective of their legal form. Alternatively, the definitions of “securities”, “collective investment schemes” and (if it is retained) “regulated investment agreement” could be adjusted; and
  - (b) by deleting the reference to “structured products”. This will avoid confusion as to whether a particular employee incentive scheme that involves a structured product requires authorisation or not.

### **14 Gambling and betting**

- 14.1 We support the exemption for products offered under a licence, permission or other authorisation under the Betting Duty Ordinance or the Gambling Ordinance (Cap 148 of the Laws of Hong Kong) (“**Gambling Ordinance**”) from the proposed definition of “structured product” (in paragraph (g)(i)). This will help clarify that if a product that could potentially be considered a “structured product” is authorised or otherwise permitted under one of those regimes, it will not need to be separately authorised under the SFO.
- 14.2 This complements existing provisions in section 404 of the SFO that disapply products regulated by the SFO from the Gambling Ordinance. We agree that only one regulatory regime should apply to any given product.
- 14.3 In the same vein, we ask the Bills Committee to consider extending section 404 of the SFO to cover the Betting Duty Ordinance, so that it is clear that a particular product will only be subject to one regulatory regime. This clarification is important because:
- (a) there is no statutory definition of “bet” or “betting”; and

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<sup>19</sup> Paragraph 5.7, 2009 Response.

- (b) under the common law a bet involves a wagering contract. This involves:
- (i) *first limb* - two parties holding differing views concerning the occurrence of an uncertain future event, with an agreement that on the determination of that event, one will lose and pay to the other a sum of money (or give something else); and
  - (ii) *second limb* - the parties having no other interest in the contract than the amount that can be won or lost, with no real consideration given by either party.

14.4 It is not difficult to imagine several types of structured products that could fall within the first limb. In relation to the second limb, there is case law to support a presumption that a financial institution will always have a commercial purpose in mind when entering into a speculative contract, and that such a contract should be construed as a commercial or financial transaction rather than a wager.

14.5 However, the scope of that case law is not certain and we suggest that the matter should be put beyond doubt by adding a reference to the Betting Duty Ordinance in section 404 of the SFO during this legislative review process. This is consistent with the exclusion in paragraph (g)(i) of the proposed definition of “structured product” and the approach taken for gambling.

## 15 Repackagings and securitisations

15.1 HKAB requested, in our 2009 Response, for guidance on the regulatory treatment of repackagings and securitisations.<sup>20</sup> In particular, we wish to understand whether (or in what circumstances), these would be considered to be “structured products”.

15.2 The Consultation Conclusions did not specifically address this issue. We would therefore be grateful for non-statutory guidance on this matter, in tandem with the implementation of the Bill.

## Part E - Other definitions

### 16 The narrow definition of “securities” in section 102 of the SFO

16.1 We suggest that the proposed definition of “securities” in section 102 of the SFO (which applies only for the purposes of Part IV of the SFO), be streamlined as follows:

*““securities” (證券) has the same meaning as that given by the definition of “securities” in section 1 of Part 1 of Schedule 1 except that it does not include structured products that ~~fall within~~ are securities only because of paragraph (g) of that definition.”*

16.2 This proposed adjustment does not change the meaning. It simply reflects that paragraph (g) of the proposed expanded definition of “securities” in Part 1 of Schedule 1 to the SFO already excludes other types of securities (that is, those that fall within paragraphs (a) to (f) of that definition).

### 17 Treasury instruments offered by authorised financial institutions

17.1 As described in paragraph 2, HKAB welcomes the proposed exemption for “currency-linked instruments”, “interest rate-linked instruments” and “currency and interest rate-linked instruments” from the expanded offer authorisation regime for structured products.

17.2 To ensure that the exemption for these products is thoroughly understood, we would appreciate further non-statutory guidance (in the form of examples and qualitative

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<sup>20</sup> Paragraph 5.6, 2009 Response.

guidance) on the types of product features that are considered acceptable and will not affect the product's regulatory treatment.

- 17.3 In this regard, we note that the SFC confirmed in its Consultation Paper that *“as long as the “bells and whistles” that are attached to the products do not contain any derivative element, they should be able to fall within the proposed definitions.”*<sup>21</sup> However, the SFC did not go so far as to provide a view about any particular types of payment conditions (eg knock-in / knock-out). HKAB suggests that this guidance is crucial to ensure transparent and consistent regulation of these products.

## **18 “Currency-linked instruments”**

- 18.1 We reiterate our request that the definition of “currency-linked instrument” include instruments that are linked to the price of gold or silver. These products are important for a number of HKAB members' treasury functions. Secondly, the prices per troy ounce of gold and silver are quoted and traded in the same way as currency.
- 18.2 If the Bills Committee considers that further consultation and more time is required to assess this request, an alternative approach is for these types of products to be designated as “currency-linked instruments” by a notice under section 392 of the SFO (as it is proposed to be amended) in the near future. This was an option that was also canvassed by the SFC in its Consultation Conclusions.<sup>22</sup>

## **19 The amended definition of “debenture”**

- 19.1 The Bill amends the definition of “debenture” under the CO and the SFO, by replacing the word “securities” with “debt securities”. HKAB supports this clarification, as it assists in resolving the current uncertainty about its scope under the common law.
- 19.2 However, the term “debt securities” is not currently defined in the CO or the SFO, nor is it proposed to be defined in the Bill. We understand that the Administration stated, in response to a query from the Legislative Council Secretariat, that:

*“[t]he term ‘debt securities’ is meant to serve a general purpose in clause 18 and hence no definition has been proposed. Please note that this term already appears in the SFO without definition e.g. the terms “convertible debt securities” and “non-interest bearing debt securities” are not defined within the definition of “specified debt securities” in Part 1 of Schedule 1 to the SFO.”*<sup>23</sup>

- 19.3 HKAB understands the need for flexibility and we do not advocate a prescriptive definition of “debt securities”. This could produce unintended results in the future.
- 19.4 However, HKAB suggests that the Bill clarify the definition of “debenture” to specify that deposits are not debentures, to address the absence of a clear common law position on this issue. We also suggest that a similar clarification be made to the definition of “specified debt securities” in Part 1 of Schedule 1 to the SFO.
- 19.5 The Legal Services Division of the Legislative Council also raised a concern that “debt securities” is not defined and also indicated that it is seeking clarification on certain drafting points.<sup>24</sup> HKAB would be pleased to provide commercial input into any further discussions on this matter, if required.

<sup>21</sup> Paragraph 53, Consultation Conclusions.

<sup>22</sup> Paragraph 53, Consultation Conclusions.

<sup>23</sup> Page 5, Batch 1 Replies (paragraph (b) of response to question on Clause 15(8)).

<sup>24</sup> Paragraph 14, “Legal Services Division Report on the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010” (LC Paper LS89/09-10).

## Part F - Implementation matters

### 20 Implementation of the Bill

20.1 HKAB is concerned about the implementation timing of the Bill and wishes to ensure that there is adequate time to prepare for, and implement, the changes. This concern is augmented by the absence of a definitive schedule for the passage and commencement of the Bill.

20.2 In particular, we request that the transitional provisions described in clause 17 of the Bill (amending Schedule 10 of the SFO) be enhanced so that:

(a) Schedule 10 of the SFO grandfathers all structured products that were offered before the commencement of the Bill, and not only the products authorised and registered under sections 38D or 342C of the CO (as currently proposed). We suggest that the transitional period for structured products that have not been authorised and registered under the CO be the earlier of:

- (i) 6 months after the commencement of the Bill; and
- (ii) the day after the last date of the period specified in the relevant offering materials as being the period during which the structured product is offered.

This will enable consistent treatment of products, provide certainty to the financial services industry and ensure that all lawful product offers under the current regime can continue to be (practicably) made until the proposals set out in the Bill take effect, in line with normal statutory reforms; and

(b) more time is allowed for members who carry on the business of dealing in, or advising on, structured products and who are not presently licensed for Type 1 or Type 4 regulated activities to obtain the relevant licences from the SFC. In this regard, we note that:

- (i) the application process can take over four months from the date of application, plus preparation time (for example, to ensure that appropriate compliance procedures are in place);
- (ii) HKAB expects that the SFC cannot issue a licence in relation to structured products that do not currently fall within the definition of "securities" in advance, before the commencement of the Bill; and
- (iii) by way of general indication, 52 of HKAB's members are not licensed by or registered with the SFC for Type 1 regulated activities.

We therefore ask that the proposed implementation period of six months be increased to 12 months.

20.3 In addition to these transitional periods, HKAB requests that the passage of the Bill match the timing of the SFC's proposed amendments to the evidentiary requirements under the Professional Investor Rules<sup>25</sup> (on which HKAB has commented separately).<sup>26</sup>

20.4 These adjustments were originally proposed by market participants (including HKAB)<sup>27</sup> as an alternative to retaining the "HKD500,000 minimum denomination / consideration" CO safe harbour. As the Bill proposes to disapply this safe harbour to the SFO, these adjustments are necessary to alleviate the practical difficulties of accrediting high net worth investors as "professional investors" for the purposes of the SFO. These difficulties

<sup>25</sup> Consultation Paper on the Evidential Requirements under the Securities and Futures (Professional Investor) Rules.

<sup>26</sup> Submitted to the SFC on 5 November 2010.

<sup>27</sup> Paragraph 2.9(a), 2009 Response.

were acknowledged by the SFC in its Consultation Conclusions<sup>28</sup> and we suggest that they should be addressed at the same time as the Bill comes into effect.

## **21 Parallel adjustments**

21.1 In addition to our suggestion in paragraph 7 that any necessary adjustments to subsidiary legislation and regulatory codes, guidelines and circulars be made in parallel to the changes made to the SFO, HKAB requests that:

- (a) the definition of “deposit” in section 2 of the Banking Ordinance be amended to exclude products authorised by the SFC or exempted from authorisation under the SFO. Excluding authorised products would be consistent with the current exemption for securities in respect of which a prospectus has been registered under the CO; and
- (b) an equivalent exemption be included in the list of “exempted loans” in Part 2 of Schedule 1 to the Money Lenders Ordinance.

21.2 We ask that these adjustments be made in parallel to the implementation of the Bill, to streamline the regulation of structured products across the Hong Kong regulatory framework.

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<sup>28</sup> See particularly paragraph 31, Consultation Conclusions

## Annexure - Comparison showing the differences between the existing section 104 of the SFO and the proposed section 104A of the SFO

- (1) On an application ~~to the Commission by any person~~, the Commission may, ~~where it~~ considers appropriate, authorize ~~any collective investment scheme~~ a structured product, subject to the condition specified in subsection (2) and to any other conditions it considers appropriate.
- (2) It ~~shall be~~ a condition of authorization of a ~~collective investment scheme~~ structured product that, ~~under subsection (1) that~~ at any time when the ~~scheme~~ product is authorized—
- (a) there is an individual approved by the Commission under subsection (3) as an approved person for the purpose of being served by the Commission with notices and decisions for the ~~scheme~~ product; and
- (b) the Commission is informed ~~of particulars~~—
- (i) subject to subparagraph (ii), of the current contact details of the approved person ~~referred to in paragraph (a)~~, including, ~~in~~ so far as applicable, the address, telephone and facsimile numbers, and electronic mail address of the approved person;
- (ii) ~~whereif~~ there is any change in ~~the those~~ contact details ~~referred to in~~ subparagraph (i), of the change, within 14 days after the change takes place.
- (3) For the purposes of subsection (2)(a), on an application by any person ~~to the Commission~~, the Commission may, ~~where it considers appropriate~~, approve ~~any an~~ individual nominated in the application in respect of a ~~collective investment scheme~~ structured product as an approved person for the purpose of being served by the Commission with notices and decisions for the ~~scheme~~, and may, ~~by notice in writing served on the person~~, withdraw the approval ~~product~~.
- (4) The Commission may at any time, by notice in writing served on the approved person for a ~~collective investment scheme~~, structured product— (a) amend or revoke any of the conditions (other than the condition specified in subsection (2)) imposed, or impose new conditions, in respect of the authorization of the product; or (b) withdraw the person's approval under subsection (1) ~~in respect of the scheme~~ 3.
- (5) Without limiting any other ground on which the Commission may refuse to authorize ~~any collective investment scheme~~ a structured product under subsection (1), the Commission may refuse to do so ~~whereif~~ if it is not satisfied that the authorization is in the interest of the investing public.
- (6) An application made ~~pursuant to~~ under subsection (1) or (3) ~~shall~~ must be accompanied by ~~such any~~ information and documents ~~as that~~ the Commission requires.
- (7) ~~Whereif~~ the Commission refuses to authorize a ~~collective investment scheme~~, structured product, or to approve an individual as an approved person, ~~pursuant to subsection (1)~~ the Commission must ~~or (3), it shall by notice~~ notify the applicant in writing ~~notify the person making the application in question of the decision~~ refusal and the reasons for ~~which it is made~~.
- (8) The Commission may publish, in ~~such any~~ manner ~~as it considers appropriate~~, particulars of ~~any collective investment scheme~~ a structured product authorized under subsection (1).
- (9) Particulars published under subsection (8) are not subsidiary legislation.”