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Panel on Financial Affairs

Meeting on 3 May 2010

**Background brief on legislative proposals
to transfer the authorization of offering documentation
in relation to structured products
from the Companies Ordinance to the Securities and Futures Ordinance**

Purpose

This paper provides background information on the legislative proposals to transfer the authorization of offering documentation in relation to structured products from the Companies Ordinance (Cap. 32) (CO) to the Securities and Futures Ordinance (Cap. 571) (SFO), and summarizes the main concerns and views expressed by members when relevant issues were discussed by the Panel on Financial Affairs (the Panel).

Background

Existing arrangements

2. In general, unless an exemption applies, documents containing an invitation to the Hong Kong public to invest in securities, regulated investment agreements or collective investment schemes must be authorized by the Securities and Futures Commission (SFC). At present, there are two separate regimes under which SFC authorizes the documents of financial products sold to the Hong Kong public, i.e. the CO prospectus regime and the SFO regime¹. Whether the public offer of a financial product is regulated under the CO prospectus regime or the SFO regime is

¹ A detailed description of the two authorization regimes is available at Appendix 2 of the report of SFC entitled "Issues raised by the Lehman Minibonds crisis - Report to the Financial Secretary at <http://www.sfc.hk/sfc/doc/EN/general/general/lehman/Review%20Report/Review%20Report.pdf>.

determined by the legal form of the product. To avoid double regulation, there is an express provision in section 103(3)(a) of the SFO that where a prospectus has complied with or is exempt from compliance with the CO prospectus regime (that is, Part II or Part XII of the CO), it is exempt from the SFO regime (that is, Part IV of the SFO).

3. Public offers of structured products in the form of debentures are regulated under the CO prospectus regime and the public offers of structured products not in the form of debentures are regulated under the SFO regime. For example, prospectuses of structured notes such as Minibonds which are structured as debentures are authorized by SFC under the CO.

Review of the public offering regimes

4. Shortly after the collapse of Lehman Brothers in September 2008, the Financial Secretary requested the Hong Kong Monetary Authority (HKMA) and SFC to submit reports on their observations, lessons learned and issues identified during the process of investigating the complaints regarding the Lehman Brothers Minibonds. On 31 December 2008, SFC and HKMA submitted the reports recommending various measures to enhance investor protection and improve the regulatory framework concerned, including the need to reconsider whether Hong Kong should retain two public offering regimes in the CO and the SFO and whether the existing exemptions from the requirement for SFC's authorisation of offering documents were too broad. The Administration has since formulated an action plan in consultation with the two regulators to take forward the various recommendations as set out in their reports.

5. On 30 October 2009, SFC published a consultation paper on "Possible Reforms to the Prospectus Regime in the CO and the Offers of Investment Regime in the SFO" with drafts of the proposed legislative amendments for a two-month consultation to solicit public views on the proposals to align the two regimes by transferring the regulation of public offers of structured products in the form of debentures from the CO prospectus regime to the regulatory regime under the SFO. As a result of this transfer, public offers of all structured products, regardless of their legal form, will be regulated under the SFO regime. In addition, the CO prospectus regime including the safe harbours in the Seventeenth Schedule to the CO will no longer be applicable to the offers of structured products. Instead, the offering of structured products regardless of their legal form will be subject to the relevant exemptions under Part IV of the SFO. SFC has also proposed in the consultation paper a definition of "structured product" to be added in both the CO and the SFO and amendments to the definition of "securities" in the SFO, and reviewed certain exemptions currently available in section 103 of the SFO for structured products.

6. Under SFC's proposals, offers to the public of shares, including preference shares, and depositary receipts over or in respect of shares will continue to be regulated under the CO prospectus regime. Accordingly, rights issues to existing

shareholders, whether they are renounceable in favour of other persons or not, will continue to be regulated under the CO prospectus regime.

7. SFC has not proposed to change the existing framework for listed structured products, as SFC's policy intention is that the Stock Exchange of Hong Kong Limited will remain the frontline regulator responsible for reviewing and approving listing documents for listed structured products. Accordingly, listed structured product issuers or their related licensed entities can continue to rely upon the exemption in section 103(2)(a) of the SFO to issue marketing documents.

Relevant deliberations of the Panel

8. While the specific subject of "authorization of offering documentation in relation to structured products" has not been discussed by the Panel in the past, relevant issues were touched on during Panel discussions on related subjects, such as the regulation of credit-linked products², the Administration's Action Plan for taking forward the recommendations in the reports prepared by SFC and HKMA on the Lehman Brothers Minibonds Incident³, and the Companies Ordinance rewrite exercise⁴. The major relevant concerns and views expressed by members are as follows-

- (a) There was an urgent need to amend the legislation on the regulation of structured financial products, including the transfer of the relevant provisions from the CO to the SFO and the review of the safe harbour provisions in the CO. The Administration should ensure good co-ordination with the relevant regulatory authorities in taking forward the legislative proposals.
- (b) In view of the complexity and high-risk nature of credit-linked notes (such as Lehman Brothers Minibonds, Octave Notes and Constellation Notes), the existing regulatory regime should be improved such that these structured products should be subject to more stringent regulatory requirements under the SFO, instead of the CO prospectus regime.
- (c) The disclosure-based regulatory regime had its limitations in protecting ordinary retail investors from the high risks complicated investment products entailed. Reference should be made to the practices of advanced economies of prohibiting the offering of investment products with returns disproportionate to the high risks involved to the public and limiting the offering to institutional and professional investors only.

² Panel meeting on 11 June 2009

³ Panel meetings on 23 February and 2 November 2009

⁴ Panel meeting on 4 January 2010

- (d) Apart from the prospectuses, SFC should ensure that there was clear and full disclosure of the nature and level of risks in the marketing materials on structured products.
- (e) A proper balance should be struck so that measures to improve the regulation of investment products would not be excessive as to hinder product diversification and innovation in the financial market.

9. In past discussions on the regulation of structured products, apart from the above issues directly related to the authorization of public offering documentation of structured products, Panel members also expressed concerns on the following issues –

- (a) market transparency of unlisted structured products;
- (b) continual disclosure requirement on intermediaries;
- (c) regulation of the sale process;
- (d) dispute resolution mechanisms; and
- (e) coordination between SFC and the Hong Kong Monetary Authority over the regulation of intermediaries.

Latest development

10. At the Panel meeting on 3 May 2010, the Administration will brief the Panel on the conclusions of the consultation conducted by SFC on the proposed transfer of the authorization of offering documentation in relation to structured products.

Relevant papers

11. The relevant papers are available at the following links:

Minutes of meeting of Panel on Financial Affairs on 4 January 2010
 (paragraph 6 to 29)

<http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20100104.pdf>

Minutes of meeting of Panel on Financial Affairs on 2 November 2009
 (paragraph 8 to 38)

<http://www.legco.gov.hk/yr09-10/english/panels/fa/minutes/fa20091102.pdf>

Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance by Securities and Futures Commission (October 2009)

<http://www.legco.gov.hk/yr09-10/english/panels/fa/papers/facb1-220-2-e.pdf>

Administration's paper on "Issues Relating to the Regulation of Credit-linked products sold to Retail Investors" (June 2009)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/papers/fa0611cb1-1829-3-e.pdf>

Minutes of meeting of Panel on Financial Affairs on 11 June 2009 (paragraph 27 to 45)

<http://www.legco.gov.hk/yr08-09/english/panels/fa/minutes/fa20090611.pdf>

Issues raised by the Lehman Minibonds crisis: Report to the Financial Secretary by Securities and Futures Commission (December 2008)

<http://www.sfc.hk/sfc/doc/EN/general/general/lehman/Review%20Report/Review%20Report.pdf>

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