

## Legislative Council Panel on Financial Affairs

### Legislative Proposals to Transfer the Regulation of Public Offers of Structured Products from the Companies Ordinance to the Securities and Futures Ordinance

#### Purpose

This paper briefs Members on the legislative proposals to transfer the regulation of public offers of structured products in the form of shares or debentures from the Companies Ordinance (“CO”) (Cap. 32) to the Securities and Futures Ordinance (“SFO”) (Cap. 571).

#### Background

2. On 30 October 2009, the Securities and Futures Commission (“SFC”) commenced a two-month consultation on Possible Reforms to the Prospectus Regime in the CO and the Offers of Investment Regime in the SFO. The SFC published its consultation conclusions on 22 April 2010<sup>1</sup>. The ensuing paragraphs set out the background and key proposals which the Administration intend to take forward, after considering comments received in the SFC’s consultation exercise.

#### The Existing Legislative Framework

3. At present there are two separate regimes under which the SFC authorizes offer documents and marketing materials of products sold to the public –

- (a) The CO prospectus regime: it is not lawful to issue any form of application for shares in or debentures of a company<sup>2</sup>

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<sup>1</sup> The SFC’s consultation conclusions are available at <http://www.sfc.hk/sfc/doc/EN/speeches/consult/ConsultationConclusions22April2010English.pdf>.

<sup>2</sup> This covers the public offering of shares in and debentures of Hong Kong companies, and the public offering in Hong Kong of shares in and debentures of non-Hong Kong incorporated companies.

unless the form is issued with a prospectus which complies with the requirements in the CO and its registration has been authorized by the SFC;

- (b) The offers of investment regime in Part IV of the SFO: the issue of advertisements, invitations or documents containing invitations to the public regarding securities, regulated investment agreements and collective investment schemes is prohibited unless they are authorized by the SFC or exempted. For collective investment schemes that are publicly offered, the schemes per se also require SFC's authorization. In applying the authorization requirements, the SFC refers to product codes and guidelines it has issued in respect of the more commonly available types of collective investment schemes. These codes and guidelines set out the bases for the authorizations including disclosure requirements and, in some cases, structural features that are broadly in line with international practices and standards.

4. The two regimes take into account the different risk and reward exposure of the respective types of products for an investor. In the case of equity or debt capital-raising, the investor's exposure is to the financial performance and prospects of the company issuing the shares or debentures. As for other investment products, in addition to the issuer (or the guarantor's) creditworthiness, the investor may also be exposed to the performance of the reference assets.

#### The Issues Involved

5. Under the existing legislative framework, the public offer of structured products, depending on their legal form, may be subject to different regimes, even though such structured products may have similar economic risk and return profiles. For example, equity-linked notes and equity-linked instruments are structured products that have similar risk and reward profiles. As equity-linked notes are in the legal form of a debenture, prospectuses of equity-linked notes are regulated under the CO prospectus regime. On the other hand, offer documents of equity-linked instruments are regulated under the SFO offers of investment regime

since they are in the legal form of securities or regulated investment agreements or a hybrid of securities and regulated investment agreements.

6. The above legislative framework should be rationalized by transferring the regulation of public offers of structured products from the CO prospectus regime to the offers of investment regime in Part IV of the SFO so that all structured products (regardless of their legal form) will be regulated under the SFO offers of investment regime, under which the SFC will publish codes and guidelines setting out its regulatory policy on such products. The SFC has proposed to issue a new SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, which would contain a new Code on Unlisted Structured Investment Products.<sup>3</sup> The SFC Handbook will set out the criteria that the SFC would normally consider before exercising its power to authorize the issue of offer documents or advertisements for unlisted structured products commonly seen in the retail market at present.<sup>4</sup>

## **The Legislative Proposals**

### Disapplication in the CO and Definition

7. The proposed transfer would involve disapplying the prospectus provisions in the CO (including sections 37 to 44B, 48A, sections 342 to 343, the Third Schedule, and the Seventeenth to Twenty-second Schedules) with respect to structured products. Regulation of public offers of structured products will be explicitly specified under the offers of investment regime in the SFO.

8. There were comments that the proposed definition of “structured product”, as set out in the consultation paper<sup>5</sup>, was too wide and would

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<sup>3</sup> The content of the new SFC Handbook is the subject of a separate consultation. Please refer to the SFC’s Consultation Paper on Proposals to Enhance Protection for the Investing Public published on 25 September 2009, which is available at <https://www.sfc.hk/sfcConsultation/EN/sfcConsultMainServlet?name=publicinvestorprotection>.

<sup>4</sup> Currently, the SFC has applied administrative measures to require issuers or guarantors of structured products to satisfy eligibility requirements similar to those in the Stock Exchange of Hong Kong’s Listing Rules for listed structured products.

<sup>5</sup> In the consultation paper, “structured product” is proposed to mean any-

include products currently not regulated under the SFO. We consider that a wide definition is necessary to avoid the possibility of issuers designing new products to fall outside the definition of “structured product” but in reality embed derivatives or have similar economic risk and return profiles. After considering such comments, we propose refining the definition of “structured product” by, among other things, excluding convertible and exchangeable bonds and subscription warrants issued for capital fund raising purposes from the definition, in addition to the originally proposed exclusions.<sup>6</sup>

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- (a) instrument under which either or both of-
    - (i) some or all of the returns or any other amounts due, or both, are payable or purport to be payable; and
    - (ii) the method of settlement, whether by payment of cash or by delivery of any type of securities, commodity, property, futures contract or otherwise, is determined or purports to be determined;
 by reference to one or more of the following:
    - (A) changes in the value or level (as the case may be) of any type of securities, commodity, index, property, interest rate, currency exchange rate or futures contract;
    - (B) changes in the value or level (as the case may be) of a basket of more than one type of securities, commodities, indices, properties, interest rates, currency exchange rates or futures contracts; or
    - (C) the occurrence or non-occurrence of an event or events specified in the instrument;
  - (b) regulated investment agreement; or
  - (c) interests, rights or property which is interests, rights or property, or is of a class or description of interests, rights or property, prescribed by notice under section 392 of the SFO as being regarded as a structured product in accordance with the terms of the notice, whether or not falling within subparagraphs (i) to (iv) below,

but does not include-

- (i) a direct interest in any collective investment scheme;
- (ii) depositary receipts;
- (iii) preference shares;
- (iv) a floating rate note; and
- (v) interests, rights or property which is interests, rights or property, or is of a class or description of interests, rights or property, prescribed by notice under section 392 of the SFO as not being regarded as a structured product in accordance with the terms of the notice.

<sup>6</sup> Under our proposal, the refined definition will capture-

- (a) an instrument where some or all of the return or amount due (or both the return and amount due) or the method of settlement is determined by reference to one or more of –
  - (i) changes in the value or level (or a range within the value or level) of any type of securities, commodity, index, property, interest rate, currency exchange rate or futures contract;
  - (ii) changes in the value or level (or a range within the value or level) of a basket of more than one type of securities, commodity, index, property, interest rate, currency exchange rate or futures contract;
  - (iii) the occurrence or non-occurrence of an event or events specified in the instrument;
 or
- (b) regulated investment agreements.

Such definition should however exclude-

- ✧ Products of which the prospectuses will continue to be regulated under the CO prospectus

9. At present, there are various exemptions in Part IV of the SFO in respect of currency and interest rate products issued by banks<sup>7</sup> as these products are generally regarded as banking transactions or treasury instruments of banks. This will continue after the proposed transfer.

10. The Stock Exchange of Hong Kong (“SEHK”) is the frontline regulator responsible for reviewing and approving listing documents for listed structured products (e.g. derivative warrants and callable bull/bear contracts). Under the current regulatory framework, listed structured product issuers generally issue marketing materials via their related licensed entities in reliance upon the exemption in section 103(2)(a) of the SFO for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 6 (advising on corporate finance) licensed intermediaries without having to seek the SFC’s prior authorization. These licensed intermediaries must, however, abide by the Guidelines on Marketing Materials for Listed Structured Products published by the SFC in September 2006. To avoid regulatory duplication, we propose that the SEHK remains as the frontline regulator for listed structured products after the proposed transfer. Accordingly, the issue by persons licensed or registered for Type 1, 4 or 6 regulated activities of offering documents and marketing materials of listed structured products and the products themselves should be exempted from the SFC’s authorization.

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regime:

- Ordinary shares, preference shares, and plain vanilla debentures;
- Convertible, exchangeable bonds and subscription warrants issued for fund raising purposes;
- Depository receipts;
- Floating rate notes;
- ✧ Products currently regulated under Part IV of the SFO and will continue to be regulated under Part IV of the SFO (but not as structured products):
  - SFC authorized collective investment schemes – these will continue to be regulated under sections 103, 104 and 105 of the SFO;
- ✧ Products that are to fall outside both the CO prospectus regime and the SFO offers of investments regime:
  - Insurance contracts (unless these also fall under the definition of collective investment scheme in the SFO);
  - Employee incentive schemes, e.g., phantom share offers;
  - Loans.

<sup>7</sup> For example, section 103(2)(c) contains an exemption for any advertisement, invitation or document made by or on behalf of an authorized financial institution in respect of leveraged foreign exchange contracts. Section 103(3)(e) also contains an exemption for any advertisement, invitation or document made in respect of the issue of a certificate of deposit by an authorized financial institution.

11. To allow flexibility and cater for financial innovation, we propose expanding the existing section 392 of the SFO which empowers the Financial Secretary to prescribe, via subsidiary legislation, interests, rights or property as being (or not being) securities or futures contracts to include structured products.

#### Authorization of Structured Products

12. We propose that the SFC be empowered to authorize structured products by replicating section 104 of the SFO, which has empowered the SFC to authorize collective investment schemes. The SFC authorization process will depend on compliance with codes and guidelines to be published by the SFC. As mentioned in paragraph 6 above, the SFC has proposed to issue the Code that will set out, among other things, certain basic structural features and disclosure benchmarks for unlisted structured products commonly seen in the retail market at present. As checks and balances, the decisions made by the SFC in respect of these unlisted structured products will be subject to review by the Securities and Futures Appeals Tribunal.

#### Safe Harbours

13. As we propose to disapply the prospectus provisions in the CO including the safe harbours in the Seventeenth Schedule to the CO, such safe harbours would no longer be available to structured products. We note that there are market concerns with respect to the loss of these safe harbours, in particular, the one for “an offer to not more than 50 persons” and the one on “an offer in respect of which the minimum denomination of, or the minimum consideration payable by a person for, the shares or in the case of debentures, the minimum principal amount to be subscribed or purchased, is not less than \$500,000”. Some market players argue that the unavailability of these safe harbours for structured products would in general impede the development of our private banking and wealth management business; and that since SFC’s authorization would be required, the market will not be able to offer structured products to investors in a timely and cost efficient manner.

14. These safe harbours are currently available only under the CO, not the SFO which has its own exemptions. The “not more than 50 persons” and “minimum denomination of \$500,000” safe harbours, when introduced in 2004<sup>8</sup>, formed part of a package to improve the prospectus regime to facilitate market development. They were based on similar exemptions in overseas markets. From the perspective of investor protection and in light of 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, i.e. not for structured products.

#### Classifying “Structured Products” as “Securities”

15. At present, the majority of the most common structured products that are publicly offered are securities-based and already subject to the regulatory requirements on “securities” in the SFO<sup>9</sup>. The SFC originally proposed to add structured products to the definition of “securities” in section 1 of Part 1 of Schedule 1 to the SFO, so that all structured products will be subject to the existing regulatory requirements on “securities”. However, there are market concerns that this proposal may be too sweeping with implications in particular for the market in bilateral transactions which are not offered to the public. We therefore propose to apply the regulatory requirements on “securities” only to structured products the offering documents etc. for which contain an invitation to the public. This is to pre-empt the possibility of the market devising non securities-based structured products to avoid such regulatory requirements in the future.

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<sup>8</sup> See the Companies (Amendment) Ordinance 2004, enacted on 9 July 2004.

<sup>9</sup> Such regulatory requirements include the licensing or registration requirements for persons that sell securities products to the public, and the conduct requirements on these licensed or registered persons. In gist, corporations carrying on regulated activities (including Type 1 (dealing in securities); Type 4 (advising on securities); etc) must be licensed or registered under the SFO. Only individuals satisfying the “fit and proper” test may be licensed or registered. The conduct of such intermediaries is governed by the Code of Conduct issued by the SFC, which sets out the general principles underpinning the conduct of securities business in Hong Kong. The Code imposes, among other things, general requirements of honesty, fairness and due diligence on intermediaries and their staff who perform regulated activities. The SFC is empowered to take enforcement action under the SFO for breaches of requirements relating to regulated activities or the Code of Conduct.

## Market Comments

16. The SFC has received 13 written submissions on the consultation proposals and has held more than 16 meetings to discuss aspects of the consultation paper with industry representatives. The respondents generally support, in principle, the proposed transfer of the regulation of public offers of structured products from the CO to the SFO subject to comments on certain detailed arrangements. The major concerns are addressed in paragraphs 8, 14 and 15 above.

## **Way Forward**

17. We are preparing the legislative provisions. Our plan is to introduce a bill to the Legislative Council within 2010 to effect the transfer.

**Financial Services and the Treasury Bureau  
Securities and Futures Commission  
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