For discussion on
19 January 2001

Paper No. 4/01

Bills Committee on
Securities and Futures Bill and Banking (Amendment) Bill 2000

Securities and Futures Bill
Part IV – Offers of Investments, Schedules 4 & 5

I. INTRODUCTION

1. Part IV of the Securities and Futures Bill (the "Bill") deals with the regulatory framework for the offering of investment products. It builds on the Protection of Investors Ordinance (Cap.335) (the "PIO") which provides for the authorization of advertisements, invitations and documents on investment products; and the part of the Securities Ordinance (Cap.333) (the "SO") which deals with the authorization of unit trusts and mutual fund corporations, as well as the requirements on offers made in respect of securities by intermediaries.

2. Schedule 4 to the Bill supplements certain provisions in Part IV in areas that are more likely to require updating over time.

3. Schedule 5 to the Bill sets out detailed requirements to be met in connection with offers to acquire or to dispose of securities.

4. A table comparing the provisions contained in Part IV and Schedules 4 and 5 with existing law is annexed to this paper.

II. POLICY OBJECTIVES AND MAJOR PROPOSALS

5. With a view to maintaining the status of Hong Kong as a regional centre for portfolio management activity, Part IV of the Bill seeks to achieve the following policy objectives:

(a) to provide a favourable environment for the development of the securities and futures industry and for the continued availability of as wide a range of investment products as the market can offer;

(b) to maintain a level playing field for market participants in respect of investment products that may be structured differently but are functionally similar in nature; and

(c) to promote sound business standards and ensure an appropriate level of investor protection.

6. Under the PIO, there is a general prohibition on the issue to the public of advertisements, invitations and documents relating to a wide range of investment products. A breach of this general prohibition is an offence, but the prohibition is subject to a number of exemptions, including the issue of advertisements, invitations and documents which the SFC has authorized. We have largely carried this over into the Bill.

7. Under section 15 of the SO, the SFC is conferred with the power to approve unit trusts and mutual fund corporations, and impose structural and operational requirements on the products. There is a gray area as to whether in approving the advertisements, invitations and documents of investment products under the PIO, the SFC has the power to impose requirements on the products as appropriate. The ambiguities cause concern in respect of those investment products that do not fall within the categories of unit trusts and mutual fund corporations. Thus, under the Bill, we have expressly empowered the SFC to approve collective investment schemes and impose conditions as appropriate (see paragraph 8(c) below).

8. In the Bill, we have introduced changes: removing ambiguities and gaps in the present legislation; resolving practical difficulties faced in the past; and addressing issues arising from market development and the increasing emergence of new, diverse and complex investment products. Major new features are:

(a) a new term "collective investment scheme" is introduced (Part 1 of Schedule 1) (see also paragraph 10 below);

(b) a new exemption for "mere conduits" in respect of the general prohibition on the issue of any marketing material regarding securities or collective investment schemes is introduced (clause 102(7) and (8)); and

(c) the SFC is expressly empowered to authorize collective investment schemes, hence allowing the SFC to impose reasonable structural and operational requirements thereon for proper investor protection; and withdraw the authorization where the requirements are not complied with (clauses 103 and 105).

III. MARKET COMMENTS AND CHANGES MADE

9. In the White Bill consultation exercise, certain key areas of concern to the market in respect of Part IV were identified and addressed. They are discussed below.

10. Some market participants were concerned that the definitions of "unit trust", "mutual fund" and "investment arrangements" under the White Bill may cause confusion as they overlapped with each other. We have redefined "collective investment scheme" by adopting the original definition under the White Bill for "investment arrangements" and deleting the references to "unit trust", "mutual fund" and "investment arrangements". This is only a technical amendment and will not affect the scope of the regulatory framework.

11. We have also received a comment suggesting there should be a wider "professional investor" safe harbour, transactions with such a person should be subject to a lighter regulatory approach. We agree that this could minimize the regulatory burden without unduly compromising investor protection. We have developed the concept of a "professional investor" (see definition in Schedule 1), in respect of whom the issue of marketing materials (clause 102(3)(j)) and the offer to acquire or dispose of securities (clause 108(5)(d)(i)) is subject to a lighter regulatory framework. The concept may be further developed through subsidiary legislation to meet emerging market needs.

12. The market was also concerned about the scope of clause 108 of the Bill governing the communication of offers to acquire or dispose of securities by certain intermediaries. We have introduced a new exemption for offers that are already regulated by the listing rules and the takeover codes (clause 108(5)(a)) from compliance with the requirements under clause 108. This is in addition to the existing exemption for offers made by exchange participants in the ordinary course of trading on a recognized stock market. Professional investors are also exempted as mentioned in paragraph 11 above.

13. There was a market comment that the notion of "invitation to the public" for the general prohibition on the issue of any marketing material regarding securities or collective investment schemes should be more precisely defined. We have not taken on board the comment. It is considered that proper investor protection requires such a broad notion, and that the notion is essentially a question of fact and should, in case of dispute, be decided by the Courts. Nevertheless, we believe that the introduction of the exemption for "professional investors" in the Bill would address substantially the market concern in this regard (see paragraph 11 above).

14. We have received a market comment that clause 107 on "Civil liability for inducing others to invest money in certain areas", which has its origin in the PIO, should be consolidated with other clauses which give rise to a civil right of action in Parts X, XIII and XIV of the Bill. The present approach addresses specific investor protection issues and provides greater clarity as to the circumstances under which an investor may resort to a private cause of action to claim damages. We shall provide a full picture to Members on these clauses on civil liabilities after Members have considered Parts X, XIII and XIV of the Bill.

15. A related issue to investment products regulated under Part IV concerns intermediaries who, under the current law, are not required to be regulated by the SFC in respect of their dealings in certain investment schemes that are not regarded as securities. This is undesirable as they give rise to exactly the same type of investor protection issues. Having regard to the comments received during the consultation exercise, we have redefined "securities" to include interests in certain collective investment schemes to fill the lacuna whereby certain intermediaries dealing in or advising on such interests are not regulated by the SFC nor any other regulator in Hong Kong.

IV. INTERNATIONAL COMPARISONS

16. This section aims briefly to outline the regulatory framework for the offering of investment products or, more specifically, collective investment schemes adopted in the United States ("**US**") and the United Kingdom ("**UK**").

The United States

17. Collective investment schemes, referred to as "investment companies" in the US, are governed primarily by the Investment Company Act of 1940 ("**Investment Company Act**"). The Investment Company Act establishes a comprehensive framework of federal regulation for the protection of US investors. The Division of Investment Management of the US Securities and Exchange Commission (the "**SEC**") administers the Investment Company Act, which requires the registration of an investment company with the SEC before it can offer its securities to the US public. The Investment Company Act also regulates most aspects of investment company governance and operations, including, among other things, disclosure, accounting, pricing, the use of leverage, transactions with affiliates, and the custody of investment company assets.

18. To ensure that US investors receive the same essential investor protection whether they acquire shares in a non-US investment company or in a US investment company, section 7(d) of the Investment Company Act requires that a non-US investment company that wishes to offer its securities publicly in the US

must first obtain an order from the SEC permitting it to register under the Investment Company Act.

19. If a non-US investment company does not meet the standards of the Investment Company Act, it may not be able to offer its securities publicly in the US.

The United Kingdom

20. The issue of investment advertisements is currently regulated in the UK under the Financial Services Act 1986 (the "Financial Services Act"), which permits three types of investment advertisements as follows:

(a) advertisements issued by an authorized person, or a person who is authorized for the purposes of the Financial Services Act, subject to any rules which the Financial Services Authority ("FSA") makes to ensure that an advertisement is fair and not misleading;

(b) advertisements issued by an unauthorized person, but approved by an authorized person; and

(c) advertisements issued by an unauthorized person but which benefit from a specified exemption from the basic restriction on unauthorized persons issuing investment advertisements.

21. Under the Financial Services Act, it is a criminal offence for an unauthorized person to issue an unapproved investment advertisement unless the advertisement falls within an exemption. In addition, contracts entered into as a result of an unapproved advertisement are not generally enforceable against the customer.

22. In addition, the Financial Services Act generally prohibits the issue of advertisements relating to collective investment schemes even by authorized persons, except where the schemes are authorized or recognized by the FSA. All collective investment schemes that are marketed to the general public in the UK need to operate in a regulatory environment that covers the operation and constitution of such schemes.

23. The financial promotion regime proposed under the Financial Services and Markets Act 2000 (the "Financial Services and Markets Act"), which is not in force yet, is essentially the same as that under the Financial Services Act, except for the following more significant aspects:

(a) the new regime moves to the media-neutral concept of "*communication of an invitation or inducement*" and provides an exemption for "*conduits*", which could include an internet service provider, who have no control over the content of a communication; and

(b) the proposed framework attempts to reduce the cost of informal capital raising by introducing a number of exemptions from the restriction for promotions to high net-worth and sophisticated investors, who are individuals with the typical characteristics of a "*business angel*" investing in start ups and small companies.

Securities and Futures Commission
Financial Services Bureau
17 January 2001

Annexure

Securities and Futures Bill
Part IV, Schedules 4 & 5

Comparison Table

Legend:
PIO – Protection of Investors Ordinance (Cap. 335)
SO – Securities Ordinance (Cap. 333)

Clause	Contents	Derivation	Notes
	PART IV - OFFERS OF INVESTMENTS		
	Division 1 - Interpretation		
101	Interpretation of Part IV	PIO s.2	Based on existing law. Definitions have been updated. The definition of "approved person" is new, as is the requirement introduced in clauses 103 & 104 that a collective investment scheme or an advertisement, etc., cannot be approved by SFC unless there is an "approved person" whose contact details are provided to the SFC and constantly updated to ensure that there can always be communication between the SFC and the scheme or advertiser. The new provision in clause 111 regarding service of notices upon "approved persons", also refers. The new definition of "representative" is adopted for ease of reference to individuals who are either licensed representatives accredited to licensed corporations or are employed by an exempt

			person in the conduct of regulated activity.
	Division 2 – Regulation of offers of investments, etc.		
102	Offence to issue advertisements, invitations or documents relating to investments in certain cases	PIO s. 4	Subclauses (1), (2), (3), (4), (5), (6) essentially follow existing law. Subclause (1)(a)(ii) refers to a new term, "regulated investment agreement", which is defined in Part 1 of Schedule 1 to mean the type of agreement that is referred to in section 3(1)(a)(ii) of the PIO. The penalty provision now features a daily fine for a continuing offence. Subclause (7) introduces an exclusion in relation to a "mere conduit" and subclause (8) provides a similar exclusion in relation to broadcasted material. The defence provided in subclause (9) is new. Subclause (10)(a) reflects section 2(2)(d) of the PIO, whereas (10)(b) is new. Subclause (11) reflects section 4(8) in whole, and section 4(3)(b) in part, of the PIO. Subclause (12) is new and seeks to assist in the interpretation of subclause (7).
103	Commission may authorize collective investment schemes	Expansion of SO s.15	The power, contained in s. 15 of the SO, to authorize unit trusts and mutual funds is expanded to all forms of collective investment schemes. Such expansion is necessitated by the development of investment products, which neither involve a trust nor take the form of a mutual fund. Subclauses (2), (3), (4), (6) & (7) are new. Subclause (7) reflects the SFC's obligation to accord procedural fairness when refusing an application for authorization.

104	Commission may authorize issue of advertisements, invitations or documents	Expansion of PIO s.4(2)(g) & (7)	The power for the SFC to authorize advertisements, etc., under s. 4(2)(g) and 4(7) of the PIO is developed into a proper enabling provision. This clause is structured almost exactly the same as clause 103.
105	Withdrawal of authorization under section 103 or 104, etc.	New	To remedy the lacuna in the current law. The approved person is provided, under subclause (5), with the safeguard of a reasonable opportunity of being heard. Clause 111 complements this new clause.
106	Offence to fraudulently or recklessly induce others to invest money	PIO s.3	Essentially follows the existing law. Subclause (2) introduces a penalty for conviction summarily.
107	Civil liability for inducing others to invest money in certain cases	PIO s.8	Essentially follows the existing law, save that subclause (3) is newly added for the avoidance of doubt.
108	Offers by intermediaries or representatives for Type 1 or Type 4 regulated activity	SO s.72	Essentially follows the existing law with the scope of the provisions updated, in the interests of proper investor protection, to cover securities issued by multilateral agencies, governments, municipal government authorities, as well as corporations. Subparagraphs (1)(b)(v), (vi)(A) & (vii) are new. Subclause (3) is new but echoes s. 72(2) of the SO. A daily fine for a continuing offence has been introduced in subclause. (4). Subclause (5)(a) is new and seeks to introduce several exclusions to avoid any unnecessary double regulation without compromising investor protection. Subclause (5)(d)(i) replaces the exclusion contained in s.72(5)(c)(i) with a reference to professional investors. Subclause (5)(g) is new and constitutes a logical extension of subclause (5)(f). Subclauses (6) and (9) are new.

109	Offence to issue advertisements relating to carrying on of regulated activities, etc.	PIO s.5	Based on existing law. Provisions have been updated to correspond with the new licensing regime under Part V for certain regulated activities which involve the giving of advice or the provision of asset management. Subclause (2) provides an exclusion in relation to the issue of any advertisement or document to all the intermediaries licensed or exempt for such regulated activities. This differs from s. 5(1A)(d) of the PIO in that trust companies are no longer excluded from the prohibition. Subclause (5) introduces an exclusion in relation to a "mere conduit" and subclause (6) provides a similar exclusion in relation to broadcasted material. The defence provided in subclause (7) is new. Subclause (8) is new.
	Division 3 - Miscellaneous		
110	Submission of information to Commission	PIO s. 7A	Follows the existing law.
111	Service of notices, etc. on approved persons	New	To ensure that notices can be effectively served upon an approved person in all circumstances.
112	Amendment of Schedules 4 and 5	New; PIO s.9; SO s.149	Follows the existing law.
	Schedule 4 - Offers of investments		
Part 1	Sum specified for purposes of section 102(3)(f)(i) and (g) of this Ordinance	PIO Schedule	Follows the existing law.
Part 2	Instruments specified for purposes of section 102(3)(g) of this Ordinance	PIO Schedule	Follows the existing law.
Part 3	Multilateral agencies	PIO Schedule	Follows the existing law.

Part 4	Exempted bodies	PIO Schedule	Parts IV & IVA of the PIO Schedule have been merged and updated.
Part 5	Sum specified for purposes of definition of "relevant condition" in section 102(13) of this Ordinance	PIO Schedule	Follows the existing law.
	Schedule 5 - Offers by intermediaries or representatives for Type 1 or Type 4 regulated activity under section 108 of this Ordinance		
Part 1	Requirements to be satisfied in relation to offers to acquire securities	SO Schedule 1	Essentially follows the existing law. Note that "closing price" replaces "last recorded price", "last price paid" and "price paid" in clause 1 to tally with the terminology adopted in the Code on Takeovers and Mergers issued by the SFC. Clause 3 is new.
Part 2	Requirements to be satisfied in relation to offers to dispose of securities	SO Schedule 2	Essentially follows the existing law. Use of "closing price" for consistency with clause 1 of Part 1 of Schedule 5. Clause 3 is based on the existing law and provides the disclosure requirements for securities issued by a corporation. Clauses 4 and 5 are introduced to cover the disclosure requirements for securities issued by a multilateral agency and a government or municipal government authority respectively. Such disclosure requirements are intended to be in line with similar requirements in the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited.