

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

Replies to LegCo Secretariat's Questions of 11 August 2010 (Batch 1)

Clause 4(5) (new section 103(3)(ea))

Please clarify:-

- (a) why the carving out is necessary; and
- (b) whether the carving out would exempt certain structured products that could fit the definition of any of the three instruments listed.

Reply

Under the existing offers of investments regime in Part IV of the Securities and Futures Ordinance (“SFO”), advertisements, invitations or documents in respect of certain currency-linked, interest rate-linked, and currency and interest rate-linked instruments issued by authorized financial institutions (i.e., banks)¹ are excluded from the SFC’s authorization requirements as these products are generally regarded as banking or treasury products. These products are therefore typically not regulated under the SFO. With the introduction of the term “structured product” into the offers of investments regime, its definition will cover other currency-linked, interest rate-linked, and currency and interest rate-linked instruments issued by authorized financial institutions the advertisements, invitations or documents of which are not already exempted by the existing section 103 of the SFO. Therefore, to maintain the existing regulatory framework, an express carve-out from the prohibition in section 103(1) is proposed so that advertisements, invitations or documents in respect of all currency linked-instruments, interest rate-linked instruments or currency and interest rate-linked instruments issued by authorized financial institutions will be exempted from the prohibition in section 103(1) and thus SFC’s authorization requirements.

¹ For example, section 103(2)(c) of the SFO 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) of the SFO contains an exemption for any advertisement, invitation or document made in respect of a certificate of deposit by an authorized financial institution.

As mentioned in the 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 issued by the SFC in April 2010, according to the public comments received by the SFC, respondents agreed that the status quo with regard to currency-linked and money market instruments issued by authorized financial institutions should be maintained. Nevertheless, authorized financial institutions selling these products are still required to comply with conduct requirements, e.g. ensuring the suitability of their recommendations and/or solicitation for the customers².

Clause 4(9) (new section 103(11A))

Please clarify the need for this provision.

Reply

The new section 103(11A) has to be read together with the amended section 103(2)(i).

The offers of investments regime in Part IV of the SFO is not intended to regulate the public offering of property which is not securities, collective investment scheme or structured product. The existing section 103(2)(i) exempts from the general prohibition the issue of any advertisement, invitation or document by a person who is engaged in the business of selling and purchasing property other than securities³ in the ordinary course of that business. Clause 4(4) of the Bill therefore proposes to extend the exemption under section 103(2)(i) of the SFO to exempt persons engaged in the business of selling and purchasing property other than structured products in the ordinary course of that business from the general prohibition in section 103(1) of the SFO. While their business is on the selling and purchasing of property which is not structured product, these persons, however, should not be allowed to “exploit” the exemption under the amended section 103(2)(i) to issue offering documents in respect of structured products which should be subject to the SFC’s regulatory scrutiny. The new section 103(11A) is therefore necessary to confine the scope of exemption under the amended section 103(2)(i) to the effect that such persons are prohibited from issuing an advertisement, invitation or document in respect of unauthorised or unlisted structured

² Please refer to the Hong Kong Monetary Authority’s circular “Selling of Investment Products” of 13 July 2009, which is available at http://www.info.gov.hk/hkma/eng/guide/circu_date/20090713e2.htm.

³ Please note that according to the definition of “securities” in section 1 of Part 1 of Schedule 1 to the SFO, “securities” include interests in any collective investment scheme.

products, unless that advertisement, invitation or document is authorised under section 105, or exempt under another provision in section 103.

Clause 5

Please confirm that it is the policy of the Administration that the authorization of structured products themselves as distinct from any requirements under section 103 is not mandatory.

Reply

The policy intent is that structured products offered to the public in Hong Kong are subject to the prior authorization of the SFC unless an exemption applies to their offering documents or advertisements. This treatment is similar to that of the collective investment schemes.

Authorization of a structured product under the SFO would normally be granted together with the authorization of its offering document(s) under section 105 of the SFO. It is the general policy of the SFC not to consider authorizing a product under the SFO alone without a concurrent authorization of its offering document(s).

Clause 11 & 12

Please clarify the reasons for adding "structured products" when "securities" should have covered the same ground.

Reply

As set out in clause 15(5) of the Bill, not all structured products will fall within the expanded definition of "securities" in section 1 of Part 1 of Schedule 1 to the SFO. In addition to the structured products which already fall within paragraphs (a) to (f) in the existing definition of "securities" (i.e. the securities-based structured products), the amended definition of "securities" is intended to cover structured products the advertisements, invitations or documents of which are required to be authorised under section 105 or are authorised under section 105 (i.e., in general terms, those that are publicly offered and do not fall within an exemption in section 103). The amended definition of "securities" typically does not cover non-securities based structured products that are not offered to the public.

In Clause 11, the addition of “structured products” will enable the SFC to apply for, and the Court to make, an order declaring a structured product that is not in the form of securities to be void or voidable. This is necessary because, in a case where section 107 has been contravened in relation to a structured product not in the form of securities, the appropriate remedy may be to declare the contract relating to the product to be void or voidable.

The amendments to Clause 12 relate to conflicts of interests provisions that are applicable to the SFC staff. The coverage of such conflicts of interests provisions is proposed to be made stricter by including structured products the advertisements, invitations or documents of which are not authorised.

Clause 15(7)

Definitions of "currency and interest rate-linked instrument", "currency-linked instrument" and "interest rate-linked instrument"

Please clarify the meaning of "method of settlement" referred to in each of the definitions. It appears that "settlement" could also mean the settlement of the structured product itself and in which case, method of settlement would not be affected by the factors listed in each of the definition. Please consider whether this ambiguity should be removed.

Reply

“Method of settlement” refers to the way of settling the contract between the buyer and issuer of the structured products which is determined by reference to certain circumstances and arrangements set out in the contract. For example, typically for equity linked-structured products, if the price or value of the linked asset reaches a certain level, the contract is to be settled by cash and when the price or value of the linked asset falls below a specified level, settlement will be by physical delivery of the linked asset. While terms and conditions of some structured products may specify different methods of settlement depending on specified circumstances, strike price⁴ and settlement style (European or American, etc.)⁵ are terms and conditions and are not methods of settlement.

⁴ Please note that strike price is the price at which the derivative can be exercised. It is not a method of settlement.

⁵ Please note that European or American refers to when the holder of an option may exercise. It is not a method of settlement.

Clause 15(8)

Definition of "structured product"

- (a) Please clarify the meaning of "method of settlement" referred to in the definition. It appears that "settlement" could also mean the settlement of the structured product itself and in which case, method of settlement would not be affected by the factors listed in the definition. Please consider whether this ambiguity should be removed.
- (b) Please clarify:-
 - (i) why a "regulated investment agreement" without more is a structured product; and
 - (ii) why paragraph (1)(a) is insufficient to cover all structured products and the aid of paragraph (1)(b) is required.

Reply

- (a) Please refer to the above reply to Clause 15(7). We believe there is no ambiguity with the use of the phrase "method of settlement".
- (b) At present, regulated investment agreements in the market predominantly comprise equity linked-deposits ("ELDs") and certain equity-linked investments ("ELIs"). These ELDs and ELIs are structured products.

While the coverage of paragraph (1)(a) is wide, it is not the same as that of "regulated investment agreement". As the concept of regulated investment agreement has been in the SFO since its inception, the proposal to include regulated investment agreement in the definition of "structured product" is the simplest and clearest way to ensure that market participants understand that regulated investment agreements are to be regulated as structured products. By incorporating paragraph (1)(b) into the definition of "structured product", it will also ensure that products that fall within the definition of "regulated investment agreement" do not fall outside the definition of "structured product" due to the differences in the definitions and accordingly circumvent the regulatory regime for structured products.

References to the new section 104A or structured products

As a consequence of adding the new section 104A, references to it has been added through amendments to existing sections in Part IV of SFO. However, similar references and references to structured products may need to be made also in the existing provisions of other Parts of SFO. Please review to see whether there is such need and explain in particular why no references to the new section or structured products are added in the following provisions of SFO:-

Sections 323(1) and 346(1); the definition of "professional investor" in section 1 of Schedule 1 and the definition of "leveraged foreign exchange contract" in Schedule 5.

Reply

We have reviewed the provisions in the SFO and its subsidiary legislation and believe that there are no other provisions which need to be amended as a consequence of adding the new section 104A.

Section 323(1) and 346(1) relate to the disclosure of interests regime in Part XV of the SFO. The existing definition of "equity derivatives" in Part XV suffices to cover the types of interests that need to be included in calculating a person's discloseable interests under that Part.

The new section 104A and reference to structured products will not affect the definition of "professional investor" and the definition of "leveraged foreign exchange contract" in Schedule 1 and Schedule 5 respectively. Hence, there is no need to make reference to the new section 104A or structured products in the definition of "professional investor" and "leveraged foreign exchange contract".

Clause 18 (section 2 of CO)

"Debt securities" does not seem to have been defined in the Bill or CO. Please clarify its meaning and whether there is need to provide a definition.

Reply

The 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.