

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

Definitions of Key Terms

Purpose

At the Bills Committee meeting held on 26 October 2010, Members requested the Administration to provide information to explain the definition of “securities” in the Securities and Futures Ordinance (“SFO”) and other definitions and terms in relation to investment products (e.g. structured products, interest rate-linked notes) covered by the Bill, with information on the underlying basic concepts, real life examples, the differences among the basic concepts, and the definitions of those terms and corresponding regulatory regimes adopted by international organizations and/or other developed markets. This paper sets out the relevant information for Members’ reference.

Key Terms

2. The table at Annex A summarizes the key terms used in the Bill. It also gives examples of products and highlights any proposed changes under the Bill. Annex B elaborates the definitions of the respective terms.

Practices in other Major Overseas Markets

3. Based on the research of the Securities and Futures Commission (“SFC”), there is no statutory definition of “structured products” in the context of securities regulation in the United Kingdom, the United States and Australia. In the absence of clearly identifiable and comparable definitions, and as the remits of the respective regulators are all different, the respective regulatory frameworks on structured products or products of certain similar features are not

directly comparable. It is thus not possible to draw a coherent comparison to the situation in Hong Kong.

**Financial Services and the Treasury Bureau
Securities and Futures Commission
November 2010**

Summary of the Key Terms used in the Bill, with Examples of Products and Proposed Change under the Bill

	Summary of definition	Location of definition	Examples of products	Change of treatment under the Bill
Structured product	An instrument which involves a derivative and which is linked to certain reference assets (e.g., equities, indices, commodities), or occurrence of events	Bill (Clause 15(8)) (see also paragraph 9 of Annex B)	Structured notes, equity linked investments, equity linked deposits	N/A – new term/concept introduced under the Bill
Securities : (existing definition, i.e., definition limbs (a) to (f))	Shares; debentures (e.g. bonds and notes); rights and options in shares and debentures; interests in collective investment schemes; interests commonly regarded as securities but does not include a number of things such as deposits or negotiable certificates or	Schedule 1 to SFO (see also paragraphs 1 and 2 of Annex B)	Shares, bonds, notes, interests in unit trusts or mutual funds, warrants, depository receipts, equity linked investments	None – structured products that are in the form of securities (existing definition) like equity-linked investments will continue to be securities

	Summary of definition	Location of definition	Examples of products	Change of treatment under the Bill
	documents evidencing a deposit.			
Securities: (new definition under the Bill, i.e. addition of limb (g))	A structured product that does not fall under the current definition of securities and for which the offer documents require SFC authorization under the SFO	Bill (Clause 15(5)) (see also paragraph 3 of the Annex B)	Equity linked deposits	Structured products that are not securities under the existing definition will become securities if the offer documents are required to be authorized or are authorized under section 105 of the SFO.
Regulated investment agreements	An agreement under which returns are linked to changes in value of property	Schedule 1 to SFO (see also paragraphs 4 and 5 of the Annex B)	Equity linked deposits Equity linked investments (sometimes a hybrid of securities and regulated investment agreements)	Regulated investment agreements will be subsumed into structured products. When these are offered to the public, they will become securities under the new limb (g).

Elaboration of the Definition of the Key Terms used in the Bill

Definition of “securities” in the SFO

1. The term “securities” is currently defined in Part 1 of Schedule 1 to the SFO to include, among others—
 - (a) shares, stocks, debentures, loan stocks, funds, bonds or notes;
 - (b) rights, options or interests (whether described as units or otherwise) in, or in respect of the items in (a);
 - (c) certificates of interest or participation in any of the items in (a);
 - (d) interests in any collective investment scheme.
2. Products falling under this definition include shares, bonds, depository receipts, warrants, structured notes (as these are debentures) etc. but do not include a number of things such as deposits or negotiable certificates or documents evidencing a deposit.
3. The existing definition of “securities” includes most but not all structured products that are publicly offered (specifically, those that are in the form of securities) e.g., equity linked investments. The Bill proposes to add a new limb (g) to the definition to include structured products that do not fall within the existing definition of “securities” (i.e., limbs (a) to (f) in the existing definition in the SFO as “securities” but which are offered to the public (and the issue of invitations, advertisements or documents in respect of which are prohibited under section 103(1) of the SFO unless authorized under section 105(1) or are otherwise exempted).

Definition of “regulated investment agreement” in the SFO

4. “Regulated investment agreement” is defined in Part 1 of Schedule 1 to the SFO as “an agreement the purpose or effect, or

pretended purpose or effect, of which is to provide, whether conditionally or unconditionally, to any party to the agreement a profit, income or other returns calculated by reference to changes in the value of any property, but does not include an interest in a collective investment regime”.

5. Equity linked deposits are predominantly the only kind of regulated investment agreements in the market whereas equity linked investments are a hybrid of regulated investment agreements and securities.

Current regime for public offers of products under the Companies Ordinance (“CO”) prospectus regime and the SFO offers of investments regime

6. Under the CO prospectus regime, prospectuses in respect of shares and debentures that are offered to the public must be authorized for registration by the SFC. This covers prospectuses for public offers of shares, bonds as well as structured notes since these are in the form of debentures.
7. The SFO offers of investments regime prohibits the issue of advertisements, invitations and documents in respect of securities (other than shares or debentures as these are covered under the prospectus regime), collective investment schemes and regulated investment agreements that are offered to the public unless these are authorised (or exempted). This covers offer documents and marketing materials in respect of equity linked investments and equity linked deposits (as well as unit trusts and mutual funds).

Definitions of terms relating to investment products covered under the Bill

8. The purpose of the Bill is to transfer the regulation of public offers of structured products that are in the form of shares or debentures from the CO prospectus regime to the offers of investments regime in Part IV of the SFO so that public offers of structured products fall under Part IV of the SFO.

9. With the transfer of structured products in the form of shares or debentures (e.g. structured notes) to the SFO, section 103(1) of the SFO is also amended to prohibit offers to the public of structured products unless the relevant offering documents or advertisements are authorized under sections 105 of the SFO or are otherwise exempted. The result is that when offered to the public, the offering documents and advertisements in respect of all structured products (in whatever legal form and unless otherwise exempted) will fall under Part IV of the SFO. The structured product will also need to be authorized under section 104A of the SFO. To implement this proposal, the term “*structured product*” is introduced and defined -

- (a) In contrast with the present approach in the CO and the SFO, the definition is not based on the legal form of the product and focuses on the economic effect of the product.
- (b) Since section 103(1) is a prohibitive provision, a wide definition of “structured product” is necessary to avoid the possibility of issuers designing new products to fall outside the definition.
- (c) Public offers of regulated investment agreements are currently regulated under Part IV of the SFO and they are to be regulated as structured products.
- (d) This definition of “structured product” will capture the most common structured products offered to the public in Hong Kong, for example, equity linked instruments, equity linked deposits, index linked instruments, commodity linked instruments and credit linked instruments.
- (e) Due to the wide definition of “structured product”, products that have never been subject to SFC regulation or are regulated under other Ordinances/regulators may also be caught. Therefore, certain carve-outs from the regime were considered necessary –

- Convertible bonds, exchangeable bonds issued for capital fund raising purposes and that are convertible or exchangeable for shares of the issuer (or a related corporation) of the convertible or exchangeable bond – public offers of these will continue to be regulated under the CO prospectus regime. (see section (2)(a) of the definition)
- Subscription warrants issued for or capital fund raising purposes that entitles the holder to subscribe for shares of the issuer (or a related corporation) of the subscription warrant – public offers of these will continue to be regulated under the CO prospectus regime. (see section (2)(b) of the definition)
- Depository receipts - public offers of these will continue to be regulated under the CO prospectus regime. (see section (2)(d) of the definition)
- Collective investment schemes – public offers of collective investment schemes are subject to sections 103 and 104 of the SFO. (see section (2)(c) of the definition)
- Floating rate notes - public offers of these will continue to be regulated under the CO prospectus regime. (see section (2)(e) of the definition)
- Employee incentive schemes – these are not regulated under the SFO or CO (see section (2)(f) of the definition)
- Gambling products – these are not regulated under the SFO or CO but fall under the Ordinances listed in sections 2(g) and (h) of the proposed definition (see section (2)(g) and (h) of the definition)
- Insurance contracts – other than investment linked assurance schemes which are authorized as collective investment schemes under section 104 of the SFO if

offered publicly, these are typically not regulated under the SFO or CO (see section (2)(i) of the definition)

- (f) Banking products - Currency linked products, interest rate linked products and currency and interest rate linked products that are issued by banks are typically not regulated under the SFO as these are banking transactions or treasury instruments of banks.
- (g) To cater for financial innovation, the Bill empowers the Financial Secretary to prescribe products as being or not being structured products (see sections 1(c) and 2(j) of the definition).