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# SFC To Implement Proposals To Enhance Regulation Of Retail Structured Products

The Securities and Futures Commission (SFC) has announced its intention to proceed with proposals to transfer the regulation of public offers of structured products from the Companies Ordinance (CO) prospectus regime to the offers of investments regime in Part IV of the Securities and Futures Ordinance (SFO) in its Consultation Conclusions on Possible Reforms to the Prospectus Regime and the Offers of Investments Regime in the Securities and Futures Ordinance, released in April 2010.

## Disapplication of the CO Prospectus Provisions to Structured Products

The regulation of public offers of structured products under current law depends on the legal form of the product. Public offers of structured products in the form of a share or debenture (e.g., an equity linked note or credit linked note) are regulated under the CO prospectus regime, whereas public offers of structured products in a legal form other than a share or debenture (e.g. a hybrid of securities and regulated investment agreements, such as an equity linked instrument) are regulated under the offers of investments regime in Part IV SFO.

Under the proposals, the CO prospectus regime will be disapplied with respect to structured products so that public offers of all unlisted structured products will be regulated under the SFO regardless of their legal form. Public offers of unlisted structured products will require SFC authorization under a new Section 104A SFO. Authorization will depend upon compliance with a new product code for unlisted structured investment products to be included in a new SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products (which is the subject of the SFC's Consultation Conclusions on Proposals to Enhance Protection for the Investing Public published in May 2010). The new product code will set out, amongst other things, certain basic structural features and disclosure benchmarks for unlisted structured products.

## Loss of CO Safe Harbours

The implementation of the proposals will mean that public offers of structured products will no longer be able to rely on the safe harbours in the Seventeenth Schedule to the CO which will not be replicated in the SFO. In particular, the loss of the 'no more than 50 persons' and the 'minimum denomination of HK$500,000' safe harbours was a cause for concern among the thirteen respondents to the consultation paper. The SFC however deemed it 'inappropriate' to replicate the CO safe harbours in the SFO.

With respect to the loss of the 'no more than 50 persons' safe harbour, the SFC notes that while the SFO does not have a similar bright line exemption, the concept is included in the SFO since Section 103 only requires authorization of documents relating to offers to the public. The SFC considers that the concept of what is a public offer is well understood without a bright line test and that guidance on the matter is unnecessary.

The SFC proposes however to review the evidential requirements of the Securities and Futures (Professional Investor) Rules (PI Rules) in order to make the professional investor exemption available under Section 103(3)(k) SFO more practical to apply. Respondents commented that intermediaries often face difficulties from clients in meeting the evidential requirements of the PI Rules: in the case of an individual, an accountant’s certificate or custodian statements are required as evidence of the individual's HK$8 million portfolio which enables him to be classified as a 'professional investor'. Other leading jurisdictions, such as the U.K., Australia and Singapore do not appear to have similar evidential requirements. The SFC plans to publish a further consultation on this subject.

## Proposed Definition of Structured Product

The SFC proposes to adopt a wide definition of 'structured product' in order to prevent products being designed to fall outside the definition which in reality embed derivatives or have similar economic risk and return profiles. Structured Products regulated under Part IV SFO

The SFC has proposed to the Government that 'structured products' should be defined as:

(a) instruments 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:

1. 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;
2. 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; or
3. the occurrence or non-occurrence of an event or events specified in the instrument; or

(b) regulated investment agreements.

Examples of products within the above definition include equity linked notes, credit linked notes, equity linked deposits and equity linked instruments.

The Financial Secretary will also have the power to prescribe any interests or rights as a 'structured product' or as not being a 'structured product' by publication of a notice in the Gazette.

The definition of 'structured product' will exclude the following:

(a) products of which the prospectuses will continue to be regulated under the CO prospectus regime

1. ordinary shares;
2. preference shares;
3. depositary receipts over or in respect of shares;
4. plain vanilla debentures (e.g., fixed rate bonds, zero coupon bonds, promissory notes);
5. floating rate notes, to the extent that the above products have no derivative element attached to them; and
6. convertible and exchangeable bonds and subscription warrants issued for fund raising purposes that entitle the holder to convert, exchange or subscribe for shares of the issuer or its related company;

(b) products that will continue to be regulated under Part IV SFO (but not as structured products)

1. SFC authorized collective investment schemes will continue to be regulated under sections 103, 104 and 105 SFO; and

(c) products that are outside both the CO prospectus regime and the SFO offers of investments regime in respect of structured products

1. insurance contracts in relation to any class of business specified in the First Schedule to the Insurance Companies Ordinance (although investment-linked assurance schemes that are offered to the public will require authorization under the new Section 104A SFO);
2. employee incentive schemes, e.g. phantom share offers; and
3. loan arrangements.

### Meaning of 'instrument' in 'structured product' definition

The SFC has clarified the following points in the Consultation Conclusions:

1. it regards an 'instrument' as being a written document;
2. while bilateral private contracts could be within the definition of 'structured product', the authorization requirements of the SFO would apply only if such contracts are publicly offered;
3. over-the-counter derivatives, which are generally bilateral private contracts, similarly would only require authorization if they are to be publicly offered; and
4. with respect to comments that futures contracts should be excluded from the 'structured product' definition, as they are already regulated under the SFO, the SFC noted that there is currently an exemption for advertisements, invitations or documents made by persons licensed or registered with the SFC for regulated activities Types 2 or 5 in respect of futures contracts. The SFC considers this exemption to be adequate to reflect the policy intent that in the case of offers of futures contracts by SFC licensed or registered persons, authorization of the related invitations or offer documents will not be required.

## Classifying Structured Products as 'securities'

In order to ensure that all the regulatory requirements of the SFO currently applicable to securities (e.g. licensing, conduct requirements and disclosure requirements) would also apply to structured products, the SFC originally proposed amending the definition of 'securities' in Schedule 1 SFO to include all structured products or rights, options or interests in respect of such products.

Strong opposition to the proposal has led the SFC to modify the proposal so that instead of classifying all structured products as 'securities', the definition of 'securities' will be amended such that any structured product (not in the form of securities) in respect of which any offer document would be subject to Section 103(1) of the SFO or any structured product which is listed on the SEHK would be included as a security.

Intermediaries selling structured products such as equity linked notes and equity linked instruments to the public are expected to comply with the requirements of the SFC'’s Code of Conduct and any other applicable SFC codes and guidelines.

## Currency Linked Instruments and Money Market Instruments Issued by Authorized Financial Institutions

A specific exemption will be included in the SFO for currency linked and interest rate linked instruments issued by authorized financial institutions to ensure that such instruments are not caught by the prohibition under Section 103(1) SFO as a result of the new definition of 'structured product'.

## Disapplying the Exemptions for Documents Issued by Type 1, Type 4 and Type 6 Licensed Intermediaries

The SFC proposes to proceed with the exclusion of unlisted structured products from the exemptions from the requirement for SFC authorization for offer documents and marketing materials issued by Type 1, Type 4 or Type 6 licensed intermediaries under Sections 103(2)(a) and 103(5)(a) SFO. Accordingly all marketing materials relating to public offers of unstructured products will require SFC authorization.

## Preservation of Existing Framework for Listed Structured Products

Listed structured products (or their related licensed entities) will continue to be able to rely on the exemption under Section 103(2)(a) SFO which allows the issue of marketing materials by Type 1, Type 4 or Type 6 licensed entities without first obtaining SFC authorization. Licensed entities must however still comply with the Guidelines on marketing materials for listed structured products published by the SFC in September 2006.

## Amendments to the Definition of 'debenture'

The definition of 'debenture' in the CO will be amended to refer to 'other debt securities' rather than 'other securities'

## Going Forward

The SFC has presented its recommendations to Government and it is expected that a bill implementing the proposals will be gazetted and tabled before the Legislative Council in 2010.

With respect to the evidential requirements in the PI Rules, these will be reviewed by the SFC and a further consultation exercise will be conducted.

*The purpose of this newsletter is to provide a summary only of the SFC's " 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" (April 2010). Its contents do not constitute legal advice and specific advice should be sought in relation to any particular situation.*

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