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# New Regime For Offers Of Structured Products Effective 13 May 2011

## Introduction

Amendments to the Hong Kong regulatory regime governing public offers of investment products came into effect on 13 May 2011 with the coming into force of The Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 (**Amendment Ordinance**). In the wake of the Lehman mini-bond crisis, the primary purpose of the amendments was to increase protection for Hong Kong’s investing public by tightening the regulation of public offers of structured products. The regulation of public offers of all structured products has been transferred from the prospectus regime of the Companies Ordinance (**CO**) to the offers of investments regime in Part IV of the Securities and Futures Ordinance (**SFO**) so that, regardless of their legal form, public offers of all structured products are now regulated under the SFO.

## The New Regime In A Nutshell

### 1. Part IV SFO

1. Public offers of structured products (such as equity or credit linked instruments) are now regulated only by Part IV SFO;
2. In the absence of a relevant exemption, public offers of structured products and the issue of advertisements and offering documents relating to such offers now require Securities and Futures Commission (**SFC**) authorization and the appointment of an SFC authorized person;
3. Public offers of structured products can no longer rely on the following exemptions:
   1. CO exemptions (e.g. for offers to less than 50 persons, offers with a minimum subscription amount of HK$500,000 or a total offer size of HK$5 million); or
   2. The exemptions under Part IV SFO for documents issued by intermediaries licensed or registered for regulated activities Type 1, 4 or 6;
4. The scope of available exemptions for offers of unlisted structured products has narrowed considerably. These are now limited to offers made only to "professional investors", to persons outside Hong Kong or in circumstances not involving an offer or invitation to "the public". There is no bright line test under the SFO to determine how many offers constitute a public offer. With the loss of the CO private placement exemption for offers to a maximum of 50 investors, this has reintroduced an element of uncertainty as to the maximum number of offerees for SFO purposes; and
5. Part IV continues to regulate offers of collective investment schemes under sections 103 to 105 (i.e. not as structured products).

### 2. The CO Prospectus Regime

1. The CO prospectus regime no longer regulates public offers of structured products: such offers are exempted under new section 38AA CO.
2. The CO prospectus regime continues to regulate offers of the following products provided they have no derivative element attached:
   1. shares (including preference shares);
   2. depositary receipts;
   3. plain vanilla debentures (e.g. fixed rate and zero coupon bonds and promissory notes); and
   4. floating rate notes,
3. The CO prospectus regime also continues to regulate offers of 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 of its related corporation (broadly, a company within the same group)[[1]](#footnote-27);

### 3. Products falling outside both the CO Prospectus Regime and Part IV SFO

The following products fall outside both the CO prospectus regime and the SFO offers of investments regime:

1. insurance contracts in relation to any class of business specified in the First Schedule to the Insurance Companies Ordinance (Cap. 41);
2. employee incentive schemes (e.g. phantom share option schemes); and
3. loan arrangements.

## Major Changes Effected By The Amendment Ordinance

### 1. Disapplication of the CO Prospectus Provisions to Structured Products

The regulation of public offers of structured products under the old law depended 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) were 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) were regulated under the offers of investments regime in Part IV of the SFO.

From 13 May 2011, the CO prospectus regime no longer applies to structured products which are exempted from it under new section 38AA CO. Instead, public offers of all unlisted structured products regardless of legal form are now regulated under Part IV of the SFO. The CO prospectus regime continues to apply to vanilla products.

### 2. Definition of "Structured product"

A wide definition of "structured product" has been introduced into the SFO by new Part 1A of Schedule 1, which is set out in full in Annex A to this note. In general, any derivative element will make a product "structured". "Structured product" is defined to include:

1. 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 price, value or level (or a range within the price, value or level) of any type of securities, commodity, index, property, interest rate, currency exchange rate or futures contract;
   2. changes in the price, value or level (or a range within the price, 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 (excluding an event or events relating only to the issuer or guarantor of the instrument or to both of them); or
2. 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 is also able 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 under Section 392 SFO.

There are a number of exclusions from the definition of "structured product" including the following, to the extent that they have no derivative element:

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); and
5. floating rate notes.

The following are also among the products excluded from the definition:

1. 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 of a related corporation of the issuer;
2. collective investment schemes which continue to be regulated under sections 103 to 105 SFO;
3. 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); and
4. employee incentive schemes.

#### The meaning of the term "instrument"

A number of respondents to the consultation queried the meaning of "instrument" which is not defined in the SFO in the definition of structured product. In its general observations, the SFC made the following points:

1. The SFC takes the view that an “instrument” is a written document;
2. A bi-lateral private contract could be within the definition of "structured product", however SFC authorization is required only if there is a public offer; and
3. Both negotiable and non-negotiable instruments are potentially within the definition of structured products.

### 3. The Definition of "Securities"

The definition of "securities" in Schedule 1 to the SFO has been amended to include:

1. structured products (not in the form of securities), in respect of which any offer document requires SFC authorization under Section 103(1) SFO; and
2. structured products which are listed on the Stock Exchange of Hong Kong.

As a result, all the regulatory requirements of the SFO that apply to securities (e.g., licensing and conduct requirements) now also apply to structured products. Accordingly, intermediaries selling structured products that require SFC authorisation (e.g. equity linked notes and equity linked instruments) need to be licensed for regulated activities Type 1 (dealing in securities) and potentially Type 4 (advising on securities). Such intermediaries must also comply with the requirements of the SFC's Code of Conduct and any other applicable SFC codes and guidelines.

The SFC is not proceeding with its original proposal of classifying all structured products as securities for the time being. This is due to concerns raised by the market that to do so would result in non-securities based products being regulated under SFO provisions intended to regulate securities.

### 4. The Requirement for SFC Authorisation for Public Offers of Structured Products

New section 104A SFO requires unlisted structured products that are to be offered to the public to be authorized by the SFC. Replicating Section 104 SFO which applies to collective investment schemes, Section 104A empowers the SFC to authorize the product itself (i.e. not just the offering documentation) and such authorization may be made subject to any conditions the SFC considers appropriate. SFC authorization will depend on compliance with the Code on Unlisted Structured Investment Products (**SIP Code**) in the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products.

### 5. The Requirement for SFC Authorization for the Issue of Advertisements and Offering Documents to the Public

The issue of any advertisement or offering document in respect of a structured product must also be authorized by the SFC under section 105 SFO.

Section 103 SFO has been expanded to cover structured products so that it is a criminal offence for a person to issue or have in his possession for the purposes of issue, whether in Hong Kong or elsewhere, an advertisement, invitation or document which to his knowledge is or contains an invitation to the public, to enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite any structured product, unless an exemption is available or the issue is authorized by the SFC. Breach of section 103 carries a maximum fine of HK$500,000 and up to 3 years' imprisonment.

### 6. Loss of CO Safe Harbours

As acknowledged in the SFC's 2010 Consultation Conclusions on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the SFO (the **Consultation Conclusions**), significant concerns were raised by respondents to the consultation regarding the loss of the CO safe harbours, in particular, the private placement exemption for offers to 'no more than 50 persons' and the exemption for offers with a minimum denomination/subscription amount of HK$500,000 (the **Minimum Denomination Exemption**), which were apparently commonly used to market structured products. The SFC however refused to heed calls for these safe harbours to be replicated in Part IV SFO.

#### Loss of safe harbour for offers to no more than 50 persons

With respect to the loss of the 'no more than 50 persons' safe harbour, 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. Respondents to the consultation raised concerns that, in the absence of a bright line test or other guidance from the SFC as to the number of offers that constitute a public offer, the resulting uncertainty would adversely affect the private placement of structured products. The loss of the CO private placement exemption for offers of structured products may be seen as having reintroduced some of the uncertainty that surrounded private placements generally before the 2004 amendments to the CO and SFO. Prior to the introduction of the 50 person test, it had been generally accepted that the acceptable number of placees for the purposes of the SFO (and its predecessor, the Protection of Investors Ordinance) was between 20 and 30, lower than the benchmark limit of 50 which had generally been accepted for private placements in relation to the CO. As 50 is the statutorily imposed upper limit on the number of private placees of non-structured products (other than collective investment schemes) under the CO and SFO, we would expect that 50 is the acceptable upper limit for private placements of structured products. The ultimate arbiter of this will however be the Hong Kong courts.

The SFC states however in the Consultation Conclusions that:

"The SFC believes that the concept of what is a public offer is well understood by the market since the concept has been contained in the SFO since its inception (and has been contained in the Protection of Investors Ordinance which precedes the SFO) without a bright line test. Accordingly the SFC takes the view that the reproduction of this safe harbour in the SFO is not necessary, in particular when the safe harbour is not commonly used. For the same reasons, the SFC believes that guidance on the matter is also unnecessary."[[2]](#footnote-38)

#### Loss of the HK$500,000 Minimum Denomination Exemption

The exemption for offers where the minimum denomination/subscription amount is HK$500,000 or more was apparently heavily relied on by issuers and distributors of structured products and products offered in reliance on this exemption accounted for a significant proportion of their structured products business.

In response to market concerns regarding the loss of this safe harbour, the SFC noted that it was originally considered that an investor who could afford to take up offers with a minimum denomination of HK$500,000 would be sufficiently knowledgeable about the risks involved or in a position to seek professional advice, and thus did not require the protection available to retail investors. The SFC concluded that it would be inappropriate to introduce this safe harbour into the SFO due to the significant development of the structured products market in the last few years, the SFC's understanding from market participants that investors making smaller investments are being increasingly targeted and the lesson from the Lehman minibond crisis that an investor affluent enough to invest HK$500,000 is not necessarily sufficiently knowledgeable to fully appreciate the risks attached to structured products.

### 7. Loss of Exemptions for Documents Issued by Type 1, Type 4 and Type 6 Licensed Intermediaries

Sections 103(2)(a) and 103(5)(a) SFO provide exemptions from the requirement for SFC authorization for offer documents and marketing materials issued by intermediaries licensed for regulated activities Type 1 (dealing in securities), Type 4 (advising on securities) or Type 6 (advising on corporate finance). Unlisted structured products are now specifically excluded from these exemptions. These exemptions continue to apply to listed structured products.

### 8. Available Exemptions for Offers of Structured Products

#### Professionals' Exemption

The SFC expects market participants to shift reliance to the professional investor exemption under Section 103(3)(k) SFO. Market participants have complained that the evidentiary requirements for establishing compliance with the relevant assets or portfolio threshold for high net worth individuals/companies to qualify as "professionals" are overly restrictive and, in practice, discourage market practitioners from relying on the exemption for offers to professionals.

In response, the SFC is to introduce a more flexible, principles-based approach allowing firms to use the methods they consider most appropriate in assessing whether an investor satisfies the relevant threshold. Alternatively firms that prefer the current practices will be able to continue to use the existing methods set out in the Securities and Futures (Professional Investor) Rules.

However, the required amendments to the Professional Investor Rules have not yet been made and compliance with the existing evidentiary requirements in relation to high net worth individuals and companies is therefore still required.

#### Exemption for Offers to Persons Outside Hong Kong

The exemption from the SFC authorization requirement for advertisements and offering documents issued to persons outside Hong Kong (section 103(3)(j)) has been extended to cover offers of structured products.

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

New section 103(3)(ea) SFO exempts from the SFC authorization requirement advertisements or offer documents relating to instruments issued by authorized financial institutions (**AFIs**) that are referenced to:

1. changes in the level of any interest rate or a basket of interest rates (i.e. interest rate linked instruments);
2. changes in the level of any currency exchange rate or a basket of currency exchange rates (i.e. currency linked instruments); or
3. changes in the level of any interest rates/a basket of interest rates and changes in the level of any currency exchange rate/a basket of currency exchange rates.

These instruments also fall outside the new definition of "securities". Nevertheless, AFIs that sell these products are still required to comply with conduct requirements, e.g. ensuring the suitability of their recommendations and/or solicitation for the customers as stated in the circular of the Hong Kong Monetary Authority dated 13 July 2009.

Respondents to the consultation queried whether currency or interest rate linked products issued by AFIs the relevant amount of which may be determined subject to conditions (other than those set out in the definitions) such as knock in or knock out features would be within the definitions of exempted instruments. The SFC's response was that so long as the attached "bells and whistles" do not contain any derivative element, the product should fall within the relevant definition.

There were also suggestions that the definition of currency linked instrument should be extended to include products issued by AFIs that are referenced to the price of gold and silver. The SFC considers this to be premature at present but would be prepared to reconsider if this is later shown to be appropriate.

### 9. The Regime for Offering Listed Structured Products

The regime for offering listed structured products remains unchanged. The exemption from the SFC authorization requirement under section 103(3)(h) SFO for advertisements and documents for securities which have been approved for listing by the Stock Exchange of Hong Kong Limited (**SEHK**), has been extended to cover structured products that have been approved for listing. Accordingly, SEHK remains the frontline regulator responsible for reviewing and approving listing documents for listed structured products.

Listed structured product issuers can continue to issue marketing materials through licensed intermediaries without obtaining SFC authorization in reliance on the exemption in section 103(2)(a) for advertisements and documents issued by intermediaries licensed for regulated activity Type 1, Type 4 or Type 6. These licensed intermediaries must however comply with the [Guidelines on marketing materials for listed structured products](http://en-rules.sfc.hk/net_file_store/new_rulebooks/h/k/HKSFC3527_2773_VER11.pdf) ([see archive](HKSFC3527_2773_VER11.pdf)) published by the SFC in September 2006.

### 10. The Definition of Debenture

The definition of "debenture" in the CO and the SFO has been amended so that it now includes debenture stock, bonds and "any other debt securities" of a company whereas previously it referred to "any other securities".

### 11. Structured Product Application and Authorization Fees

The Securities and Futures (Fees) Rules have been amended to provide for payment of an application fee and authorization fee in respect of a structured product of HK$2,000 and HK$1,000, respectively.

## Consequential Changes To Selling Restrictions

A new standard form of Hong Kong selling restriction has been agreed by certain of the larger Hong Kong law firms to reflect the changes made to the regulatory regime governing offers of investment products in Hong Kong. The new standard form is reproduced at Annex B to this note.

## Annex A

### The Definition of "structured product" in Part 1A of Schedule 1 to the SFO (Part 1A)

The term "structured product" is defined by Section 1 of Part 1A as:

1. an instrument under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to one or more of:—
   1. changes in the price, value or level (or a range within the price, value or level) of any type or combination of types of securities, commodity, index, property, interest rate, currency exchange rate or futures contract;
   2. changes in the price, value or level (or a range within the price, value or level) of any basket of more than one type, or any combination of types, of securities, commodity, index, property, interest rate, currency exchange rate or futures contract; or
   3. the occurrence or non-occurrence of any specified event or events (excluding an event or events relating only to the issuer or guarantor of the instrument or to both the issuer and the guarantor);
2. a regulated investment agreement; or
3. any interests, rights or property prescribed, or of a class or description prescribed, by notice under section 392 of the Securities and Futures Ordinance as being regarded as structured products in accordance with the notice.

The following are specifically excluded from the definition of "structured product" by section 2 of Part 1A:

1. a debenture issued for capital fund raising purposes that is convertible into or exchangeable for shares (whether issued or unissued) of the issuer of the debenture or of a related corporation1 of the issuer;
2. a subscription warrant issued for capital fund raising purposes that entitles the holder to subscribe for shares (whether issued or unissued) of the issuer of the warrant or of a related corporation of the issuer;
3. a collective investment scheme;
4. a depositary receipt;
5. a debenture that would come within subsection (1)(a) only because it has a variable interest rate that is reset periodically to equate to a money market or interbank reference interest rate that is widely quoted (whether or not subject to a predetermined maximum or minimum rate) plus or minus a specified rate (if any);
6. a product under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to securities of a corporation, or of its related corporation, that is issued by the corporation only to a person who is:
   1. a bona fide employee or former employee of the corporation or of its related corporation; or
   2. a spouse, widow, widower, minor child (natural or adopted) or minor step-child of a person referred to in subparagraph (i);
7. a product that may be possessed, promoted, offered, sold, printed or published only:
   1. under a licence, permission or other authorization under the Betting Duty Ordinance (Cap. 108) or the Gambling Ordinance (Cap. 148); or
   2. under the Government Lotteries Ordinance (Cap. 334);
8. an instrument issued in relation to:
   1. a contest authorized by section 37 of the Broadcasting Ordinance (Cap. 562); or
   2. a contest included in a service licensed under Part IIIA of the Telecommunications Ordinance (Cap. 106);
9. a contract of insurance in relation to any class of insurance business specified in the First Schedule to the Insurance Companies Ordinance (Cap. 41); or
10. any interests, rights or property prescribed, or of a class or description prescribed, by notice under section 392 of the Securities and Futures Ordinance as not being regarded as structured products in accordance with the notice.

## Annex B

### New Hong Kong Selling Restrictions from 13 May 2011

**Standard Form Agreed between Allen & Overy, Clifford Chance, Freshfields Bruckhaus Deringer, Linklaters, Mallesons Stephen Jaques, Simmons & Simmons and Slaughter and May**

The changed form of restrictions (as they would apply to an international institutional offering of shares, bonds or notes drawn down off a programme, whether the issuer is incorporated in Hong Kong or outside Hong Kong) is as follows:

**Each [Manager] [Dealer] has represented and agreed that:**

1. it has not offered or sold and will not offer or sell in Hong Kong, by means of any document, any [Securities] [(except for [Securities] which are a "structured product" as defined in the Securities and Futures Ordinance (Cap. 571) of Hong Kong)1] other than (a) to "professional investors" as defined in the Securities and Futures Ordinance [(Cap. 571) of Hong Kong] 2 and any rules made under that Ordinance; or (b) in other circumstances which do not result in the document being a "prospectus" as defined in the Companies Ordinance (Cap. 32) of Hong Kong or which do not constitute an offer to the public within the meaning of that Ordinance; and
2. it has not issued or had in its possession for the purposes of issue, and will not issue or have in its possession for the purposes of issue, whether in Hong Kong or elsewhere, any advertisement, invitation or document relating to the [Securities], which is directed at, or the contents of which are likely to be accessed or read by, the public of Hong Kong (except if permitted to do so under the securities laws of Hong Kong) other than with respect to [Securities] which are or are intended to be disposed of only to persons outside Hong Kong or only to "professional investors" as defined in the Securities and Futures Ordinance [(Cap. 571) of Hong Kong] 3 and any rules made under that Ordinance.

**How to use the standard form**

For a standalone offering, or a drawdown of specific Securities:

If the Securities are either shares or debentures and are not structured products, include both Limb 1 and Limb 2; delete the words in red (and include the words in green; omit the words in blue). If the Securities are structured products, delete Limb 1 (the Companies Ordinance restriction); only Limb 2 (the SFO restriction) applies. Include the words in blue.

Where the selling restriction is included in a programme:

1. Include the words in red if the Securities could include structured products: for example in an MTN programme which permits drawdown of both vanilla and structured notes.
2. Omit the words in green if the words in red referred to in footnote 1 are included.
3. Include the words in blue if Limb 1 of the selling restriction is not included.

If the programme provides for the issue only of vanilla debentures, and does not provide for the issue of any structured products, include both Limb 1 and Limb 2; delete the words in red (and include the words in green; omit the words in blue).

If the programme permits the issue of structured products, include both Limb 1 and Limb 2; include the words in red; omit the words in green and in blue.

**Variations to the standard form**

It is intended that this form will normally be used for standard offerings of shares or debentures by companies in the international institutional market. Other types of transactions may require adjustments to the language to suit circumstances.

In offerings by a non-Hong Kong incorporated company only, it is not wrong to include as an additional carve out in paragraph 1 a reference to "persons whose ordinary business is to buy or sell shares or debentures, whether as principal or agent". If a manager or issuer client prefers to see this language, it may be included.

Other stylistic variations may also be necessary – and are unobjectionable – to conform to the style or conventions used in a document or to the house style of a law firm (for example the way Ordinances are referred to). Generally in these cases "draftsman’s privilege" applies and the style preferred by the law firm with drafting responsibility for the document should be accepted.

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1. 2 or more corporations are related if one is the holding company or the subsidiary of the other or a subsidiary of the holding company of the other. Further where an individual: (i) controls the composition of the board of directors of 2 or more corporations, (ii) holds more than half the voting power at general meetings of 2 or more corporations, or (iii) holds more than half the issued share capital of 2 or more corporations, then each such corporation and its subsidiaries are regarded as "related corporations" of each other (Part 3 of Schedule 1 to the SFO). [↑](#footnote-ref-27)
2. The Consultation Conclusions at paragraph 22 [↑](#footnote-ref-38)