



SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

**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**

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Executive summary

1. On 30 October 2009, the Securities and Futures Commission (**SFC**) issued a Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance (**Consultation Paper**) for a two-month consultation period ending on 31 December 2009. The Consultation Paper invited comments on the proposals for transferring the regulation of public offers of structured products currently under the Companies Ordinance (Cap. 32) (**CO**) prospectus regime to the offers of investments regime in Part IV of the Securities and Futures Ordinance (Cap. 571) (**SFO**), under which the SFC would publish codes and guidelines setting out its regulatory policy on such products¹. The overriding purpose of the proposals is to enhance protection for the investing public in Hong Kong by enhancing the regulatory regime governing public offers of structured products in Hong Kong.
2. The SFC received a total of 13 written submissions, mainly from market participants and professional bodies. Most respondents support, in principle, the transfer of the regulation of public offers of structured products from the CO to the SFO, subject to comments on the specific proposals. Concerns raised revolved around the following main areas:
 - (a) respondents generally supported the proposal to transfer the regulation of public offers of structured products to Part IV of the SFO but voiced significant concerns with respect to the loss of the CO safe harbours, in particular, the “no more than 50 persons” safe harbour and the minimum denomination HK\$500,000 safe harbour which are commonly used to market structured products;
 - (b) respondents commented that the proposed definition of “structured product” is too wide and covers a wide range of derivatives that are currently not regulated under the SFO. Most respondents called for additional exclusions from the proposed definition;
 - (c) most respondents disagreed with the proposal to include “structured product” in the definition of “securities” in the SFO. They were concerned that it would have far reaching consequences causing regulation of non-securities based products to fall under SFO provisions that were designed for regulating securities;
 - (d) whilst respondents agreed that currency linked and money market instruments issued by authorized financial institutions should not require authorization under the SFO, they further suggested that these products be excluded from the definition of “structured product” so that they are not regulated under other parts of the SFO; and

¹ It has been proposed that the SFC would issue a new SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products that would contain a new Code on Unlisted Structured Investment Products. The SFC Handbook sets out the criteria that the SFC would normally consider before exercising its power to authorize the issue of offer documents or advertisements for unlisted structured products with a view to enhancing product transparency and disclosure. The SFC Handbook is the subject of a separate consultation. See the Consultation Paper on Proposals to Enhance Protection for the Investing Public published by the SFC on 25 September 2009 (**September 2009 Consultation**) on the SFC’s website at www.sfc.hk.



- (e) most respondents agreed that the current regulatory framework for listed structured products should be maintained. However, some respondents took the view that there should be a level playing field for listed and unlisted structured products and the exemptions in sections 103(2)(a) and 103(5)(a) of the SFO should be retained for unlisted structured products.
3. In addition to written responses, the SFC has also held more than 16 meetings to discuss aspects of the Consultation Paper with industry representatives. The SFC's responses are based on both the submissions received and comments raised in the discussions.
4. The SFC has considered all responses and comments received in detail and has provided its recommendations to Government on the policy objectives of the proposals and amendments that should be made to the CO and the SFO to implement the policy. In summary, the SFC has recommended:
 - (a) to proceed with the proposal in the Consultation Paper to disapply the CO prospectus provisions to structured products;
 - (b) the CO safe harbours should not be replicated in the SFO. However, pursuant to market responses, the SFC will review the evidential requirements in the Securities and Futures (Professional Investor) Rules (Cap. 571D) (**PI Rules**) for professional investors. This will be the subject of a separate consultation to be issued in due course;
 - (c) the proposed definition of "structured product" should be refined;
 - (d) the proposal to include all structured products in the definition of "securities" should be modified so 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 Stock Exchange of Hong Kong Limited (**SEHK**) would be included as a security;
 - (e) currency linked instruments and interest rate linked instruments (referred to in the Consultation Paper as money market instruments) issued by authorized financial institutions should be exempted from the authorization requirements;
 - (f) the current regulatory framework for listed structured products should be maintained but the exemption in section 103(2)(a) of the SFO should be blocked for unlisted structured products; and
 - (g) to proceed with the proposal in the Consultation Paper to require unlisted structured products to be authorized under a new section 104A of the SFO.
5. The Government is in the process of drafting the amendments to the CO and the SFO. An amendment bill is expected to be gazetted in due course. Accordingly, indicative drafts of the amendments to the CO and the SFO are not provided in these conclusions.
6. The main comments and concerns raised, together with the SFC's responses to these, are discussed in greater detail below. A list of the respondents who sent in submissions is at **Appendix A** to this paper, and the full text of the submissions can be viewed at the SFC's website at www.sfc.hk.



Comments received and the SFC's responses

Disapplying the CO prospectus provisions to structured products

The SFC's proposal in the Consultation Paper²:

7. Under current law, depending on the legal form of the product, public offers of structured products may be regulated under the CO prospectus regime (where the structured product is in the form of a share or debenture, e.g., an equity linked note or a credit linked note) or the offers of investments regime in Part IV of the SFO (where the structured product is in a legal form other than a share or debenture, e.g., as a hybrid of securities and regulated investment agreements such as an equity linked instrument).
8. The SFC proposed to transfer the regulation of public offers of structured products from the CO to the SFO such that public offers of all structured products regardless of their legal form would be regulated under the offers of investments regime in the SFO. The proposed transfer was to be achieved by disapplying the prospectus provisions in the CO (i.e., sections 37 to 44B and section 48A, sections 342 to 343 of the CO, the Third Schedule, and the Seventeenth to Twenty-second Schedules to the CO) with respect to structured products. This would mean that the exemptions under section 103(2)(ga), section 103(3)(a), (b) and (c) of the SFO will not apply and public offers of all structured products (regardless of their legal form) will be regulated under Part IV of the SFO.
9. As the proposal was to disapply the prospectus provisions in the CO including the safe harbours in the Seventeenth Schedule, the proposal meant that the safe harbours would not be replicated in Part IV of the SFO and made available to structured products.

Public comments:

10. Most respondents welcomed and supported the SFC's proposal to regulate public offers of structured products under the offers of investments regime in Part IV of the SFO. However, they voiced significant concerns with respect to the loss of the CO safe harbours, in particular, the "no more than 50 persons" safe harbour and the minimum denomination HK\$500,000 safe harbour which are commonly used to market structured products.
11. Whilst some respondents commented that all of the safe harbours in the Seventeenth Schedule to the CO should be replicated in the SFO, most respondents suggested that the "no more than 50 persons" safe harbour and the minimum denomination HK\$500,000 safe harbour, in particular, should be replicated in the SFO.
12. There were also suggestions that:
 - (a) a new exemption be introduced in the SFO that should have the same scope and effect as paragraph 6 of the Seventeenth Schedule to the CO and apply to structured products which are offered as consideration in a takeover offer (e.g., share options and convertible bonds); and
 - (b) the exemption under section 103(2)(e) of the SFO be expanded to have the same scope and effect as paragraph 8 of the Seventeenth Schedule to the CO and apply with respect to offers of structured products to employees and to

² See (a) paragraphs 15 to 18, 20 and 21; and (b) questions 1 to 3, of the Consultation Paper.



cover employee incentive schemes that fall under the proposed definition of “structured product” (e.g., phantom shares offered under a phantom share option scheme).

13. Respondents commented that the unavailability of these safe harbours for structured products would in general:
- (a) impair Hong Kong’s competitiveness and impede the development of Hong Kong’s private banking and wealth management business - respondents have asserted that as Hong Kong is not the only wealth management and private banking hub in the region, the lack of similar safe harbours for structured products will draw business away from Hong Kong to other regional markets where safe harbours are available (e.g., there are similar exemptions in Singapore, Australia and the United Kingdom);
 - (b) reflect an inconsistent approach on the policy – the SFC administers two offering regimes under the CO prospectus provisions and Part IV of the SFO. Respondents questioned the logic for different treatment of exemptions under the two regimes. They also questioned whether and why the SFC is of the view that the rationale for introducing the safe harbours in 2004 is no longer valid, in particular, since the real issue of the recent events in Hong Kong was misselling;
 - (c) limit investor choice – without the safe harbours, more products would require SFC authorization. As a result, intermediaries will not be able to offer structured products to investors in a timely and cost efficient manner; and
 - (d) compromise investor protection – some respondents argued that if the minimum denomination HK\$500,000 safe harbour is unavailable, it would effectively force investors to be classified as professional investors (so that issuers/distributors can make use of the professional investors exemption under Part IV of the SFO). This, they argue, would result in investors who were previously protected by the provisions of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) (i.e., the suitability requirement) not being afforded the same level of protection.
14. Some respondents commented that if the “no more than 50 persons” safe harbour is not to be introduced in the SFO, the SFC should provide some guidance on the interpretation of the term “public” in the SFO and confirm that an offer to no more than 50 persons will not constitute a public offer.
15. In meetings with market participants to discuss the Consultation Paper, some market participants suggested that the SFC could relax the evidential requirements for professional investors in the PI Rules³ as intermediaries often face practical difficulties from clients in respect of the certification requirements.
16. One respondent suggested that the SFC should, as part of its implementation process, draw guidance and references from market survey data collected from the financial industry and the investing public to assess the specific reasons for and appropriateness

³ For example, section 3(b)(i) and (ii) of the PI Rules.



of certain CO safe harbours, in particular the “no more than 50 persons” and the minimum denomination HK\$500,000 safe harbours.

17. Questions were also raised as to whether the CO safe harbours would continue to be applicable to structured products in the form of shares and suggestions were made to replicate the liability provisions in the CO.

The SFC’s response:

18. Based on the general support for this proposal, the SFC has made recommendations to proceed with the proposal to transfer the regulation of public offers of structured products to the SFO by disapplying the prospectus provisions in the CO (including sections 37 to 44B and section 48A, sections 342 to 343 of the CO, the Third Schedule, and the Seventeenth to Twenty-second Schedules to the CO) with respect to such products. The transfer would enable public offers of all structured products (regardless of their legal form) to be regulated under the offers of investments regime in Part IV of the SFO under which the SFC would publish codes and guidelines setting out its regulatory policy on such products. In September 2009, the SFC conducted a consultation on the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (**SFC Handbook**) that would contain a new Code on Unlisted Structured Investment Products (**SP Code**). The SP Code sets out the criteria that the SFC would normally consider before exercising its authorization powers.
19. It should be noted that whilst the proposal in the Consultation Paper referred to a transfer of the regulation of “structured products in the form of debentures” from the CO to the SFO, the intention was to transfer the regulation of all structured products, regardless of their legal form, to the SFO. This intention is consistent with the proposed legislative amendments to the CO in Appendix A to the Consultation Paper. At the time of preparing the Consultation Paper, the SFC’s focus was on structured products in the form of debentures as these are the most common forms of structured products dealt with under the CO. In view of consultation responses and in line with the original policy intent, the SFC would like to clarify that the proposal is to transfer the regulation of public offers of structured products in the form of shares or debentures from the CO to Part IV of the SFO. Accordingly, once the amendments have been implemented, structured products offered to the public in Hong Kong regardless of their legal form will be regulated under Part IV of the SFO.
20. The SFC understands that industry respondents were most concerned with whether the CO safe harbours will be replicated in Part IV of the SFO.
21. Having considered responses received, possible alternatives as well as market data, the SFC believes that it would be inappropriate at present to replicate any of the CO safe harbours in the SFO. The SFC’s key considerations are set out below.
22. “No more than 50 persons” safe harbour
 - (a) The “no more than 50 persons” safe harbour was introduced into the CO in 2004 on the basis that in practice many local market practitioners have been using the numerical limit of 50 persons as a benchmark for private placements. Respondents have asserted that without the bright line test the private placement market would be “plagued with uncertainty” and this would adversely affect private placement of structured products.



- (b) Whilst the SFO does not set out a similar bright line exemption, the concept is retained in the SFO since section 103 only requires authorization of documents in respect of offers to the public and the SFO regime has worked well. Based on data provided by the market, the SFC understands that the “no more than 50 persons” safe harbour is not commonly used.
- (c) The SFC believes that the concept of what is a public offer is well understood by the market since this 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.

23. The minimum denomination HK\$500,000 safe harbour

- (a) The SFC understands that issuers and distributors rely heavily on the minimum denomination HK\$500,000 safe harbour. Products offered via this safe harbour account for a significant portion of their structured products businesses.
- (b) The rationale for introducing the minimum denomination HK\$500,000 safe harbour in 2004 was that an investor who can afford to take up such offers should be sufficiently knowledgeable to understand the risks involved or should be able to secure professional advice if considered necessary. It was believed then that such an investor would not need the protection afforded to a retail investor by a prospectus. The value of HK\$500,000 was considered to be an appropriate amount based on a similar exemption in the United Kingdom.
- (c) The SFC has considered the concerns raised by respondents as well as potential alternatives that could be introduced (including increasing the HK\$500,000 threshold, imposing additional conditions on the exemption (e.g., disclosure requirements) as well as selling requirements, anti-avoidance provisions, post-vetting, etc.).

24. The SFC appreciates the responses submitted by the market in respect of the safe harbours and is sympathetic to issuers and distributors’ concerns that without these safe harbours, the ability of structured products businesses to issue products in a timely/cost efficient manner to investors will be compromised. The SFC is also cognizant that some businesses may withdraw from Hong Kong. However:

- (a) although the overseas markets have similar safe harbours, the SFC understands that some of these markets are reviewing their offering regimes and the safe harbours may be tightened to increase investor protection. Hence a comparison with the current exemptions in overseas markets may be premature and inaccurate;
- (b) in overseas markets where a similar exemption is available, retail investors tend to generally (for tax and historical reasons) hold their long term savings in pension funds that are managed by professionals. Retail investors in Hong Kong tend to prefer to actively manage their own investment decisions;



- (c) whilst the reasoning for introducing the safe harbours in 2004 may have been logical, with the significant development of the structured products markets in the last few years, the SFC understands from discussions with industry participants that issuers/distributors are increasingly targeting investors who make smaller sized investments. In addition, recent experience suggests that investors in Hong Kong who are sufficiently affluent to invest HK\$500,000 in a product may not be sufficiently knowledgeable to understand the risks involved. Accordingly, these investors may benefit from the protection afforded by an authorized prospectus; and
- (d) the CO safe harbours are currently available to structured products prospectuses that are regulated under the CO. These safe harbours are not available to structured products or other investment products that are regulated under Part IV of the SFO which has its own set of exemptions. An introduction of the safe harbours into the SFO is an expansion of the scope of the exemptions to the whole range of products regulated under Part IV of the SFO.

25. In view of the above observations, the SFC believes that it would be inappropriate at present to introduce these CO safe harbours into the SFO.
26. The SFC does not agree with respondents' concerns that without the minimum denomination HK\$500,000 safe harbour, investors would be forced to be classified as professional investors (so that issuers/distributors can make use of the professional investors exemption under Part IV of the SFO) and this would result in investors not being afforded the same level of protection under the Code of Conduct. The requirements in the Code of Conduct which may be waived in respect of a client who is a professional investor include the need to ensure the suitability of a recommendation or solicitation for that client is reasonable as set out in paragraph 5.2⁴ of the Code of Conduct. However, in order for certain Code of Conduct requirements to be waived for a professional investor who meets the HK\$8 million threshold, the licensed or registered person must assess and be reasonably satisfied that the client is knowledgeable and has sufficient expertise in relevant products and markets. The Code of Conduct sets out specific matters which the licensed or registered person must consider in making this assessment. (These matters are the subject of a separate consultation⁵. See also paragraph 31.) If the licensed or registered person is satisfied of the above, it should provide a written explanation to the client of the risks and consequences of being treated as a professional investor and obtain a written and signed declaration from the client that he consents to being treated as a professional investor. The licensed or registered person must also perform an exercise annually to ensure that the client continues to fulfil the HK\$8 million requirement set out in the PI Rules. That said, even though the suitability requirement in paragraph 5.2 of the Code of Conduct may be waived, a licensed or registered person providing services to a client (including a professional investor) in derivative products is required to assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products (i.e., paragraph 5.3 of the Code of Conduct).

⁴ Paragraph 5.2 of the Code of Conduct states as follows: "Having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances."

⁵ See the September 2009 Consultation.



27. With respect to the suggestion to provide an exemption for structured products which are offered as consideration in a takeover offer in section 103 of the SFO, the SFC believes that:

- (a) if shares are offered as consideration in a takeover offer, the Codes on Takeovers and Mergers and Share Repurchases (**Takeovers Code**) published by the SFC require disclosure of certain information about those shares. These disclosure requirements are similar to those under the CO which are administered by the Companies Registry. The exemption under paragraph 6 of the Seventeenth Schedule to the CO therefore helps avoid duplication of disclosure requirements as well as avoiding the need for the issuer of the shares or debentures to have to deal with two regulators;
- (b) it is proposed that the regulatory requirements for public offers of structured products be aligned so that public offers of structured products, regardless of their legal form, will be regulated under the SFO;
- (c) under the current proposals, the issue of offer documents and marketing materials relating to unlisted structured products would require prior SFC authorization and authorization would depend on compliance with the provisions of the SFC Handbook⁶ (as well as certain codes and guidelines). The SFC Handbook sets out the criteria that the SFC would normally consider before exercising its power to authorize the issue of offer documents or advertisements for unlisted structured products with a view to enhancing product transparency and disclosure. These features are not mirrored in the Takeovers Code;
- (d) as the SFC would administer both the new structured product regime as well as the Takeovers Code, the relevant teams would work closely together to avoid duplication; and
- (e) given the above, the SFC does not consider it appropriate to grant a blanket exemption along the lines of paragraph 6 of the Seventeenth Schedule to the CO to structured products which are offered as consideration in a takeover offer. Compliance with the Takeovers Code is not a sufficient substitute to the provisions of the new regime.

28. Exemption for employee incentive schemes

- (a) The SFC recognizes that phantom share option schemes and other employee incentive schemes may be offered to employees and shares the view that such schemes should not be caught by the prohibition in section 103 of the SFO. However, instead of amending or expanding the scope of section 103(2)(e) of the SFO, the SFC has suggested in its recommendations to Government that an exclusion should be created in the definition of “structured product” for employee incentive schemes (e.g., phantom share option schemes) so that such schemes will not be caught by section 103 of the SFO⁷.

29. The SFC has also considered the other CO safe harbours that have not been discussed above and takes the view that these safe harbours are either rarely used or not

⁶ See paragraph 18 of this conclusions paper.

⁷ See paragraph 41(d) of this conclusions paper.



applicable to offers of structured products and hence should not be introduced into Part IV of the SFO.

30. The SFC wishes to stress that the decision to recommend that the CO safe harbours should not be introduced into the SFO has not been taken lightly and has been the subject of many discussions.
31. Notwithstanding the proposal not to introduce the CO safe harbours into the SFO, the SFC has considered suggestions to review the evidential requirements in the PI Rules. Under the PI Rules, the portfolio of a professional investor (in the case of an individual) must be established by an auditor or accountant's certificate or by reference to custodian statements⁸. According to some respondents, there are practical difficulties in satisfying the evidential requirements and a refinement of the requirements will make the professional investors exemption (that is available under Part IV of the SFO) more practical to apply. This may help to alleviate some participants' concerns with the loss of the CO safe harbours for structured products. Other leading jurisdictions such as the United Kingdom, Australia and Singapore do not appear to have similar evidential requirements. Accordingly, the SFC will study this matter further and consult the market in due course.
32. With respect to suggestion that the CO liability regime should be replicated in Part IV of the SFO, as explained in the Consultation Paper⁹, the SFC will consider as part of the CO Phase 3 law reform exercise whether any elements of the statutory requirements and liability provisions in the CO prospectus regime should appropriately be aligned with those in the offers of investments regime in Part IV of the SFO (or vice versa). A consultation paper on the CO Phase 3 law reform will be published in due course.

⁸ Section 3(b)(i) and (ii) of the PI Rules.

⁹ See paragraph 18 of the Consultation Paper.



Proposed definition of “structured product”

The SFC’s proposal in the Consultation Paper¹⁰:

33. The SFC proposed to introduce a wide definition for “structured product” (as set out in paragraph 23 of the Consultation Paper) and to subsume “regulated investment agreement” in its entirety into the proposed definition of “structured product” as a limb to itself so that a regulated investment agreement will be regulated as structured products under Part IV of the SFO. It was proposed that public offers of shares (including preference shares), depository receipts over or in respect of shares (i.e., including rights issues to existing shareholders), floating rate notes etc. will continue to be regulated under the CO regime whilst products like convertible bonds and exchangeable bonds will be regulated under Part IV of the SFO but the SFC will draw reference from the disclosure requirements in the Third Schedule to the CO.
34. To address the issue of financial innovation, it was proposed that the Financial Secretary be empowered to prescribe any interests, rights or property whether in the form of an instrument or otherwise as “structured product” or as not being regarded as “structured product”, respectively, by notice published in the Gazette.

Public comments:

35. A wide range of comments on the proposed definition of “structured product” were received. Some comments were made in respect of general policy objectives behind the proposed definition whilst some were on the detailed drafting of the proposed definition.
36. Most respondents commented on the following aspects of the proposal:
 - (a) the proposed definition of “structured product” is too wide and includes a range of products that are currently not regulated under the SFO;
 - (b) the use of “instrument” in the proposed definition of “structured product” causes confusion. Some respondents commented that the use of the term “instrument” includes over-the-counter derivatives (that are bilateral, private contracts) as opposed to securitized derivatives and questioned whether this could be the SFC’s intention. Some suggested that only securitized derivatives should be regulated;
 - (c) diverse comments were received on the proposed treatment of regulated investment agreements. Whilst most respondents agreed that the proposed definition of “structured product” encompasses regulated investment agreements, some suggested that all references to (including the definition of) regulated investment agreement should be removed altogether, others suggested retaining the current treatment of regulated investment agreements or agreed with the proposed approach to regulate regulated investment agreements as structured products for the purposes of Part IV of the SFO;
 - (d) respondents generally agreed with the SFC’s proposed exclusions from the definition. Additional exclusions were suggested for currency linked and money market instruments issued by authorized financial institutions to better

¹⁰ See (a) paragraphs 19, 22 to 24 and 27; and (b) questions 4 to 7 and 10, of the Consultation Paper.



reflect the current practice where treasury products are not regulated under the SFO (see paragraphs 49 to 55 below), as well as convertible bonds, exchangeable bonds, subscription warrants etc. Some respondents also commented that the wide definition proposed would include products that are generally not transacted for investment purposes such as loan arrangements, insurance contracts and which should not be regulated under Part IV of the SFO (or the CO prospectus regime). There was also a suggestion to provide a carve out from the definition for futures contracts as these are already subject to regulation under the SFO; and

- (e) respondents generally agreed that the Financial Secretary should be empowered to prescribe any interests, rights or property whether in the form of an instrument or otherwise as “structured product” or as not being regarded as “structured product”, respectively, by notice published in the Gazette. However, one respondent questioned whether this is an effective mechanism since the Government is not readily aware of innovations in global financial markets.

37. Respondents also sought clarification on a number of issues, which include whether the SFC intends to include over-the-counter derivatives as well as derivatives in securitized form in the definition of “structured product” and what the SFC intends to be the meaning of the term “instrument”. Some respondents have also raised questions that mainly concern the regulation of collective investment schemes offered to the public in Hong Kong and the interpretation of the SP Code.

The SFC’s response:

38. The SFC acknowledges that the proposed definition of “structured product” is wide but believes that a wide definition is necessary to avoid the possibility of issuers designing new products to fall outside the definition of “structured product” but in reality embed derivatives or have similar economic risk and return profiles.
39. The SFC has proposed to Government that the definition of structured products should include:
- (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:
 - (i) 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;
 - (ii) 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
 - (iii) the occurrence or non-occurrence of an event or events specified in the instrument; or
 - (b) regulated investment agreements.



40. The SFC appreciates the comments in relation to regulated investment agreements and understands that there may be a certain degree of overlap between a regulated investment agreement and the coverage of the proposed definition of “structured product” in paragraph 39 above. At present, equity linked deposits are predominantly the only kind of regulated investment agreements in the market, whereas some equity linked instruments can be a hybrid of securities and regulated investment agreement. Both equity linked deposits and equity linked instruments are structured products. As the concept of regulated investment agreements has been in the SFO since its inception, the SFC believes that for the time being the proposal to include regulated investment agreements in the definition of “structured product” is the simplest and clearest way to ensure market participants understand that regulated investment agreements are to be treated as structured products, the authorization of which will be subject to the SP Code.
41. The SFC acknowledges that it is necessary to provide exclusions from the wide definition that has been proposed for “structured product”. In this respect, the SFC believes certain products may fall within the proposed definition of “structured product” but would be more appropriately regulated under the CO such as floating rate notes, depository receipts etc. There may also be other instruments that should not be regulated under Part IV of the SFO or the CO prospectus regime. The overall effect of the definition that has been recommended to Government should reflect the following:
- (a) Products that are to be regulated as structured products under Part IV of the SFO
 - (i) Products that have the features described in paragraph 39 above but are not any of the products in subparagraphs (b), (c) and (d) of this paragraph. Examples of such products would include equity linked notes, credit linked notes, equity linked deposits, equity linked instruments etc.
 - (b) Products of which the prospectuses will continue to be regulated under the CO prospectus regime
 - (i) Ordinary shares;
 - (ii) Preference shares;
 - (iii) Depository receipts over or in respect of shares;
 - (iv) Plain vanilla debentures (e.g., fixed rate bonds, zero coupon bonds, promissory notes);
 - (v) Floating rate notes,

to the extent that these products have no derivative element attached to them;
and
 - (vi) 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.
 - (c) Products currently regulated under Part IV of the SFO and that will continue to be regulated under Part IV of the SFO (but not as structured products)



- (i) SFC authorized collective investment schemes – these will continue to be regulated under sections 103, 104 and 105 of the SFO.
- (d) Products that are to fall outside both the CO prospectus regime and the SFO offers of investments regime in respect of structured products
 - (i) Insurance contracts in relation to any class of business specified in the First Schedule to the Insurance Companies Ordinance (Cap. 41)¹¹;
 - (ii) Employee incentive schemes, e.g., phantom share offers; and
 - (iii) Loan arrangements.

42. Whilst the SFC believes that it is premature and inappropriate to provide definitive answers to how the definition of “structured product” should be applied to different types of structures, it would like to take the opportunity to respond to some of the questions or suggestions raised by respondents. The following are the SFC’s general observations on the questions raised. However, a view on how the definition of “structured product” is to be applied to a particular structure can only be dealt with on a case by case basis.

- (a) Meaning of “instrument” in the definition of “structured product” – some respondents commented that they were confused as to what “instrument” means as it is not a term that is defined in the SFO. Whilst the term “instrument” is not defined in the SFO, there are numerous references to it in the SFO. The SFC’s view is that an instrument is a written document. The SFC clarifies that it is intended that bilateral private contracts would be included in the definition of “structured product”. However, market participants should bear in mind that only public offers are subject to the authorization requirements hence offers of bilateral contracts would not be automatically caught under the authorization requirements (see paragraph 42(b) below). Some respondents also asked whether by virtue of use of “instrument” in the definition of “structured product”, the intention is to only cover negotiable instruments. The SFC would like to clarify that non-negotiable instruments are intended to be included.
- (b) Whether it is intended for over-the-counter derivatives as well as derivatives in securitized form to be included in the definition of “structured product” – as explained above, the proposed wide definition of “structured product” will include over-the-counter derivatives which are generally bilateral private contracts. However, market participants should note that section 103 of the SFO applies only when there is an offer to the public. As such, the authorization requirements in Part IV of the SFO will not automatically apply to bilateral or private contracts unless these are publicly offered. The SFC does not believe it is appropriate to exclude bilateral contracts from the definition of “structured product” as it may be possible to offer such contracts publicly in which case the authorization requirements should apply.
- (c) Whether currency linked and money market instruments issued by authorized financial institutions should be excluded from the definition – treasury products are currently not regulated under the SFO. The SFC agrees that to maintain

¹¹ For investment-linked assurance schemes (ILAS) that are offered to the public, authorization under section 104 of the SFO is required.



this status quo, currency linked and money market instruments issued by authorized financial institutions should not be regulated under the SFO. Since the SFC has recommended to modify the original proposal of classifying all structured products as “securities” (with the remainder of the proposal being deferred for further consideration), an exemption from the authorization requirements will achieve the same result. This is also in line with other exemptions for treasury products¹² (see also paragraphs 49 to 55 below).

- (d) The SFC also noted some respondents have raised a few questions that mainly concern the regulation of collective investment schemes offered to the public in Hong Kong and the interpretation of the SP Code. The former is outside the scope of the present consultation and the SFC is not proposing any policy change so far as collective investment schemes are concerned. The SFO and the present Code on Unit Trusts and Mutual Funds (subject to finalization of the amendments following the September 2009 Consultation¹³) will continue to apply. The SP Code is currently the subject of the September 2009 Consultation and yet to be finalized. It would be premature to attempt to explain the application or interpretation of the SP Code in this paper. In general, all unlisted structured products offered to the public will be subject to the impending SP Code once effective.
- (e) Futures contracts should be excluded from the definition of “structured product” as these are already regulated under the SFO – there is currently an exemption for advertisements, invitations or documents made by persons licensed by or registered with the SFC for Type 2 or Type 5 regulated activity in respect of futures contracts. The SFC believes that this exemption is adequate to reflect the policy intent that where a futures contract is offered by an appropriately licensed/registered person, authorization of the related advertisements, invitations or documents will not be required.
- (f) Clarifications relating to the definition of “floating rate note” – respondents queried what is a “widely quoted money market reference rate” referred to in the definition. Widely quoted money market reference rates are rates that are widely used by banks in borrowing funds from other banks in the interbank market and as reference rates for financial instruments. Examples include the London Interbank Offered Rate (i.e., LIBOR) and the Hong Kong Interbank Offered Rate (i.e., HIBOR). However, the SFC wishes to clarify that a floating rate note which has other feature(s) that fall within the definition of “structured product” should not fall within this carve-out.

43. In view of the support for the Financial Secretary to be empowered to prescribe any interests, rights or property whether in the form of an instrument or otherwise as “structured product” or as not being regarded as “structured product”, respectively, by notice published in the Gazette, the SFC will proceed with the proposal. Under this mechanism, the SFC or other interested parties may make suggestions to the Government to exercise this power hence the mechanism is an effective means to cater for financial innovation.

¹² Section 103(2)(c) of the SFO provides an exemption for advertisements, invitations or documents 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 advertisements, invitations or documents made in respect of the issue of a certificate of deposit by an authorized financial institution.

¹³ See footnote 1 of this conclusions paper.



44. A number of specific drafting suggestions were provided. To the extent that the suggestions would better reflect the policy intentions, they have been reflected in the SFC's recommendations to the Government on the legislative amendments.



Classifying “structured product” as “securities”

The SFC’s proposal in the Consultation Paper¹⁴:

45. In order to ensure that the regulatory requirements in the SFO (and not only the disclosure requirements) will apply to all structured products regardless of their legal form, the SFC proposed to amend the definition of “securities” in the SFO to include structured products or any rights, options or interests (whether described as units or otherwise) in, or in respect of, such structured products.

Public comments:

46. Most respondents disagreed with the proposal to classify “structured product” as “securities” on the basis that it would have far reaching consequences causing regulation of non-securities based products to fall under SFO provisions that were designed for regulating securities. They argued that this would have significant impact on costs and operation, result in overlapping regulation with the Hong Kong Monetary Authority (**HKMA**) and ultimately stifle the Hong Kong market. In addition, there was also criticism that the proposal to include structured products as “securities” is tantamount to an overhaul of the licensing and supervision regime and hasty implementation of this proposal may create unintended consequences.

The SFC’s response:

47. The SFC believes that the objective of the original proposal – that all structured products should be subject to all of the regulatory requirements under the SFO – remains valid and plays an important role in enhancing investor protection. However, in view of the market’s responses, the SFC has decided to modify the original proposal, with the remainder of the proposal being deferred for further consideration. Instead of classifying all structured products as “securities”, the SFC has recommended to Government that the definition of “securities” in Schedule 1 to the SFO should 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. All of the regulatory requirements under the SFO that currently apply to securities (e.g., licensing, conduct requirements, etc.) will thus apply to these structured products. This helps to achieve the objective of the original proposal and enhance protection for investors who are offered these structured products.
48. Intermediaries selling structured products like equity linked notes and equity linked instruments to the public are expected to comply with the requirements in the Code of Conduct as well as any other applicable SFC codes and guidelines.

¹⁴ See (a) paragraph 25; and (b) question 8, of the Consultation Paper.



Currency linked instruments and money market instruments issued by authorized financial institutions

The SFC's proposal in the Consultation Paper¹⁵:

49. Currently advertisements, invitations or documents in respect of currency linked instruments and interest rate linked instruments (referred to in the Consultation Paper as money market instruments) issued by authorized financial institutions are excluded from the SFO authorization requirements as these products are generally regarded as banking transactions or treasury instruments of banks. As confirmed in a circular issued by the HKMA dated 13 July 2009, currency and interest rate linked products issued by authorized financial institutions are typically not regulated by the SFO. In line with this regulatory intent and to maintain the existing practice, the SFC proposed to introduce a specific exemption in the SFO in respect of currency linked instruments and interest rate linked instruments issued by an authorized financial institution to ensure that the common types of currency linked and interest rate linked instruments issued by authorized financial institutions will not be caught under the prohibition in section 103(1) of the SFO as a result of the introduction of the definition of "structured product".

Public comments:

50. Most respondents agreed with this proposal and suggested that currency linked instruments and interest rate linked instruments be carved out from the definition of "structured product". There were also suggestions that the definitions of currency linked instruments and interest rate linked instruments should be expanded to cover "hybrid" products, i.e., products with both foreign exchange and interest rate features.
51. A few questions were raised as to whether currency linked or interest rate linked instruments with certain features that are issued by authorized financial institutions would fall within the proposed definitions.

The SFC's response:

52. The SFC will pursue this proposal and has recommended that an exemption from the authorization requirements be provided for advertisements, invitations or documents in respect of instruments issued by authorized financial institutions that are referenced to: (a) changes in the level of any interest rate or a basket of interest rates (i.e., interest rate linked instruments); or (b) changes in the level of any currency exchange rate or a basket of currency exchange rates (i.e., currency linked instruments); or (c) 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.
53. Some respondents asked whether currency or interest rate linked products issued by authorized financial institutions the relevant amount of which may be determined subject to conditions (other than those set out in the proposed definitions) such as knock in or knock out features would fall within the proposed definitions. The SFC takes the view that as long as the "bells and whistles" that are attached to the products do not contain any derivative element, they should be able to fall within the proposed definitions. With respect to the suggestion to expand the definition of currency linked instrument to include products issued by authorized financial institutions that are referenced to the price of gold and silver, the SFC believes that it would be inappropriate at present to

¹⁵ See (a) paragraphs 28 and 29; and (b) questions 11 and 12, of the Consultation Paper.



provide too wide a definition for these products. If experience gained from administering the new regime for structured products suggests that it would be appropriate to expand the definition in such manner, the SFC may recommend the Financial Secretary to prescribe such products as currency linked instruments.

54. With respect to the suggestions that these instruments (when issued by authorized financial institutions) should be excluded from the definition of “structured product”, the SFC believes that the purpose of the suggestion was to ensure that these products would not be regulated under the SFO. Since the SFC has recommended to modify the original proposal of classifying all structured products as “securities” (with the remainder of the proposal being deferred for further consideration), we believe that the recommendation to exempt these products from the authorization requirements will achieve the same result (see paragraph 47 above).
55. Market participants should note however that 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 customers¹⁶.

¹⁶ See HKMA circular dated 13 July 2009.



Disapplying the exemptions in sections 103(2)(a) and 103(5)(a) of the SFO to unlisted structured products and preserving the current framework for listed structured products

The SFC's proposal in the Consultation Paper¹⁷:

56. The SFC proposed to exclude unlisted structured products from section 103(2)(a) and section 103(5)(a) of the SFO such that the exemptions in section 103(2)(a) and section 103(5)(a) of the SFO for Type 1, Type 4 or Type 6 licensed intermediaries will not apply to offer documents and marketing materials relating to unlisted structured products.
57. The SFC also proposed that the current regulatory framework for listed structured products should remain unchanged so that listed structured product issuers (or their related licensed entities) can continue to rely upon the exemption in section 103(2)(a) of the SFO to issue marketing documents in respect of listed structured products.

Public comments:

58. Respondents generally agreed that the current regulatory framework for listed structured products should remain unchanged. However, mixed views were received on the proposal to disapply the exemptions in section 103(2)(a) and section 103(5)(a) of the SFO to unlisted structured products. Some respondents asserted that there should be a level playing field for both unlisted structured products and listed structured products issuers and questioned the rationale for different treatment for the two types of products. They argued that the exemptions in sections 103(2)(a) and 103(5)(a) of the SFO should be retained for unlisted structured products.

The SFC's response:

59. The SFC believes that it is necessary to vet and authorize offer documents and marketing materials for unlisted structured products under the SP Code and to preserve the practice that has been working well for listed structured products. The SFC is of the view that the SEHK should remain the frontline regulator responsible for reviewing and approving listing documents for listed structured products. As such, the SFC has recommended to proceed with this proposal. Listed structured product issuers may continue to issue marketing materials via their related licensed entities in reliance upon the exemption in section 103(2)(a) of the SFO for Type 1, Type 4 and Type 6 licensed intermediaries without having to seek SFC's prior authorization. These licensed intermediaries must, however, abide by the Guidelines on marketing materials for listed structured products published by the SFC in September 2006.

¹⁷ See (a) paragraphs 30 to 32; and (b) questions 13 and 14, of the Consultation Paper.



Authorization of structured products under a new section 104A of the SFO

The SFC's proposal in the Consultation Paper¹⁸:

60. The SFC proposed to replicate section 104 of the SFO for structured products by introducing a new section 104A into the SFO. The new section 104A of the SFO will subject structured products to an authorization process similar to section 104 of the SFO for collective investment schemes. SFC authorization will depend on compliance with the codes and guidelines to be published by the SFC. The SP Code setting out, amongst other things, certain basic structural features and disclosure benchmarks for unlisted structured products, has been the subject of a separate consultation.

Public comments:

61. Most respondents agreed with this proposal but one respondent commented that the regulatory regime is moving away from a disclosure-based regime to a merit-based regime.

The SFC's response:

62. In view of the general support, the SFC has recommended to proceed with this proposal. Upon implementation of the legislative amendments for this proposal, structured products will be subject to an authorization process set out in section 104A of the SFO and SFC authorization will depend on compliance with the codes and guidelines to be published by the SFC. The SFC has proposed to issue the SP Code which will set out, amongst other things, certain basic structural features and disclosure benchmarks for unlisted structured products¹⁹.
63. Notwithstanding the requirement to comply with basic structural features prescribed in the SP Code, the regulatory regime will continue to be disclosure-based. The proposals in the SFC Handbook (e.g., Product Key Facts Statement, disclosure of issuers' and guarantors' eligibility) serve to increase product transparency. This enhanced approach should not be equated with "product" or "merit" regulation.
64. To avoid regulatory duplication, the SEHK will remain the primary regulator for regulation of listed structured products under the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited. If the issue of offer documents and marketing materials of listed structured products is exempt under section 103(2)(a) or 103(3)(h) of the SFO, there would be no need for the structured product itself to be authorized under the new section 104A of the SFO.

¹⁸ See (a) paragraphs 33 to 35; and (b) questions 15 and 16, of the Consultation Paper.

¹⁹ See paragraph 18 of this conclusions paper.



Other matters

Other amendments to the definition of “securities”²⁰

65. In order to avoid issuers circumventing the regulatory requirements in the SFO by creating structured products in the form of debentures and specifically providing that such debentures are “not negotiable or transferable” so as to fall within the exclusion in paragraph (vi) of the definition of “securities” in section 1 of Part 1 of Schedule 1 to the SFO, the SFC originally proposed to amend the exclusion in paragraph (vi) so that structured products in the form of debentures cannot make use of that exclusion.
66. Most respondents agreed with the proposed amendment to the exclusion in paragraph (vi) of the definition of “securities”.
67. In view of the SFC’s modified proposal 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, it is not necessary to pursue this proposal.

Amendments to the definition of “debenture”

68. As reflected in the indicative draft legislative amendments attached to the Consultation Paper, amendments were proposed to the definitions of “debenture” in the CO and the SFO so that it would make reference to “other debt securities” rather than “other securities”. No objections were received with respect to this proposal.
69. The SFC has recommended that the proposal to amend the definitions of “debenture” in the CO and the SFO should be pursued.

Amendments to the exceptions in section 103 of the SFO

70. The SFC had not originally proposed to amend the exceptions in section 103 of the SFO to the general prohibition in section 103(1) of the SFO as it would have been unnecessary due to the proposal to classify all structured products as “securities”. Due to the responses received and the SFC’s decision that not all structured products should be classified as “securities”, certain amendments to the exceptions from the general prohibition have been recommended to be included in the amendment bill.
71. Apart from excluding unlisted structured products from section 103(2)(a), section 103(5)(a) and section 103(6)(a) of the SFO, the following amendments have been recommended:
 - (a) Section 103(2)(e) – currently exempts advertisements, invitations or documents made by or on behalf of a corporation to holders of securities, creditors of, or employees employed by or agents acting in a professional capacity on behalf of the corporation, or a related corporation of that corporation in respect of securities of that corporation or a related corporation from the authorization requirements. If structured products are offered by the corporation to these persons, the exemption should equally apply. Hence the exemption needs to be expanded to include structured products in all forms.

²⁰ See (a) paragraph 26; and (b) question 9, of the Consultation Paper.



- (b) Section 103(2)(f) - currently exempts advertisements, invitations or documents made by or on behalf of the Government in respect of Government-issued securities from the authorization requirements. This exemption should be expanded so that it will apply to structured products issued by Government.
- (c) Section 103(2)(i) – currently exempts advertisements, invitations or documents made by or on behalf of a person who is engaged in the business of buying and selling property other than securities in respect of documents containing offers made in the ordinary course of that business from the authorization requirements. This provision should be amended so that advertisements, invitations or documents made by or on behalf of a person who is engaged in the business of buying and selling property other than securities and structured products would be exempted from the authorization requirements.
- (d) Section 103(3)(h) – currently exempts advertisements, invitations or documents made in respect of securities the listing of which on a recognized stock market has been approved by the recognized exchange company by which the recognized stock market is operated (i.e., the SEHK) from the authorization requirements. As the SEHK is permitted under section 20 of the SFO to list securities and other financial products²¹ and to reflect the policy intent that the SEHK remains the frontline regulator of listed structured products, this provision should be expanded to include structured products the listing of which has been approved by the SEHK.
- (e) Section 103(3)(j) – currently exempts advertisements, invitations or documents made in respect of securities, collective investment schemes and regulated investment agreements that are offered to overseas investors from the authorization requirements. The exemption should be expanded so that it will apply equally to advertisements, invitations or documents in respect of structured products that are offered to overseas investors.
- (f) Section 103(3)(k) – currently exempts advertisements, invitations or documents made in respect of securities, collective investment schemes and regulated investment agreements that are offered to professional investors from the authorization requirements. The exemption should be expanded so that it will apply equally to advertisements, invitations or documents in respect of all structured products that are intended to be disposed of to professional investors.
- (g) A new exemption for currency linked instruments and interest rate linked instruments issued by authorized financial institutions will be created²².

Transitional arrangements

72. Some respondents asked that a lengthy transitional period be provided for. The SFC understands that such request stemmed from the proposal to classify all structured products as “securities”. Since the SFC has recommended to modify the original proposal (with the remainder of the proposal being deferred for further consideration) such that not all structured products will be classified as “securities”, the SFC believes that a lengthy transitional period may not be necessary. In addition, the SFC will review

²¹ The SFC has also recommended that the definition of “financial product” in the SFO to be amended to include structured products.

²² See paragraphs 52 to 55 of this conclusions paper.



the relevant requirements in the Code of Conduct and subsidiary legislation and make appropriate amendments in respect of non-security type products (if necessary). Existing prospectuses that have been authorized under the CO should be grandfathered.



Conclusion and way forward

73. Having considered the responses received and the regulatory objectives of the proposals, the SFC has provided its recommendations on the legislative amendments to Government so that Government may draft a bill to implement the proposals. It is expected that the bill will be gazetted and tabled before the Legislative Council within 2010.
74. With respect to the evidential requirements in the PI Rules, the SFC will study this issue and conduct a consultation exercise shortly.
75. The SFC would like to take this opportunity to thank all respondents who have sent in submissions and who have participated in various meetings and discussions for their time, effort and contribution.



Appendix A

List of respondents

(in alphabetical order)

1. Allen & Overy
2. Baker & McKenzie
3. Barclays Capital Asia Limited
4. Clifford Chance responded on behalf of 17 institutions:
 - (a) Alliancebernstein Hong Kong Limited
 - (b) Barclays Bank PLC
 - (c) BlackRock (Hong Kong) Limited
 - (d) BNP Paribas
 - (e) Credit Suisse (Hong Kong) Limited
 - (f) Deutsche Bank AG Hong Kong branch
 - (g) Goldman Sachs (Asia) LLC
 - (h) JPMorgan Chase Bank, NA
 - (i) Legg Mason Asset Management Hong Kong Limited
 - (j) Macquarie Capital Securities Limited
 - (k) Merrill Lynch International
 - (l) Morgan Stanley Asia Limited
 - (m) Nomura International (Hong Kong) Limited
 - (n) PIMCO Asia Limited
 - (o) Standard Chartered Bank (Hong Kong) Limited
 - (p) The Royal Bank of Scotland plc
 - (q) UBS AG
5. Consumer Council
6. DBS Bank (HK) Ltd.



7. Frederick B. H. Ng
8. International Swaps and Derivatives Association, Inc. (ISDA) /Securities Industry and Financial Markets Association (SIFMA)
9. Lovells
10. M. J. Kenny
11. Mallesons Stephen Jaques
12. SG Securities (HK) Limited
13. The Hong Kong Association of Banks