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

Submissions of the Hong Kong Bar Association

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1. Summary

1.1 The Hong Kong Bar Association ("**HKBA**") supports the proposed legislative amendments to unify the regulation of public offers of structured products under the Securities and Futures Ordinance (Cap. 571) ("**SFO**") by defining "structured products" and subjecting the public offers of them to regulation under the SFO while excluding the same from the Companies Ordinance (Cap. 32) ("**CO**").

(1) The amendments would reduce the potential for regulatory arbitrage.

(2) It makes sense to place structured products with other investment products such as collective investment schemes, e.g., unit trusts, mutual funds, and insurance-linked assurance schemes.

(3) The SFO allows for a more comprehensive regime than the CO does for the regulation of increasingly complex structured products.

1.2 Details of the HKBA's submissions are as follows.

2. Existing Law

2.1 Existing law allows and regulates 3 methods for making public offers of financial investments:

(1) With a prospectus authorized by the Securities and Futures Commission ("**SFC**") or, in case of an offer of shares to be listed on the exchange, the Stock Exchange of Hong Kong ("**SEHK**") for registration and registered with the Companies Registry under section 38 or section 342 of the CO;

(2) As an investment product authorized by the SFC under section 104 of the SFO, with such advertisement, invitation or document as also authorized by the SFC under section 103 the SFO; and

(3) Through intermediaries licensed by or registered with the SFC (essentially securities firms and banks), thereby qualifying for the exception in section 103(2)(a) of the SFO.

2.2 The CO's regulation of the first method for making public offers is known as the "prospectus regime". The SFO's regulation of the second method is called the "offer of investment regime". The third method is not commonly used. In this submission it will be referred to as the "103(2)(a) exception".

2.3 The prospectus regime applies to shares and debentures of companies. The term "shares" has a relatively straightforward meaning and covers shares and stocks. The term "debenture" is defined widely to include debenture stocks, bonds, and other debt securities.

2.4 Shares and debentures are sometimes described as securities "in legal form", i.e., they fall within particular classifications in law and have some pre-defined rights and obligations.

2.5 The SEHK vets and authorizes for registration prospectuses for offers of shares to be listed on the exchange. The SFC does so for other shares and debentures.

2.6 The offer of investment regime ostensibly applies to all public offers of securities and regulated investment agreements. But it contains a number of exceptions. For present purposes, the main exception is where a public offer is made with a prospectus that complies with or is exempt from compliance with the prospectus regime.

2.7 Whether a public offer is regulated (including being exempted from regulation) by the prospectus regime of the CO or the offer of investment regime of the SFO has significant practical consequences.

2.8 The 2 regimes differ in their regulatory incidence.

(1) The prospectus regime is disclosure based. The regulatory focus is on the prospectus, not the investment. The aim is to ensure disclosure of all the material information.

(2) In contrast, the offer of investment regime applies to both the disclosure (any advertisement, invitation or other document of the public offer, which must be authorized under section 103 of the SFO) and the investment itself (which is to be authorized under section 104 of the SFO).

2.9 The 2 regimes have their own definitions of and exemptions from what constitute a public offer. Most notably, the exemptions for marketing to investors deemed to be sophisticated operate differently.

(1) Section 1 of the 17th Schedule of the CO excludes from the definition of "prospectus" any document for offer to "professional investors" within the meaning of the SFO. Consequently, offers to professional investors are exempt from compliance with the prospectus regime.

(2) Section 3 of the 17th Schedule excludes from the definition of prospectus any document for an offer where the minimum denomination or principal amount of the investment is HK$500,000. For ease of discussion, this will be referred to as the "HK$500,000 exemption".

(3) Section 103(3)(k) of the SFO exempts offers to professional investors from regulation under the offer of investment regime.

2.10 The Securities and Futures (Professional Investor) Rules (Cap. 571D) has defined professional investors to include high net worth individuals having a portfolio of HK$8 million or more. Paragraphs 15.1-15.5 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission impose a number of further requirements on any intermediary intending to treat a client as a professional investor. The effect is that such an intermediary would have to have in place a system for ascertaining each client's portfolio value, explaining to him the consequences of being treated as a professional investor, conducting annual confirmations etc.

3. The Issues

3.1 The parallel running of the prospectus regime and the offer of investment regime raises 3 important issues.

3.2 Firstly, it allows potential regulatory arbitrage. Economically identical products could be created as a debenture issued by a corporate vehicle (including a special purpose vehicle) thus taking "legal form" and falling within the prospectus regime, or as an investment agreement and falling within the offer of investment regime. As discussed earlier, the practical consequences can be very different.

3.3 This is undesirable. Difference in mere form (legal versus contractual) should not result in products being regulated significantly differently. The present legislative proposals would bring all structured products into the offer of investment regime. Proposed amendment to section 103(2)(a) would also end the application of the 103(2)(a) exception to structured products. In short, the proposals would "level the playing field".

3.4 Secondly, it is somewhat counterintuitive to place structured products, e.g., equity-linked notes ("**ELNs**"), with shares and debentures in the CO. A lay person could well read "shares and debentures" to mean stocks and corporate bonds, thinking of them as things that a company would issue to raise capital for its business. On the other hand, it is quite natural to place structured products with collective investment schemes, e.g., unit trusts, mutual funds, insurance-linked assurance schemes, in the SFO. Common sense says that they are all investment products not primarily related to corporate businesses.

3.5 Thirdly, structured products are becoming increasingly complex. There are likely cases or aspects of cases where a disclosure-based approach alone is not enough or not optimal. As discussed above, the offer of investment regime of the SFO applies to both disclosure about the product and the product itself. For example, in its recent Code on Unlisted Structured Investment Products, the SFC has set a number of parameters for eligibility of issuers, guarantors, product arranger, and on product structure. In short, the regime is more flexible and more suitable for structured products as a diverse class of investments.

3.6 For the above reasons, the HKBA supports the legislative amendments to unify the regulation of public offers of structured products under the SFO.

4. Ending the $500,000 Exemption

4.1 As discussed earlier, the prospectus regime contains 2 exemptions for offers to investors deemed to be more sophisticated: (a) offers to professional investors as defined in the SFO; and (b) offers where the denomination or principal amount of the investment is HK$500,000 or higher. In a manner of speaking, the prospectus regime is more generous than the offer of investment regime to intermediaries. Both exempt offers to professional investors. But the former also provides the HK$500,000 exemption.

4.2 The HK$500,000 exemption is a significant one. It is relatively easy and simple to qualify for, viz., by setting the denomination or principal amount of a product at half a million dollars. Indeed, in recent years, intermediaries have designed and marketed whole arrays of products, notably ELNs, pursuant to this exemption.

4.3 Substantial businesses have grown upon the HK$500,000 exemption. The present legislative proposals to unify regulation of structured products under the offer of investment regime and to disapply the prospectus regime would inevitably affect intermediaries that engage in such activities. This requires some consideration.

4.4 The basic question is whether the HK$500,000 exemption should be available to offers of structured products in general – not only those designed to fall within the prospectus regime. If the answer is yes, then the exemption should be imported into the SFO to apply to all. Otherwise, there should be no principled objection to ending this exemption.

4.5 This is more a policy than a legal choice. But given the recent rise in complaints and public concerns about misselling of investments in general and mistreatment of lay consumers as sophisticated investors in particular, prudence is well justified. The HKBA supports the present legislative proposals, which would not import the HK$500,000 exemption into the SFO and would, in effect, end this exemption for offers of structured products.

5. Proposed Definition of Structured Products

5.1 The present legislative proposals would bring all "structured products" into the SFO. Proposed new section 1A of Schedule 1 gives a rather lengthy definition. In essence, it encompasses all securities the return or the amount due on which depends on (a) "*changes of the price, value or level ... of any type or combination of types [or 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 (b) "*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)*".

5.2 This definition appears sufficient to cover the presently known kinds of structured products.

5.3 Proposed amendment to section 392 would empower the Financial Secretary (the "**FS**") to prescribe "*any interests, rights or property, whether in the form of an instrument or otherwise, or any class or description of any such interests, rights or property*" to be regarded or not regarded as structured products. Moreover, the FS can prescribe "*the circumstances under which or the purposes for which*" such interests, rights or property are to be regarded or not regarded so. This builds into the regime the flexibility to react and adapt to innovation in investment products.

6. Exceptions for Currency-linked Instruments and Interest Rate-linked Instruments

6.1 Proposed new section 103(3)(ea) exclude 3 types of products issued by authorized financial institutions, i.e., banks, from the definition of structured products:

(1) "Currency-linked instruments", i.e., instruments that would fall within the definition only because the return or the amount due on them depends on (a) "*changes in the value or level ... of any one or more currency exchange rates or currency exchange rate indices*"; or (b) "*the occurrence or non-occurrence of any specified event or events relating to any one or more currency exchange rates or currency exchange rate indices*";

(2) "Interest rate-linked instruments", i.e., instruments that would fall within the definition only because the return or the amount due on them depends on (a) "*changes in the value or level ... of any one or more interest rates or interest rate indices*"; or (b) "*the occurrence or non-occurrence of any specified event or events relating to any one or more interest rates or interest rate indices*"; and

(3) "Currency and interest rate-linked instruments", i.e., combinations of the above 2 types of instruments.

6.2 These have been generally regarded more as banking instruments than investment products. Their nature and use put them next to traditional banking activities such as foreign exchange deposits and interest rate swaps. Indeed, the placement of subsection (ea) – between subsection (e) (giving an exception for certificates of deposit issued by banks) and subsection (f) (giving an exception for certificates of deposits issued by multilateral agencies and foreign banks) – reflects this policy rationale.

6.3 The proposed exception for these 3 types of instruments applies only if they are issued by banks. This potentially creates a disparity between banks and securities firms. As a matter of principle, this is undesirable.

6.4 However, there is the competing consideration that exceptions should be tailored narrowly to situations with concrete justifications. Given the policy rationale for

these instruments, restricting the exception to instruments issued by banks is quite understandable. Unless some industry participants step forth to explain why and how securities firm should be able to issue and offer these 3 types of instruments to the public under the CO rather than under the SFO, the policy rationale appears justified.

6.5 Moreover, Hong Kong's laws provide for separate regulation of different types of intermediaries, namely banks, securities firms, and insurance companies. Given this overall framework, there will inevitably be some situations where different intermediaries engaging in seemingly the same activities are subject to different requirements.

6.6 On balance, the proposed exception appears reasonable. But the HKBA urges the Government and the regulatory authorities to monitor the banks' offering of the 3 types of instruments, so as to identify any concerns about investor protection and, where appropriate, to vary or even disable this exception.

7. A Remark on the Legislative Language

7.1 The SFO's regulation of investment instruments is premised on first classifying them. The legislation contains an overall concept of "financial products". But the substantive provisions apply by reference to the different types of products.

7.2 The term "financial products" has little operative significance. What matters is each of the constituent types of products. If the present proposals are passed into law, there will be 5 types:

(1) securities;

(2) futures contracts;

(3) collective investment schemes ("**CISs**");

(4) leveraged foreign exchange contracts; and

(5) structured products.

7.3 Each type has its own elaborate definition, which in places cross-refer to (whether to include or exclude) other types of products.

7.4 In particular, the relationship between securities and structured products will be quite convoluted. If amended, section 1 of Schedule 1 will define "securities" to include, as paragraph (g), structured products that does not otherwise come within the definition, "*but in respect of which the issue of any advertisement, invitation or document that is or contains an invitation to the public to do any act referred to in section 103(1)(a) ... is authorized or required to be authorized*". In other words, the ambit of the definitional provision will depend on the operation of a substantive provision. This makes rather difficult reading.

7.5 In addition, this will be on top on an already lengthy section 103, which contains numerous exceptions and exceptions to the exceptions.

7.6 Furthermore, the present proposals will add a special definition of "securities" for purposes of Part IV of the SFO, i.e., the offer of investment regime. It would be the same as the general definition, but without new paragraph (g).

7.7 The Government has explained the reason for these proposed wordings. It is to bring structured products offered to the public, and the activities of intermediaries relating thereto, but not structured products that are not offered to the public, nor the activities of intermediaries in relation thereto, within regulation under the SFO. See: Legislative Council Brief dated 30 June 2010, at paragraph 13.

7.8 Indeed, as any statutory regime grows over time, and as new matters are added to fit with existing provisions, complication to the legislative language is inevitable. Moreover, the users of the Part IV of the SFO are mostly industry participants and their legal advisers, who presumably will be able to work through the words. For these reasons, the difficult language is not a cause of serious concern.

7.9 Nonetheless, the HKBA notes that the Government and the regulatory authorities have planned a major exercise to review the regulation of public offers as a whole. This might well serve also as an opportunity to reorganize the statutory provisions.

8. Conclusion

8.1 In conclusion, for the reasons discussed above, the HKBA supports the proposed legislative amendments to unify the regulation of all public offers of structured products under the SFO.

The Hong Kong Bar Association
3rd December 2010