

**ISDA**<sup>®</sup>



Comments by the International Swaps and Derivatives Association, Inc. (**ISDA**) and the Asia Securities Industry & Financial Markets Association (**ASIFMA**) on the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill

**2 December 2010**

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To the Hon Starry Lee Wai-king:

ISDA and ASIFMA<sup>1</sup> appreciate the opportunity to collectively express our views on the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010. We note that the Bill has incorporated many of the recommendations set out in the SFC's Consultation Conclusions dated 22 April 2010 on Possible Reforms to the Prospectus Regime in the Companies Ordinance and the Offers of Investments Regime in the Securities and Futures Ordinance, and in light of this we will be making references to the Consultation Conclusions in our submissions below.

## **Executive Summary**

We note that the Consultation Conclusions have addressed many of the concerns raised in our joint submission to the SFC dated 24 December 2009 and we thank both the SFC and the Bills Committee for this. We support the Government's efforts to harmonise the two existing offering regimes.

A brief summary of our comments and suggested changes follows:

- With the loss of the “no more than 50 persons” safe harbour, clear regulatory guidance as to the meaning of “public” and what amounts to an “invitation to the public” in the SFO is required.
- The proposed expanded definition of “securities” (albeit already narrowed from the original proposal to classify all structured products as “securities”) will nonetheless have far reaching and potentially unintended consequences throughout the rest of the SFO, its subsidiary legislation and other non-statutory regulatory literature. Members believe further review and market consultation is necessary before the Bill is implemented, in order to ensure that all consequential amendments accord with the provisions in the Bill.
- Currency rate-linked and interest rate-linked instruments (and hybrids thereof) issued by authorised financial institutions should be carved out from the definitions of “securities” and “structured products”, rather than just being exempt from section 103(1). In addition, futures contracts should be carved out from the definition of “structured product”.
- The exemptions under sections 103(3)(h) and (i), which relate to listed securities, should also include a reference to “structured products” so as to ensure that all structured products, regardless of form, which are approved for listing by a recognised market will be exempt from the authorisation requirements under 103(1).
- The proposed relaxation of evidential requirements of the Securities and Futures (Professional Investor) Rules (**PI Rules**) should coincide with the end of the Bill's proposed transitional period, such that market participants will be better able to avail themselves of the professional investor exemption.

### **1. Definition of “public”**

- 1.1 In line with the Consultation Conclusions, we note that the Bill does not replicate any of the private placement safe harbours in the Seventeenth Schedule of the Companies Ordinance (**CO**), in particular the “minimum HK\$500,000 denomination” and “no more than 50 persons” exemptions, in the SFO. Whilst noting that this will make Hong Kong out of line with other financial centres that have similar safe harbours (albeit the SFC has

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<sup>1</sup> Descriptions of these associations are provided in Appendix 1.

indicated that some jurisdictions are considering tightening the existing safe harbours<sup>2</sup>), we respect this policy decision and appreciate that the SFC has recently proposed to relax the evidential requirements under the PI Rules which should help alleviate some of the practical difficulties faced by market participants in making use of the professional investor exemption<sup>3</sup>.

- 1.2 However, members are deeply concerned that removal of the “not more than 50 persons” bright line test will expose market participants to considerable uncertainty surrounding the meaning of “public”. Indeed the bright line test was introduced in the 2004 CO amendment to clarify a legal uncertainty that the market had considered long overdue, and against this background it now seems inconsistent to suggest that certainty is no longer required because the “concept of what is a public offer is well understood by the market”<sup>4</sup>.
- 1.3 The Consultation Conclusions also noted that while the bright line exemption is not replicated in the SFO, the “concept is retained in the SFO”<sup>5</sup>. Given that one of the objectives of the Bill is to reform the regulation of the public offering of structured products in the wider context of the policy for greater investor protection, members submit that there is significant merit in providing certainty as to what the “public” means, and specifically what amounts to an “invitation to the public” for the purposes of section 103 of the SFO, rather than relying on a “concept” that is subject to differing interpretation. In the event of a dispute as to the interpretation of an “invitation to the public”, the courts may look to the legislative intent as an aid, and members submit that if it is the clear intention of the Consultation Conclusions that the “concept” of the bright line test is to remain in the SFO, there should be either clear legislative provisions or, at the very least, appropriate regulatory guidance.
- 1.4 Members suggest that such guidance may be in the form of (a) a clear definition of “public” to replace the existing definition in Schedule 1 of the SFO; (b) subsidiary legislation; or (c) non-statutory guidelines issued by the SFC.

## 2. **Definition of “securities”**

- 2.1 Members appreciate that the SFC and the Bills Committee have, in response to feedback from market participants, narrowed the scope of the new definition of “securities” such that it now covers only those structured products (not in the form of securities) in respect of which any offer document would be subject to authorisation under section 105 of the SFO.
- 2.2 However, despite the narrow definition of “securities”, the effect is that it now extends to non-security type structured products, including over-the-counter derivatives, which the SFO (and its subsidiary legislation) were not designed to regulate. This will have far reaching consequences, which are not limited to statutory regulation but also filters through to the large number of non-statutory codes, guidelines and circulars that utilise the defined term “securities” and/or are applicable to “dealing in securities” and “advising on securities”. Members believe there should be a careful and considered examination of the wide ranging effects of the new definition of “securities” before the Bill is brought into force, in order to avoid inadvertently triggering regulatory provisions that were not intended for such purpose.
- 2.3 One example of inadvertent regulation can be seen in the proposals surrounding “currency-linked instruments”, “interest rate-linked instruments” and “currency and interest

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<sup>2</sup> Paragraph 24(a) of the Consultation Conclusions

<sup>3</sup> SFC’s Consultation Paper on the Evidential Requirements under the Securities and Futures (Professional Investor) Rules, the consultation period for which ended on 5 November 2010

<sup>4</sup> Paragraph 22 of the Consultation Conclusions

<sup>5</sup> Paragraph 22 of the Consultation Conclusions

rate-linked instruments” issued by authorised financial institutions (together referred to in this paper as **money market instruments**), as will be discussed in more detail in paragraph 3 below.

- 2.4 Members therefore strongly urge that there should be further study and market consultation on the effects of the new definition of “securities”, such that appropriate amendments to the relevant requirements in both statutory and non-statutory regulation can be made at the same time, rather than passing the Bill without having considered fully the consequences.

### 3. **Money market instruments**

- 3.1 The Consultation Conclusions have confirmed that the regulatory intent was to maintain the existing practice that money market instruments should not typically be regulated by the SFO.<sup>6</sup> It was then proposed that this should be achieved by providing an exemption for these products from section 103(1), and hence the Bill now contains a proposed section 103(3)(ea) for this purpose.

- 3.2 However, members note that while the proposed section 103(3)(ea) means that money market instruments will not be subject to authorisation under section 105 and therefore will fall outside of the scope of the proposed paragraph (g) of the definition of “securities”, these products could still be caught by the existing paragraphs (a) to (f) of that definition. This would mean that a money market instrument could still be classified as a “security”, which could then inadvertently trigger regulation by other provisions – for example, the licensing requirements under Part V of the SFO and requirements under related subsidiary legislation such as the administrative requirements contained in the Securities and Futures (Contract Notes, Statements of Account and Receipt) Rules.

- 3.3 Members therefore suggest that the proposed exemption in section 103(3)(ea) should be moved into the definition of “securities” in Part 1 of Schedule 1 to the SFO and the definition of “structured product” in Part 1A of Schedule 1 to the SFO, such that money market instruments are expressly carved out from both definitions. This would reflect the regulatory intent and keep the regulation of these products, irrespective of their form, consistent and outside of the SFO.

- 3.4 In addition, members suggest that there should be non-statutory guidance on the types of product features that would be considered to fall within the proposed definitions of the money market instruments – we note that the SFC is of 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”<sup>7</sup>. However, members feel that the market will benefit from further guidance, such as examples of what features would or would not be acceptable, in order to ensure the market understands and can take appropriate measures in response to the new regulatory measures.

### 4. **Definition of “structured product”**

- 4.1 Members appreciate that the Consultation Conclusions have provided general guidance regarding how the definition of “structured product” should be applied to different types of structures (though at the same time noting that the actual application can only be dealt

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<sup>6</sup> Paragraph 49 of the Consultation Conclusions

<sup>7</sup> Paragraph 53 of the Consultation Conclusions

with on a case by case basis), and in particular the SFC has clarified that the proposed definition is meant to cover bilateral private contracts and OTC derivatives.<sup>8</sup>

- 4.2 However, members note that the definition of “structured product”, as currently proposed, would also capture futures contracts, which are already regulated separately under the SFO. Members appreciate that the SFC is of the view that the exemption currently available under section 103(2)(b) of the SFO is adequate to reflect the policy intent that where a futures contract is offered by an appropriately licensed/registered person, authorisation of the related offering documents will not be required.<sup>9</sup> However, members suggest that there should be an express carve out for futures contracts from the definition of structured products, in order that they are not inadvertently regulated as structured products.
- 4.3 Similarly, the definition of “structured products” should contain an express carve out for all money market instruments, as explained in paragraph 3.3 above.

## 5. **Exemptions under s.103**

- 5.1 Members note that Part IV of the SFO, including section 103, will be subject to the proposed narrower definition of “securities” to be inserted into section 102(1), such that “securities” will have the same meaning as that in section 1 of Part 1 of Schedule 1 except that it does not include structured products that are securities only because of paragraph (g) of that proposed definition (i.e. for the purposes of Part IV, “securities” could potentially cover structured products in security form that fall within paragraphs (a) to (f) of the definition of “securities”, but would not cover non-security type structured products).
- 5.2 In light of this, members note that the Bill proposes to amend a number of the current exemptions under sections 103(2) and 103(3) to additionally cover all structured products (such as the proposed amendment to the professional investor exemption under sections 103(3)(k)) or to additionally cover just listed structured products (such as the proposed amendment to the exemption for offering documents issued by intermediaries licensed for types 1, 4 and 6 regulated activity under section 103(2)(a)).
- 5.3 However, members wish to point out that structured products should also be covered in the sections 103(h) and (i) – these are exemptions for securities which are listed in Hong Kong or in overseas jurisdictions. A reference to “structured product” should be added to these provisions after the existing reference to “securities”, such that all listed structured products, regardless of their form, will be exempt from 103(1), as otherwise there will be an inconsistency in the regulation of listed structured products that depend solely on their form. In particular, the insertion of “structured products” into section 103(3)(h) would be consistent with the SFC’s view that this exemption should be expanded to include structured products the listing of which has been approved by the SEHK<sup>10</sup>, and members submit that this approach should also apply to structured products approved for listing by a recognised stock market.

## 6. **Transitional arrangements**

- 6.1 Members would again highlight the importance of further analysis and market consultation as to the consequences flowing from the expanded definition of “securities”, before the Bill comes into effect, as discussed in paragraph 2 above.

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<sup>8</sup> Paragraph 42 of the Consultation Conclusions

<sup>9</sup> Paragraph 42(e) of the Consultation Conclusions

<sup>10</sup> Paragraph 71(d) of the Consultation Conclusions

6.2 In addition, when considering the Bill's transitional arrangements, members respectfully request that the proposals to relax the PI Rules<sup>11</sup> should be implemented in parallel. With the proposed removal of the CO safe harbours, members note that the professional investor exemption will be increasingly relied upon for private placements, and therefore urge that implementation of the Bill should coincide with the relaxation of the PI Rules, such that by the end of the Bill's proposed transitional period market participants will be better able to avail themselves of the professional investor exemption.

## 7. **Conclusion**

We fully support the initiative to transfer the regulation of public offers of structured products from the prospective regime of the CO to the offers of investments regime of the SFO. Our comments in this paper represent a genuine effort to work with the Bills Committee to improve the clarity of the future legislation, in the hope that this will in turn make its implementation by market participants as smooth as possible. We take this opportunity to express our gratitude to the SFC and the Bills Committee for consulting and taking into consideration the views of market participants in preparing the Consultation Conclusions and the Bill. We very much appreciate the opportunity to present our views on the Bill, and are committed to working with the SFC and the Government to help to re-build confidence in the structured products market in Hong Kong.

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<sup>11</sup> SFC's Consultation Paper on the Evidential Requirements under the Securities and Futures (Professional Investor) Rules, the consultation period for which ended on 5 November 2010

## APPENDIX 1

The International Swaps and Derivatives Association, Inc. (ISDA) has over 840 member institutions from 58 countries on six continents. These members include most of the world's major institutions that deal in privately negotiated derivatives, as well as many of the businesses, governmental entities and other end users that rely on over-the-counter derivatives to manage efficiently the financial market risks inherent in their core economic activities. As such, we believe that ISDA brings a unique and broad perspective, both in terms of the depth of representation across the derivatives industry and in terms of international representation and understanding of the regulatory arrangements in other jurisdictions.

The Asia Securities Industry & Financial Markets Association (ASIFMA) is an independent association whose mission is to promote the development of liquid, efficient and transparent capital markets in Asia and encourage their orderly integration into the global financial system. Association priorities are driven by the active participation of over 40 member companies, including global and regional banks, securities dealers, brokers, asset managers, credit rating agencies, law firms, trading and analytic platforms, and clearance and settlement providers involved in Asia-Pacific's capital markets. ASIFMA is located in Hong Kong and works closely with its global alliance partners: the Global Financial Markets Association (GFMA), the Securities Industry and Financial Markets Association (SIFMA) and the Association for Financial Markets in Europe (AFME).