

Structured products to be regulated under the SFO – with effect from today

Introduction

The Securities and Futures Commission (SFC) began a consultation process in October 2009 concerning proposals to move the regulation of structured products from the prospectus regime under the Companies Ordinance (CO) to the offers of investments regime under the Securities and Futures Ordinance (SFO). This process culminated last week with the passing of the Securities and Futures and Companies Legislation (Structured Products Amendment) Ordinance 2011 (the Amendment Ordinance) which takes effect today. Detailed information relating to the consultation process and its conclusions has been the subject of an earlier briefing note.

[SFC proposes amendments to rules for public offers of unlisted structured products in Hong Kong. April 2010.](#)

The Amendment Ordinance amends the SFO and the CO so that all structured products offered to the public in Hong Kong, whether issued in the form of debentures or in other legal form, must be authorised by the SFC under the SFO. All advertisements, invitations and offering documents issued in connection with such an offering must also be authorised.

Structured products

A new definition of structured products has been inserted by adding a new section 1A to Schedule 1 of the SFO. The new definition catches any instrument under which some or all of the return or amount due (or both the return and the amount due) or the method of settlement is determined by reference to underlying events, including changes in values of underlying securities, commodities, interest rates, currency exchange rates or futures contracts (or a basket of more than one of these).

There are a number of exclusions from this new definition, including convertible and exchangeable bonds and subscription warrants. These along with ordinary and preference shares and plain vanilla bonds will continue to be regulated under the CO.

In addition, the exemption for currency-linked products and interest rate linked products (and products which combine features of both) which are issued by authorised financial institutions has been implemented in the form originally proposed by the SFC and therefore the offering of these products will continue to be regulated by the Hong Kong Monetary Authority (HKMA).

Collective investment schemes offered in the form of a corporation are not structured products and therefore remain subject to the regulatory regimes of both the CO and the SFO with the result that the safe harbours under the CO will continue to be available for collective investment schemes in corporate form.

All structured products, to the extent they were not already, that are offered or promoted to the public are now securities for the purposes of the SFO.

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Safe harbours

As highlighted in our earlier briefing, one of the effects of the Amendment Ordinance is that the safe harbour provisions under the CO and which were previously available to structured products issued in the form of debentures are no longer available. The most commonly used safe harbour provisions of the CO were the 'minimum HK\$500,000 denomination' and the 'no more than 50 persons' rule.

There are no similar safe harbours expressed under the SFO. The SFC has declined to provide any additional guidance as to how many people would constitute the 'public' in Hong Kong for the purposes of an offering to the public of an unlisted structured product.

Further, the exemptions available under sections 103(2)(a) and 103(5)(a) of the SFO to offerings of securities by intermediaries with Type 1, Type 4 or Type 6 licences will not be available to an offering of unlisted structured products to the public in Hong Kong.

Professional investors

The professional investors exemption is available to unlisted structured products provided that certain evidential requirements set out in the Securities and Futures (Professional Investor) Rules (the PI Rules) are satisfied. This exemption requires that, where the professional investor is an individual, that person have a portfolio valued at not less than HK\$8 million and that has been certified by an auditor or accountant.

In practice, market participants have had difficulties in satisfying these evidential requirements as a result of which a separate consultation process was undertaken by the SFC, the conclusions of which were published in February 2011. Among the conclusions is the proposal that market participants adopt a "principles-based" approach in determining whether a person meets the relevant high net-worth threshold set out in the PI Rules. The existing evidential requirements will remain as an alternative. The proposals will be gazetted in due course.

In any event, for suitability purposes before a person can be treated as a professional investor, firms must satisfy themselves that that person is knowledgeable and has sufficient expertise in the relevant products and markets being offered as required under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

Authorisation

As mentioned above, where an unlisted structured product (in whatever legal form) is proposed to be offered to the public in Hong Kong prior authorisation must be obtained from the SFC for any advertisements, invitations or offering documents to be issued in connection with such offering, in which case application is made under section 105(1) of the SFO, as well as for the product itself, in which case application is made under the new section 104A(1) of the SFO.

For an application made under section 104A(1), this must be accompanied by "any information or documents that the [SFC] requires". In applying the authorisation requirements under the SFO, it is to be expected that the SFC will refer to the requirements set out in the Code on Unlisted Structured Investment Products (the SIP Code).

Fees are payable in respect of an application (HK\$2,000) and authorisation (HK\$1,000) of an unlisted structured product under section 104A of the SFO.

One immediate and practical consequence of the changes effected today is that all structured products which are not authorised by the SFC will need to include revised selling restrictions. New selling restrictions have already been prepared by market participants.

The SIP Code

Among the more important provisions of the SIP Code which will apply to any current or proposed offering of unlisted structured products are:

- The eligibility requirements for issuers and guarantors;
- Requirements for the appointment of a product arranger where neither the issuer nor the guarantor is a licensed bank regulated by the HKMA or a corporate entity licensed by the SFC;
- Requirements relating to the reference assets to which the structured product is linked, for example, that the reference assets be acceptable to the SFC and that there be information about the reference assets available to investors, regularly and free of charge;
- Eligibility requirements relating to any collateral held;
- Continuing disclosure requirements;
- Requirement for a key facts statement;
- Allowing the investor a cooling-off period of at least five business days; and
- Requirements to provide bi-weekly market making for unlisted structured products with scheduled tenors of more than six months.

Detailed information relating to the consultation process and conclusions in relation to the SIP Code can be found in earlier briefing notes:

(1) [SFC maps the future for unlisted structured products in Hong Kong October 2009](#); and

(2) [Consultation Conclusions on proposals to enhance protection for the investing public in HK May 2010](#).

Conclusion

The Amendment Ordinance is in line with market expectations. However, it changes fundamentally the manner in which unlisted structured products may be marketed in Hong Kong and these changes take effect today.

This Client briefing does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

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