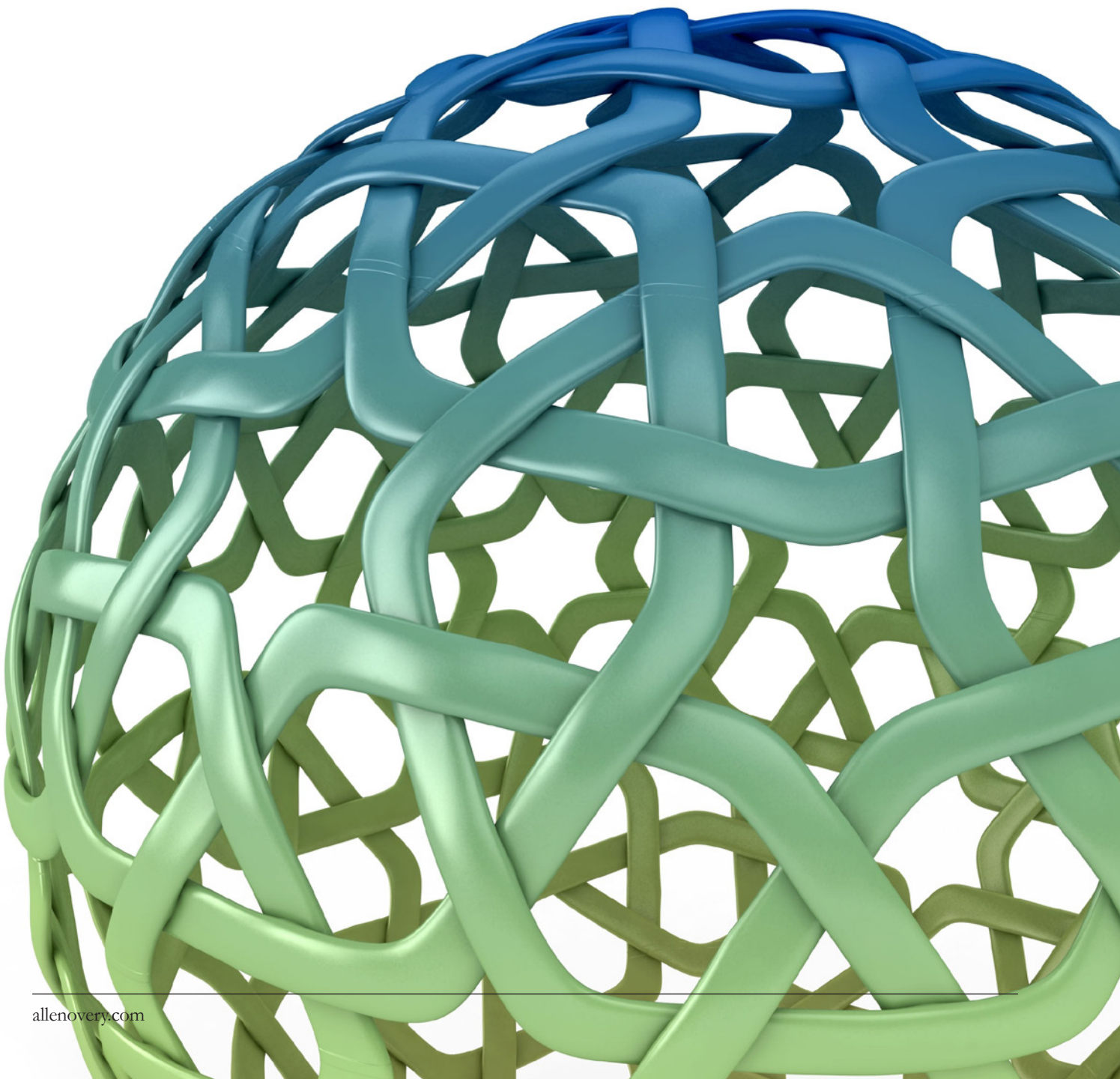


# ALLEN & OVERY

## Sale and Distribution of Debt Instruments with Loss-absorption Features

---



On 30 October 2018, the Hong Kong Monetary Authority (**MA**) issued guidance on enhanced investor protection measures on the sale and distribution of debt instruments with loss-absorption features and related products (**Circular**).

The Circular is directed at registered institutions (**RI**s) ie banks in Hong Kong who are registered with the Securities and Futures Commission (**SFC**) to undertake regulated activities – in particular sales and distribution.

Given debt instruments with loss-absorption features are subject to the risk of being written down or converted to ordinary shares, potentially resulting in a substantial loss to the investors concerned, the MA is of the view that such debt instruments and investment products that invest mainly in, or whose returns are closely linked to the performance of such instruments (together, **Loss-absorption Products**) are inherently complex<sup>1</sup>, of high risk and generally unsuitable for retail investors.

The guidance is available here at: <https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2018/20181030e2.pdf>. This guidance follows a previous circular issued by the MA on distribution of fixed income and structured products on 8 February 2018.

## Only allowed for professional investors

To this end, RIs should only sell and distribute Loss-absorption Products to professional investors (**PI**s) in both primary and secondary markets. Steps to be taken by the RI in Hong Kong will vary depending on whether the person is an individual, corporate or institutional PI.

The securities offering regime pursuant to the Securities and Futures Ordinance (**SFO**) is not altered by the Circular; whilst the securities offering regime under the SFO provides for safe harbours including offers to PIs, where Loss-absorption Products are sold or distributed by RIs they must be PIs only.

## Requirements to be observed by RIs in the sale and distribution of Loss-absorption Products

RIs dealing with individual PIs should observe all requirements set out in the Circular without any exception. RIs dealing with institutional and corporate PIs are subject to certain exemptions. The requirements are summarised below.

<sup>1</sup> Classification of Loss-absorption Products as “complex” is consistent with the Securities and Futures Commission’s view published on 28 March 2018

Requirements to be observed by RIs ...	...when dealing with individual PIs	...when dealing with corporate PIs	...when dealing with institutional PIs
Product risk ratings	<ul style="list-style-type: none"><li>– RIs should take into account the complex and high risk nature of Loss-absorption Products and assign appropriate product risk ratings.</li><li>– Non-leveraged investment in Loss-absorption Products to be treated as of at least high risk.</li><li>– Leveraged investment (ie transactions conducted by a customer on a margin basis) to be treated as of the highest risk.</li></ul>	Exempted, provided that RIs have complied with paragraphs 15.3A and 15.3B <sup>2</sup> of the SFC's Code of Conduct	Automatically exempted
Suitability assessment	<ul style="list-style-type: none"><li>– RIs should assure themselves that customers have adequate knowledge or experience in products with contingent write-down or contingent convertible features.</li><li>– RIs should ensure that Loss-absorption Products are suitable for the customer in all the circumstances, irrespective of any solicitation or recommendation to the customer.</li><li>– Strong justification would be needed for any risk-mismatches.</li><li>– RIs are reminded that mere mechanical matching of an investment product's risk rating with a customer's risk tolerance level may not be sufficient to discharge their suitability obligations.</li><li>– Due consideration to all relevant circumstances specific to a customer, including concentration risk, when performing suitability assessment.</li></ul>		
Product information disclosure (I)	Potential customers in primary and secondary markets should be directed to any selling restrictions and key warning statements in the offering and product documents.		
Product information disclosure (II)	RIs should provide sufficient relevant information to a customer (irrespective of whether the customer is an individual, corporate or institutional PI), in particular: <ul style="list-style-type: none"><li>– the product is subject to the risk of being written down or converted to ordinary shares;</li><li>– the circumstances that the contingent write-down or conversion may happen, and the implications to investors (including that it may potentially result in a substantial loss);</li><li>– it is a high risk product;</li><li>– it is a complex product, as the circumstances in which the product may be required to bear loss are difficult to predict and ex ante assessments of the quantum of loss will also be highly uncertain;</li><li>– the product is targeted at PIs only, and is generally not suitable for retail investors; and</li><li>– credit ranking (eg subordinated) and implications to investors.</li></ul>		

<sup>2</sup> Requirements under paragraphs 15.3A and 15.3B of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission are summarised as follows:

- the RI is satisfied that (a) the corporate PI has the appropriate corporate structure and investment process and controls, (b) the persons responsible for making investment decisions on behalf of the corporate PI have sufficient investment background, and (c) the corporate PI is aware of the risks involved which is considered in terms of the persons responsible for making investment decisions;
- the RI has obtained from the corporate PI a written and signed declaration;
- the RI has fully explained to the client the consequences of being treated as a PI; and
- the RI has specified that the client is treated as a PI in a particular product and market and has informed the client that he has a right to withdraw from being treated as a PI.

## The Circular in perspective

The Circular's enhanced investor protection measures are broadly consistent with the statutory product disclosure requirements of debt instruments with Loss-absorbing Capacity under the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements-Banking Sector) Rules (Cap. 628B, Laws of Hong Kong) (the **LAC Rules**). At a high level, the LAC Rules provides that any prospectus, notice, circular, advertisement or brochure prepared by or for the issuer in relation to debt instruments with loss-absorbing capacity must

- a. disclose the risks inherent in the holding of the instrument (including the risks in relation to its subordination and the circumstances in which the holder may suffer loss as a result of the holding);
- b. contain a statement that the instrument is complex and high risk; and
- c. if issued in Hong Kong the instrument must be issued to a professional investor.

It should be noted that the disclosure requirements under the LAC Rules apply to offering documents prepared by or for issuers of such instruments to which the LAC Rules applies whilst the Circular is addressed to RIs, in the course of their sales and distribution of Loss-absorption Products (ie acting as intermediaries), regardless of whether LAC Rules are relevant. The Circular does not apply to banks not registered with the SFC as RIs and thus a non-RI issuer is not directly subject to the Circular; if their Loss-absorption Products are sold by or through RIs (or indeed a licensed corporation pursuant to SFC's complex product requirements), the enhanced investor protection measures will need to be complied.

## Going forward

### *Primary market*

In terms of sales and distributions in the primary market, RIs are requested by the MA to implement the requirements set out in its guidance as soon as possible, but no later than 6 April 2019.

Though we recognise the practical difficulties for RIs to immediately implement the requirements set out in the Circular, we suggest RIs begin putting in place operational enhancements to meet the requirements ahead of the deadline of 6 April 2019, further noting that the Circular provides that RIs should implement the requirements *as soon as possible*.

### *Secondary market*

The MA has made clear for Loss-absorption Products that were issued before 30 October 2018 (ie the date of the Circular), the enhanced investor protection measures, including selling restrictions, in the Circular will only be applicable to future sale and distribution by RIs in the secondary market.

In the context of secondary markets, the enhanced investor protection measures are applicable only to the extent that an RI, in the course of it being an intermediary in the secondary market are involved in the sale and distribution of Loss-absorption Products. Where existing documentation is insufficient to address the enhanced investor protection measures, RIs will need to consider ways of supplementing it.

---

## KEY CONTACTS

---

### Charlotte Robins

Partner – Hong Kong  
Tel +852 2974 6986  
charlotte.robins@allenoverly.com

### Agnes Tsang

Partner – Hong Kong  
Tel +852 2974 7167  
agnes.tsang@allenoverly.com

### Stephen Miller

Registered Foreign Lawyer,  
E&W – Hong Kong  
Tel +852 2974 6926  
stephen.miller@allenoverly.com

### John Lee

Registered Foreign Lawyer,  
E&W – Hong Kong  
Tel +852 2974 7354  
john.lee@allenoverly.com

### Andre Da Roza

Of Counsel – Hong Kong  
Tel +852 2974 6980  
andre.daroza@allenoverly.com

### Jaclyn Yeap

Of Counsel – Hong Kong  
Tel +852 2974 7220  
jaclyn.yeap@allenoverly.com

---

## GLOBAL PRESENCE

---

Allen & Overy is an international legal practice with approximately 5,400 people, including some 554 partners, working in 44 offices worldwide. Allen & Overy LLP or an affiliated undertaking has an office in each of:

Abu Dhabi	Bucharest (associated office)	Ho Chi Minh City	Moscow	Seoul
Amsterdam	Budapest	Hong Kong	Munich	Shanghai
Antwerp	Casablanca	Istanbul	New York	Singapore
Bangkok	Doha	Jakarta (associated office)	Paris	Sydney
Barcelona	Dubai	Johannesburg	Perth	Tokyo
Beijing	Düsseldorf	London	Prague	Warsaw
Belfast	Frankfurt	Luxembourg	Riyadh (cooperation office)	Washington, D.C.
Bratislava	Hamburg	Madrid	Rome	Yangon
Brussels	Hanoi	Milan	São Paulo	

**Allen & Overy** means Allen & Overy LLP and/or its affiliated undertakings. The term **partner** is used to refer to a member of Allen & Overy LLP or an employee or consultant with equivalent standing and qualifications or an individual with equivalent status in one of Allen & Overy LLP's affiliated undertakings.

© Allen & Overy LLP 2018 | CA1811039