

Guidance on Enhanced Investor Protection Measures on Sale and Distribution of Debt Instruments with Loss-absorption Features and Related Products

Background

Debt instruments with loss-absorption features are subject to the risk of being written down or converted to ordinary shares (such as recapitalising the issuer as it goes through resolution), potentially resulting in a substantial loss to the investors concerned. The circumstances in which these debt instruments may be required to bear loss are difficult to predict and ex ante assessments of the quantum of loss will also be highly uncertain. Hence, debt instruments with loss-absorption features are inherently complex and are of high risk, and are generally not suitable for retail investors.

Applicability

The requirements below apply to the primary and secondary market sale and distribution of the following products (referred to as “Loss-absorption Products”):

- (i) debt instruments with features of contingent write-down or conversion to ordinary shares on the occurrence of the following:
 - (a) when a financial institution is near or at the point of non-viability; or
 - (b) when the capital ratio of a financial institution falls to a specified level.

For the avoidance of doubt, plain vanilla debt instruments and deposits (including certificates of deposits) are not captured as “Loss-absorption Products” for the purpose of applying the enhanced investor protection measures as set out in this Annex.

and

- (ii) investment products that invest mainly in, or whose returns are closely linked to the performance of, instruments described in (i) above (for example, collective investment schemes which have a principal investment strategy and/or objective to invest in instruments described in (i) above (“Loss-absorption Funds”), or structured products whose returns are closely linked to the performance of instruments described in (i) above).

(A) Selling restrictions

Registered institutions (“RIs”) should stay vigilant and sell and distribute Loss-absorption Products only to professional investors (“PIs”), as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance, in both primary and secondary markets.

(B) Product risk rating

The contingent write-down or conversion to ordinary shares entailed in Loss-absorption Products would pose substantial risk to investors. When conducting product due diligence, RIs should take this into account and assign appropriate product risk ratings. Any leveraged investment in Loss-absorption Products (e.g. transactions conducted by a customer on a margin basis) will amplify the risk and should be assigned a higher risk rating.

(C) Suitability assessment

Loss-absorption Products are complex products¹. RIs should assure themselves that customers who wish to invest in Loss-absorption Products have adequate knowledge or experience in products with contingent write-down or contingent convertible features.

RIs should ensure that a transaction in Loss-absorption Products¹ is suitable for the customer in all the circumstances, irrespective of whether there is any solicitation or recommendation to the customer.

(D) Disclosure of product information

RIs should provide and explain to the customer relevant product information and warnings, such as key product nature, features and risks, in particular:

- the product is subject to the risk of being written down or converted to ordinary shares (as the case may be);
- 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);
- it is a high risk product;
- 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

¹ Save for Loss-absorption Funds. See Section (E) below.

- quantum of loss will also be highly uncertain;
- the product is targeted at PIs only, and is generally not suitable for retail investors; and
- credit ranking (e.g. subordinated) and implications to investors.

(E) Loss-absorption Funds

In respect of sale and distribution of Loss-absorption Funds, the enhanced investor protection measures in (C) and (D) above are not applicable. For the avoidance of doubt, RIs are still required to follow applicable requirements promulgated by the Securities and Futures Commission (“SFC”), e.g. to categorise whether a Loss-absorption Fund is complex or non-complex (having regard to the factors set out in paragraph 6.1 of the SFC’s “Guidelines on Online Distribution and Advisory Platforms”, the notes under paragraph 5.5 of the SFC’s “Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission” (“Code of Conduct”), and the non-exhaustive list of examples of non-complex and complex products set out on the SFC’s website); to comply with the applicable requirements for a transaction of a complex product² if the Fund is categorised as a complex product; and to comply with the suitability requirement under paragraph 5.2 of the SFC’s Code of Conduct if RIs solicit the sale of or recommend a Loss-absorption Fund to a customer regardless of whether it is complex or non-complex.

(F) Exemptions for Institutional PIs and Corporate PIs³

RIs dealing with Institutional PIs are automatically exempted from the above enhanced investor protection measures in (B), (C) and (D). RIs dealing with Corporate PIs could be entitled to same exemptions as applied to Institutional PIs, provided that RIs have complied with paragraphs 15.3A and 15.3B of the SFC’s Code of Conduct.

² For example, SFC’s “Guidelines on Online Distribution and Advisory Platforms” and paragraph 5.5 of the SFC’s Code of Conduct.

³ “Institutional PIs” and “Corporate PIs” are defined in the SFC’s Code of Conduct.