

Frequently Asked Questions on Sale and Distribution of Loss-absorption Products

(A) Scope of products

1. What types of debt instruments fall within the scope of the Circular?

The policy intention is to capture debt instruments with features of contingent write-down or contingent 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.

These include:

- debt instruments that meet the qualifying criteria to be Additional Tier 1 Capital or Tier 2 Capital under the Banking (Capital) Rules. The same principle applies to debt instruments issued under an equivalent regime of non-Hong Kong jurisdictions (collectively called “AT1/T2 debt instruments”); and
- debt instruments that meet the qualifying criteria to be external LAC debt instruments under the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules; and debt instruments issued under a regime of non-Hong Kong jurisdictions which implements Financial Stability Board’s standards for “Total Loss-absorbing Capacity Term Sheet”.

For the avoidance of doubt, instruments in the legal form of equities (including ordinary shares and preferred shares), and all types of deposits (including certificates of deposits) are excluded.

As part of the product due diligence process, registered institutions (“RIs”) should understand the nature and risks of investment products, and determine the applicability of the Circular to each individual product. RIs should seek information from the product issuer if needed.

2. Do all debt instruments which could be bailed in fall within the scope of the Circular?

Not all debt instruments which could be bailed in are within the scope. As to the in-scope debt instruments, please refer to the answer to Question 1.

- 3. Are the following regarded as in-scope products covered by the Circular:**
- (a) “non-preferred senior debt instruments” (may be named as “Tier 3” in some jurisdictions); and**
 - (b) senior or subordinated debt instruments issued by a holding company of a financial institution?**

The above instruments which fall within the circumstances described in the answer to Question 1 will be in-scope products.

- 4. Are structured notes such as equity-linked notes which could be bailed in in-scope products?**

Not all bonds or notes which could be bailed in automatically fall within the scope of the Circular. For example, structured notes involving embedded derivatives may not fall within the scope of external LAC debt instruments under the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules.

- 5. How should RIs determine whether the principal investment strategy and/or objective of a collective investment scheme (“CIS”) is to invest in instruments as described in the answer to Question 1? Is there a threshold that RIs may apply?**

Instead of adopting a bright-line threshold, it is considered more appropriate for RIs to exercise professional judgement to reasonably determine whether a CIS is an in-scope product. Normally, the product document of a CIS should have disclosed the investment objectives and strategies (e.g. whether a CIS will invest mainly in debt instruments which are in-scope products). Such disclosure in the product document of a CIS could facilitate RIs to determine at a CIS level as to whether a CIS is an in-scope product.

- 6. When determining whether the principal investment strategy and/or objective of a CIS is to invest in instruments as described in the answer to Question 1, can it include only investments in Additional Tier 1 instruments but not Tier 2 or Tier 3 instruments, given CIS usually diversify investment exposure by**

setting limits for each issuer?

The HKMA considers that it should be cautioned that debt instruments with loss-absorption features as described in the answer to Question 1 are meant to be instruments that are readily available for loss-absorption. Such debt instruments with loss-absorption features issued by financial institutions may have high correlation, especially at times of volatile market environment and financial crisis. A CIS that invests heavily in debt instruments with loss-absorption features offered by different issuers may not have adequately diversified its risk exposure in terms of asset class and industry.

(B) Product risk rating

7. What is the standard of RIs expected in assigning product risk rating of Loss-absorption Products?

Different Loss-absorption Products may have different features and risks. RIs should consider the circumstances in each case (such as the respective ranking in the loss-absorption hierarchy, the issuer, the terms and conditions, etc.) in determining the product risk rating.

(C) Disclosure of product information

8. Can RIs exercise the flexibility provided by the regulators in streamlining product disclosure in selling and distributing Loss-absorption Products?

RIs may exercise the flexibility provided in the regulators' guidance, e.g. section (A)(II.2) of Annex 1 to the HKMA's circular dated 25 September 2019¹, the answer to Question 8 of the HKMA's Frequently Asked Questions dated 23 December 2020², Q6B of the SFC's "FAQs on Compliance with Suitability Obligations" and Q38 and Q39 of the SFC's "FAQs on Guidelines on Online Distribution and Advisory Platforms and Paragraph 5.5 of the Code of Conduct".

¹ "Investor Protection Measures in respect of Investment, Insurance and Mandatory Provident Fund Products"

² "Frequently Asked Questions on Investor Protection Measures"

(D) External asset manager model / Shared relationship structure

9. A customer may have contractual relationships with two different regulated entities which provide the following services:

- (a) one acting as:**
 - (i) an investment adviser (“IA”) and providing investment advice to the customer; or**
 - (ii) an asset manager (“AM”) and managing a discretionary portfolio for the customer; and**
- (b) another acting as an execution broker and providing execution services to the customer by executing the orders placed by the IA or AM on behalf of the customer.**

These contractual relationships, commonly known as external asset manager model and shared relationship structure, may operate under different forms.

If the IA or AM places an order in a Loss-absorption Product (irrespective of whether the order arises from solicitation or not) on behalf of the customer with an execution broker, is the execution broker required to comply with the requirements set out in the Circular when executing the transaction?

In respect of these specific scenarios, the HKMA considers that the execution broker is not required to comply with the requirements set out in the Circular, provided the following conditions are met:

- (a) the IA or AM (as the case may be) is licensed by or registered with the SFC or is regulated by the banking or securities regulator in the overseas jurisdiction where the investment advisory or discretionary portfolio management services are provided;**
- (b) the execution broker merely provides order execution and custody services to the customer and has no day-to-day contact or direct communication with the customer (e.g. the execution broker does not do any of the following: advises on the customer’s trades, manages the customer’s investment portfolio, handles the customer’s enquiries on Loss-absorption Products or the customer’s requests to trade Loss-absorption Products);**
- (c) the execution broker has agreed in writing with the IA or AM (as the case may be) that the IA or AM (as the case may be) is responsible for complying with**

the applicable requirements of the relevant jurisdiction before transmitting the customer's order to be executed; and

- (d) the execution broker has ensured that the customer has been informed in writing of the arrangement referred to in paragraphs (b) and (c) above.

Once the customer has been informed of the arrangement pursuant to (d) above, the arrangement and the notification do not need to be repeated for each applicable transaction executed for the same customer. Where there is any change to the arrangement (e.g. termination of the arrangement among the parties), the execution broker should ensure that an update is provided to the customer in writing as soon as possible.

The above clarification applies to the specific scenarios set out in the answer. It does not apply to the scenario where the customer requests to purchase a Loss-absorption Product directly with the execution broker. When a customer wishes to purchase a Loss-absorption Product directly with the execution broker, the execution broker could execute the transaction only if the applicable requirements set out in the Circular are complied with.

Whether an intermediary acting as an execution broker is required to observe the requirements set out in the Circular is a question of fact, which should be assessed against the circumstances of each case. However, in no circumstances should the above-mentioned arrangement be abused to circumvent the requirements.

(E) Discretionary portfolio management (“DPM”)

10. Do RIs that provide DPM service need to observe the enhanced investor protection measures in the Circular on a transaction-by-transaction basis?

Taking into the account the nature of DPM, RIs can handle investment in Loss-absorption Products under DPM on a holistic basis rather than on a transaction-by-transaction basis, including disclosing relevant information (e.g. investment objective and strategy, and possible investment in Loss-absorption Products) and conducting suitability assessment at the outset, and assigning an appropriate risk rating for a DPM on a portfolio level.