

**Sale and Distribution of**  
**Debt Instruments with Loss-absorption Features and Related Products**  
**(collectively called “Loss-absorption Products”)**

**Frequently Asked Questions (“FAQs”)**

***(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
- 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 the 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. What types of collective investment scheme (“CIS”) fall within the scope of the Circular?**

(1) It is our general principle that a CIS which invests more than 50% of net asset value in debt instruments with loss-absorption features is an in-scope product covered by the Circular.

(2) Notwithstanding the general principle in (1) above, in view of international practices, for a CIS that also meets all of the following criteria, an RI would only be required to comply with the enhanced investor protection measure as set out in “(A) Selling restrictions” in the Circular, and would be exempted from the other measures under “(B) Product risk rating”, “(C) Suitability assessment” and “(D) Disclosure of product information” in the Circular

when selling and distributing such a CIS:

- (a) belongs to any of the following:
  - (i) authorized or approved for offering to public by an overseas regulator and being regulated in a specified jurisdiction for non-exchange-traded unauthorized funds<sup>1</sup>;
  - (ii) traded on an exchange in a specified jurisdiction for exchange-traded products<sup>1</sup>;
  - (iii) authorized by the Securities and Futures Commission (“SFC”); or
  - (iv) traded on The Stock Exchange of Hong Kong Limited;
- (b) invests not more than 30% of net asset value in AT1/T2 debt instruments;  
and
- (c) has made adequate written disclosure to customers about (i) the fund’s maximum total exposure to debt instruments with loss-absorption features; and (ii) the associated risks.

The HKMA will keep in view international developments and review the requirements where appropriate.

**6. It is the general principle that a CIS which invests more than 50% of net asset value in debt instruments with loss-absorption features is an in-scope product. For this purpose, can the calculation only include 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?**

For the scope of CIS covered by the Circular, please refer to the Circular and the answer to Question 5. 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.

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<sup>1</sup> Here refers to the list of specified jurisdictions for non-exchange-traded unauthorized funds or the list of specified jurisdictions for exchange-traded products published by the Securities and Futures Commission.

- 7. It takes time and resources to see through the investments of a CIS to determine whether it is a Loss-absorption Product. What are the expected standards of the HKMA in this aspect?**

The HKMA expects that the product document of a CIS should contain adequate disclosure, including the investment objectives and strategies (e.g. whether a CIS will invest mainly in debt instruments which are in-scope products, or the maximum exposure of the CIS to debt instruments which are in-scope products). Such disclosure could facilitate RIs to determine at a CIS level as to whether a CIS is a Loss-absorption Product.

- 8. Does a CIS traded on an exchange that invests more than 50% of net asset value in debt instruments with loss-absorption features fall within the scope of the Circular?**

Generally yes, except for the exemption mentioned in part (2) of the answer to Question 5 above.

***(B) Product risk rating***

- 9. Can RIs have any flexibility in assigning product risk rating of the products, since they may have some variations in features and risks?**

The HKMA acknowledges that different Loss-absorption Products may have different features and risks. The general principle is that non-leveraged investment in Loss-absorption Products should be treated as of high risk, whereas leveraged investment in Loss-absorption Products should be treated as of the highest risk.

Leveraged investment in Loss-absorption Products is referring to transactions in Loss-absorption Products conducted by a customer on a margin basis. For the avoidance of doubt, where RIs provide financing to a customer for general purposes that may include acquiring investment products, and the customer makes full payment in purchasing a Loss-absorption Product, such transaction in Loss-absorption Product is not regarded as leveraged investment.

RIs should consider the circumstances in each case (such as the respective ranking in the loss-absorption hierarchy, the issuer, and the terms and conditions, etc.) in determining the product risk rating. In other words, everything being equal, a senior debt instrument may warrant a slightly lower product risk rating (within the higher risk buckets) as compared with a subordinated debt of the same issuer.

Further, RIs should clearly disclose the features and risks of a Loss-absorption Product to customers.

The HKMA does not expect mere mechanical matching of an investment product's risk rating with a customer's risk tolerance level. For a customer who does not have a high risk tolerance level, a proportion of his / her portfolio in Loss-absorption Products may not be unsuitable so long as this is commensurate with the risk return profile of the portfolio and the RI is able to satisfy itself that this investment is likely to meet the investment objectives and other personal circumstances of the customer.

***(C) Disclosure of product information***

**10. Do RIs that sell and distribute Loss-absorption Products have any flexibility in providing specific information under part (D)(ii) of the Circular to Professional Investors ("PIs")?**

Taking into account that Institutional PIs and Corporate PIs are generally more sophisticated, the HKMA considers it appropriate to further extend the exemptions for such PIs. RIs that sell and distribute Loss-absorption Products to Institutional PIs and Corporate PIs (provided that RIs have complied with paragraphs 15.3A and 15.3B of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission ("SFC's Code of Conduct")) are exempted from the enhanced investor protection measures set out in (D)(ii) about specific disclosure requirements, in addition to (B), (C) and (D)(i) in the Circular.

Notwithstanding that, RIs remain obliged to make adequate disclosure of relevant material information (e.g. terms and conditions) of a product in their dealings with the clients under GP5 of the SFC's Code of Conduct.

For the avoidance of doubt, the above exemption will not affect the obligation of an issuer to make certain disclosures in the prospectus or offering documents

about the inherent risks, complexity and risk level, and restriction about the investor base in primary issuance in relation to the instruments under the Banking (Capital) Rules and the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules.

***(D) External asset manager model / Shared relationship structure***

**11. 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")***

**12. 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.

***(F) Implementation deadline***

**13. Will the HKMA consider extending the implementation deadline?**

Having considered that more time may be needed to further consider the matters clarified in this set of FAQs, the HKMA considers it appropriate to extend the deadline for Loss-absorption Products (except for in-scope CIS which is further elaborated below) to 6 September 2019; and the deadline for in-scope CIS to 31 December 2019 for RIs to implement the requirements in the Circular together with this set of FAQs.

Having said that, RIs are encouraged to comply with the requirements in the Circular and this set of FAQs as soon as possible, and are expected not to sell and distribute any products that RIs have known or identified to be Loss-absorption Products to non-professional investors before the extended implementation deadlines.

**14. Will there be any retrospective effect on the enhanced investor protection measures concerning existing customers' holdings?**

No. RIs are expected to implement the requirements stipulated in the Circular and this set of FAQs according to the implementation deadline in the answer to Question 13 above.

For the avoidance of doubt, RIs are reminded that GP5 of the SFC's Code of Conduct applies at all times concerning making adequate disclosure of relevant material information to the customers.