



**CONSULTATION PAPER ON
DRAFT INSURANCE (SPECIAL PURPOSE BUSINESS) RULES
SUBMISSIONS**

1. The Insurance Authority released a *Consultation Paper on the Draft Insurance (Special Purpose Business) Rules* (“Consultation Paper”) on 4 September 2020 for views and comments.
2. The Law Society makes the following submissions on the consultation questions posed. Unless otherwise stated, the Law Society adopts the definitions set out in the Consultation Paper.

Question 1:

Do you agree with the proposed scope of eligible investors for ILS? Are there any types of investors which may be added or excluded?

Law Society’s Response:

3. We are not clear why certain collective investment schemes such as Mandatory Provident Fund Schemes (“MPF schemes”) and Occupational Retirement Schemes (also known as ORSO schemes) should be excluded from the definition of “eligible ILS investor”.
4. Our preference is to seek to keep consistency in terms of product offering between the various regulatory regimes.
5. We believe ILS and Loss-Absorbing Capacity (“LAC”) products are both inherently complex and of high risk. Similar concerns as to suitability and risk profile apply to both types of instrument.

6. Our starting point would be for the ILS regime to follow the regime required by the Hong Kong Monetary Authority (“HKMA”) for LAC products.
7. The HKMA’s approach is to use the term “professional investor” as defined in the Securities and Futures Ordinance (Cap. 571) (“SFO”) for the distribution of LAC products.¹ For consistency, we suggest using this approach for ILS.
8. If the IA disagrees with this method, perhaps rather than defining a new class of professional investors – the “eligible ILS investors” – a more holistic approach to maintaining consistency throughout the regulatory regimes would be to make reference to “professional investor” as defined in the SFO and then make exclusions to certain types of professional investors as appropriate. This was the approach taken, for example, in a previous version of the Listing Rules for Chapter 37 Debt Issues to Professional Investors Only.²
9. Although exclusion of ILS for investment by small ORSO schemes (which may have limited governance and/or sophistication of trustees) may be appropriate, it is conceivable that, for example, a large, defined benefit ORSO scheme could conceivably benefit by having access to investment in ILS (particularly ILS of shorter duration, which may give diversification and enhanced-yield opportunities without locking the investment into a non-liquid investment for a long time period). This type of large, defined benefit retirement scheme may be considered akin to an institutional investor. And section 27 of the Occupational Retirement Schemes Ordinance (Cap. 426) does not appear to restrict an ORSO scheme from making such investments. As such, it might be appropriate to permit an ORSO scheme to invest in an ILS arrangement only if the scheme satisfied certain minimum specified criteria, such as minimum number of members, minimum size of fund and maximum percentage of the fund that could be invested in the ILS arrangement.
10. On a related note, should the IA decide to impose the restrictions on ORSO and MPF schemes, we query whether concomitant restrictions will be imposed on ORSO and MPF schemes and funds under the ORSO/MPF regimes, rather than solely having such restriction placed under the ILS/insurance law regime. If the intent of excluding these schemes is to protect the investors' retirement monies, we submit that a better approach would be to impose concomitant restrictions on the trustee / insurer of these schemes, given they are accountable to the investors.

¹ Under Rule 2(1) of the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) (Cap. 628B) (“LAC Rules”), “professional investor” is defined as “having the meaning given by Section 1 of Part 1 of Schedule 1 to the SFO”.

² Under the previous Listing Rule 37.58, “Professional Investor” is “as defined in Part 1 of Schedule 1 to the SFO (excluding those prescribed by the rules made under section 397 of the SFO)”.

11. Further, there is a potential confusion as to whether these restrictions will be “read through”, in the event that the SPI has issued ILS to an eligible investor; which itself issues or offers some type of security or investment into which an ORSO scheme/fund invests (or, potentially an MPF scheme/fund, although they may already be restricted from such investment under the more restrictive MPF investment rules). Given that there may be no restriction on the ORSO scheme investing in such vehicle/investment, and given the SPI has met its requirements in terms of eligible recipients of the ILS, this would seem to be permissible.
12. Paragraph 9 of the Consultation Paper states that there is an intention to prevent “re-packaging” of ILS for retail investors, However, it is unclear from the draft Rules how this can be achieved; imposing a US\$1 million (or any other) minimum investment requirement will not suffice to prevent such two-step, or indirect, investment in an ILS. Therefore, we propose that the IA to consider whether a “read through” restriction should apply, to prevent this two-step type of investment.

Question 2:

Do you agree with the proposed minimum investment size for ILS? If not, what are the reasons?

Law Society’s Response:

13. By reference to paragraph 21 of the Consultation Paper, if the intention is to discourage the “repackaging” of ILS for sale to ordinary investors, it is not clear that having a US\$1 million minimum would accomplish this - as anyone in the business of arranging such re-packaging would no doubt choose, to achieve sufficient scale, to invest more than such minimum. It is not clear whether the stated restrictions will achieve the desired result of keeping unsophisticated investors out of this market.
14. That being said, if US\$1 million is consistent with the minimum threshold in other jurisdictions, it would appear to be an acceptable minimum. However, if the intention is to make Hong Kong more competitive than other jurisdictions with respect to issuance of ILS, the IA may wish to consider a lower minimum, which is still consistent with limiting investment to sophisticated investors (eg. USD\$500,000 or USD\$250,000).
15. The IA may also wish to note that the minimum denomination for instruments to qualify as HKMA LAC products and Additional Tier 1 and Tier 2 Capital is

set at a lower amount – HKD\$2,000,000 or its equivalent if denominated in other currencies. Subject to market views, for consistency between regulatory regimes, the IA could consider following the denominations set by the HKMA.

16. We would observe that, for this product to be commercially successful, in our view it will need to attract institutional investors rather than relatively small "sophisticated investors".

Question 3:

Do you agree with the formulation of the offence in Rule 3 of the draft Rules? If not, what are the reasons?

Law Society's Response:

17. The proposed offence in Rule 3 covers sales activities of ILS in both the primary and secondary markets.
18. For primary issuance, to keep consistency, we suggest using the same approach that was taken by the HKMA in the LAC Rules.³
19. For secondary distribution, the distribution of securities is already heavily regulated by comprehensive regimes under the SFO and the SFC's Codes of Conduct.
20. We suggest that the focus be instead on ensuring the attributes of ILS are sufficient to ensure it is covered by the existing secondary distribution regime. We expect that the ILS would be so covered.⁴
21. We expect that the ILS will be treated as a complex product by the SFC, and so subject to an even more rigorous regulatory regime.
22. We do not see a need for ILS to be subject to a different secondary distribution

³ Rules 60 – 62 of the LAC Rules outline the enforcement procedures for breach of the LAC Rules with reference made to an offence being committed under Section 19 of the Financial Institutions (Resolution) Ordinance (Cap. 628).

⁴ For completeness, the secondary distribution regime would not apply (amongst other exclusions) if the ILS is issued by a Hong Kong private company. Securities issued by a Hong Kong private company are excluded from the definition of 'securities' in Schedule 1 to the Securities and Futures Ordinance (Cap. 571), which largely means secondary distribution of private company securities is unregulated (although licensed corporations and registered institutions will remain subject to their 'good conduct' fit and proper requirements in any event, both for regulated and unregulated products). The rationale is that private company securities issues should not require regulatory supervision. If this is a concern for the Insurance Authority, the Insurance Authority may decide to issue a general condition to carrying on special purpose business under section 8A of the Insurance Ordinance (which is not yet in force) by requiring the authorized company not to be a Hong Kong private company.

regime compared to other security- products. To set up individual regulatory regimes for secondary distribution would, in our view, complicate Hong Kong's securities market with little benefit.

23. For background information, the HKMA also considered regulating the secondary distribution of LAC products in the Consultation Paper on the Rules on Loss-absorbing Capacity Requirements for Authorized Institutions⁵. HKMA's initial proposal for secondary market regulation closely reflects the distribution requirements for complex products that are already set out in Paragraph 5.5 of the SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission. After receiving market responses, rather than layering on top of the existing distribution restrictions, the HKMA decided to concentrate on the regulation of the primary issuance to professional investors.⁶
24. For the sake of good disclosure, we note that after the consultation conclusions were issued, the HKMA issued a circular⁷ to banks who are registered with the SFC as registered institutions. The circular was issued because the HKMA is the lead regulator over banks that are also registered with the SFC as registered institutions. The insurance regulatory regime does not have a similar concept of insurers being registered for distribution and so we would not expect a similar circular to be issued by the IA. It is unlikely that insurers will be involved as distributors of ILS in the secondary market (and, if they were, they would likely require a licence from the SFC to do so).⁸
25. As far as the draft Rules is concerned, we have the following comments.
26. Rule 2 - "authorized financial institution" is defined to mean an authorized institution, as definite in section 2(1) of the Banking Ordinance. This would seem to mean that throughout the draft rules, the term "authorized financial institution" should be used, rather than "authorized institution". Yet, in two places in the definition of "bank", the term "authorized institution" is used rather than "authorized financial institution". Please consider whether these should be changed to "authorized financial institution". Alternatively, "authorized institution" could be changed to "authorized institution (as defined in the Banking Ordinance (Cap.155))".
27. Rule 3(4)(e)(ii) - Query whether there could be any confusion regarding the

⁵ The Consultation Paper on the Rules on Loss-absorbing Capacity Requirements for Authorized Institutions is available at:

https://www.hkma.gov.hk/media/eng/doc/key-functions/banking-stability/resolution/LAC_CP_ENG.pdf

⁶ Section 1(1)(m) of Schedule 1 to the LAC Rules only stipulates distribution restrictions of LAC products by the "issuer" and makes no reference to any restrictions for secondary markets.

⁷ The HKMA's Circular is available at:

<https://www.hkma.gov.hk/media/eng/doc/key-information/guidelines-and-circular/2018/20181030e2.pdf>

⁸ There are however certain exclusions to the licensing requirement that may be available for distributors. See in particular footnote 4.

words “similarly constituted”. Given that “collective investment scheme” appears to extend to such schemes constituted outside of Hong Kong, please consider replacing the proposed Rule 3(4)(e)(ii) by:

“(e)(ii) is a collective investment scheme constituted under the law of any place outside of Hong Kong and, if it is regulated under the law of such place, is permitted to be operated under the law of such place,”

28. Rule 3(4)(f) - Query why municipal government authorities are excluded as eligible investors?

The Law Society of Hong Kong
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