

# Equity Derivatives 2020

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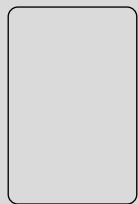
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Reza Mojtabae-Zamani**

Latham & Watkins LLP

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Lexology Getting The Deal Through is delighted to publish the fifth edition of *Equity Derivatives*, which is available in print and online at [www.lexology.com/gtdt](http://www.lexology.com/gtdt).

Lexology Getting The Deal Through provides international expert analysis in key areas of law, practice and regulation for corporate counsel, cross-border legal practitioners, and company directors and officers.

Throughout this edition, and following the unique Lexology Getting The Deal Through format, the same key questions are answered by leading practitioners in each of the jurisdictions featured. Our coverage this year includes new chapters on the Cayman Islands and France.

Lexology Getting The Deal Through titles are published annually in print. Please ensure you are referring to the latest edition or to the online version at [www.lexology.com/gtdt](http://www.lexology.com/gtdt).

Every effort has been made to cover all matters of concern to readers. However, specific legal advice should always be sought from experienced local advisers.

Lexology Getting The Deal Through gratefully acknowledges the efforts of all the contributors to this volume, who were chosen for their recognised expertise. We also extend special thanks to the contributing editors, Witold Balaban, Rafal Gawlowski, Catherine Lee and Reza Mojtabae-Zamani of Latham & Watkins LLP, for their continued assistance with this volume.



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# Contents

<b>Overview</b>	<b>3</b>	<b>Mexico</b>	<b>50</b>
Witold Balaban, Rafal Gawlowski, Catherine Lee and Reza Mojtabae-Zamani Latham & Watkins LLP		Pablo Perezalonso Ritch Mueller Heather y Nicolau SC	
<b>Australia</b>	<b>5</b>	<b>Norway</b>	<b>58</b>
Andrew Kim, Jamie Ng, Joseph Chow and Sarah Dulhunty Ashurst LLP		Linn M A Wilhelmsen and Per Morten Christiansen Advokatfirmaet Selmer AS	
<b>Cayman Islands</b>	<b>12</b>	<b>Spain</b>	<b>65</b>
Philip Paschalides, Paul Osborne and Shikha Kasal Walkers		Gonzalo García-Fuertes Garrigues	
<b>France</b>	<b>19</b>	<b>Switzerland</b>	<b>73</b>
Thomas Vogel and Suzana Sava-Montanari Latham & Watkins LLP		Olivier Stahler, Patrick Hünerwadel and Patrick Schleiffer Lenz & Staehelin	
<b>Germany</b>	<b>28</b>	<b>United Kingdom</b>	<b>84</b>
Frank Bierwirth, Dirk Kocher, Axel Schiemann and Vanessa Sekker Latham & Watkins LLP		Shatha H Ali, Jeremy Green, Dean Naumowicz and Sanjev D Warna-kula-suriya Latham & Watkins LLP	
<b>Hong Kong</b>	<b>37</b>	<b>United States</b>	<b>92</b>
Posit Laohaphan, Derek S H Chua and Michael Hardy Latham & Watkins LLP		Witold Balaban, Rafal Gawlowski, Yvette Valdez, Catherine Lee and Reza Mojtabae-Zamani Latham & Watkins LLP	
<b>Japan</b>	<b>44</b>		
Kentaro Nakanishi and Akihiro Tsukamoto TMI Associates			

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## OVERVIEW

### Typical types of transactions

1 | Other than transactions between dealers, what are the most typical types of over-the-counter (OTC) equity derivatives transactions and what are the common uses of these transactions?

Typical types of OTC equity derivatives transactions in Hong Kong include the following (together with common uses):

- options and swaps: commonly used for hedging purposes or to monetise an equity stake and for synthetic or physical share repurchases; in the convertible debt context, call spread transactions are entered into to effectively increase the conversion price of convertible debt;
- margin loans: commonly used to monetise or leverage large equity stakes held by shareholders (usually involving the granting of security over the underlying shares);
- collars, prepaid forward contract and collar loans: used to monetise a position, and as a hedge to limit the range of possible positive or negative returns; and
- stock borrowing transactions and economic equivalents: often entered into between a shareholder of the issuer and the underwriter of the issuer's convertible debt (and, separately, between such an underwriter and the holders of such convertible debt) in order to enable the holders of such convertible debt to hedge their equity exposure by short selling in the market. See 'Borrowing and selling shares' below.

### Borrowing and selling shares

2 | May market participants borrow shares and sell them short in the local market? If so, what rules govern short selling?

Yes, market participants may borrow shares and short sell them in the local market provided that:

- the securities are on the list of designated securities eligible for short selling published by The Stock Exchange of Hong Kong Limited (SEHK); and
- they comply with the relevant trading rules of the SEHK.

Under the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO), naked short selling of shares in Hong Kong is prohibited. Under section 170 of the SFO, a person shall not sell securities at or through a recognized stock market unless, at the time that person sells them: (1) that person has or, where that person is selling as an agent, that person's principal has; or (2) that person believes and has reasonable grounds to believe that he or she has or, where selling as an agent, that his or her principal has, a presently exercisable and unconditional right to vest the securities in the purchaser of them. Separately:

- under the Securities and Futures (Short Position Reporting) Rules, any person who has a reportable short position is required to notify the Securities and Futures Commission by making a submission through the Short Position Reporting Service; and
- any short selling is subject to the general provisions on market misconduct in the SFO.

### Applicable laws and regulations for dealers

3 | Describe the primary laws and regulations surrounding OTC equity derivatives transactions between dealers. What regulatory authorities are primarily responsible for administering those rules?

While there is no single unified regulatory framework on OTC equity derivatives transactions between dealers in Hong Kong, the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) is the legislation of primary relevance. Among other things, it sets out (in each case, as addressed in further details in other sections below):

- the licensing requirements for dealers in Hong Kong and the framework for mandatory clearing, reporting, record-keeping and trading requirements in Hong Kong;
- the authorization requirements for advertisement, invitation or document in respect of the offering of structured products or equity derivatives products to the public in Hong Kong; and
- civil and criminal liabilities in respect of insider dealing, false trading, price rigging, stock market manipulation, disclosure of information about prohibited transactions and disclosure of false and misleading information inducing transactions.

The Securities and Futures Commission (and, in certain respects, the Hong Kong Monetary Authority (HKMA)) are responsible for administering the SFO. Moreover, the HKMA plays a role in the OTC equity derivatives transactions by regulating authorized institutions and approved money brokers in respect of capital, liquidity and other relevant requirements under the Banking Ordinance (Cap. 155 of the laws of Hong Kong), together with subsidiary legislation, regulations and guidelines. In particular, see 'Exchanging collateral' below regarding mandatory margining requirements.

In addition to the above, OTC equity derivatives transactions that reference shares of a listed company are subject to the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited.

### Entities

4 | In addition to dealers, what types of entities may enter into OTC equity derivatives transactions?

There are no specific prohibitions on the types of entities that may enter into OTC equity derivatives transactions. Subject to the memorandum and articles of association, charters or other constitutional documents

of the relevant entities (as applicable), corporates, funds, private companies as well as individuals may enter into OTC equity derivatives transactions.

### Applicable laws and regulations for eligible counterparties

- 5 Describe the primary laws and regulations surrounding OTC equity derivatives transactions between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer? What regulatory authorities are primarily responsible for administering those rules?

See 'Applicable laws and regulations for dealers' above.

The Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) is the primary regime governing OTC equity derivatives transactions in Hong Kong between a dealer and an eligible counterparty that is not the issuer of the underlying shares or an affiliate of the issuer. The SFO sets out the licensing requirements of dealers in Hong Kong and the laws relating to advertisement, invitation and offering document made in respect of the offering of structured products or equity derivatives products to the public in Hong Kong (see 'Liability regime' below). The Securities and Futures Commission is the regulatory authority primarily responsible for the administering of the SFO.

### Securities registration issues

- 6 Do securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative?

No Hong Kong law securities registration issues arise if the issuer of the underlying shares or an affiliate of the issuer sells the issuer's shares via an OTC equity derivative. However, the seller should comply with the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong), the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) and the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited when conducting such sale. Generally speaking, it is uncommon for the issuer of the underlying shares or an affiliate of the issuer to sell the issuer's shares via an OTC equity derivative.

### Repurchasing shares

- 7 May issuers repurchase their shares directly or via a derivative?

An issuer may repurchase their shares either directly or via a derivative. An issuer may engage in four different types of share buy-back:

- on-market share buy-back;
- off-market share buy-back;
- exempt share buy-back; and
- share buy-back by general offer.

The Code on Share Buy-Backs published by the Securities and Futures Commission (SFC) sets out the rules and procedures relating to share buy-backs. In particular, for an off-market share buy-back, approval must be granted by at least three-fourths of the votes cast on a poll by disinterested shareholders in attendance or by proxy at a general meeting of the shareholders of the issuer and such buy-back must be approved by the Executive Director of the Corporate Finance Division of the Securities and Futures Commission or his or her delegate. For on-market buy-backs, the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited also set out additional rules and regulations that an issuer must comply with such as timing and price restrictions.

In the case where the issuer enters into a cash settled equity derivatives transaction referencing its own shares, the buy-back rules set out above do not apply.

The general provisions of the Companies Ordinance (Cap. 622 of the laws of Hong Kong) and the SFO with respect to financial assistance and market misconduct, etc, will also need to be considered (see 'Restricted periods' below).

### Risk

- 8 What types of risks do dealers face in the event of a bankruptcy or insolvency of the counterparty? Do any special bankruptcy or insolvency rules apply if the counterparty is the issuer or an affiliate of the issuer?

There are no special bankruptcy or insolvency rules that would apply to a counterparty if it is the issuer or an affiliate of the issuer.

However, more generally, in the case of a bankruptcy or insolvency of a counterparty, the key risk that a dealer would face is credit risk (its ability to recover any amounts and collateral owed to it by the counterparty). Generally speaking, a secured creditor may take enforcement action in respect of a validly granted and perfected security interest irrespective of whether the counterparty is factually or legally insolvent.

For a counterparty that is a Hong Kong company, the principal insolvency legislation is the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong) (C(WUMP)O) (in the case of an authorized institution, the Banking Ordinance (Cap. 155 of the laws of Hong Kong) is also relevant and for an individual, the principal bankruptcy legislation is the Bankruptcy Ordinance (Cap. 6 of the laws of Hong Kong)). The C(WUMP)O sets out the primary statutory grounds upon which a liquidator of a counterparty being wound up may seek to challenge a transaction, including unfair preference, transaction at an undervalue, extortionate credit transactions, dispositions of property after commencement of winding up and floating charge created within the relevant hardening period.

The moratorium under section 186 of the C(WUMP)O that generally applies upon a winding-up order being made, or a provisional liquidator being appointed, in respect of a counterparty will not prevent a termination right against the counterparty being exercised (or an out-of-court of enforcement of security over the counterparty's assets).

If the counterparty is a 'within scope financial institution' for the purposes of the Financial Institutions (Resolution) Ordinance 2016 (Cap. 628 of the laws of Hong Kong), certain obligations of the counterparty may be temporarily suspended and termination rights against the counterparty may be temporarily stayed, but set-off, netting, title transfer and security arrangements are generally protected in relation to partial property transfers and bail-in.

As regards OTC equity derivatives transactions documented using an ISDA Master Agreement, ISDA has commissioned Hong Kong legal opinions regarding the enforceability of, among other things, close-out netting under an ISDA Master Agreement and collateral arrangements constituted under standard ISDA documentation (see 'Legal opinions' below).

### Reporting obligations

- 9 What types of reporting obligations does an issuer or a shareholder face when entering into an OTC equity derivatives transaction on the issuer's shares?

For a listed issuer, the key reporting obligations arise under Part XIVA of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) and the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (SEHK Listing Rules). Under Part XIVA of the SFO, a listed issuer is required to disclose specific material

price sensitive information (about the issuer, a shareholder or officer of the issuer, or listed securities of the issuer or their derivatives) to the public as soon as reasonably practicable. A similar requirement is also set out in Rule 13.09(2) of the SEHK Listing Rules, which requires a listed issuer to simultaneously announce the information when the listed issuer is required to do so under Part XIVA of the SFO. Moreover, listed issuers are required to disclose certain 'notifiable transactions' and 'connected transactions' under the SEHK Listing Rules.

Under Part XV of the SFO, directors, chief executives and substantial shareholders of a listed issuer are required to disclose their interests in voting rights in the listed company. Generally speaking, a director or a chief executive of the listed company must disclose all interests and short positions in any shares of the listed company as well as all dealings in respect of such interests and positions. In contrast, the disclosable obligations of a shareholder are triggered when such person holds a long interest of 5 per cent or above and applies to any changes in such interest that cross a whole percentage point above the 5 per cent threshold. More generally, the disclosure obligations:

- take into account parties acting in concert;
- are applicable to OTC equity derivatives transactions on a gross basis (no netting of long and short positions); and
- apply regardless of whether a transaction is cash or physically settled.

Obligations under the Securities and Futures Commission Code of Takeovers and Mergers to disclose certain dealings during an offer period should also be taken into account.

### Restricted periods

**10 | Are counterparties restricted from entering into OTC equity derivatives transactions during certain periods? What other rules apply to OTC equity derivatives transactions that address insider trading?**

The Model Code For Securities Transactions By Directors Of Listed Issuers (ie, the required standard that The Stock Exchange of Hong Kong Limited requires all listed issuers and their directors to meet, any breach of which is regarded as a breach of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited) provides that, in essence, a director of a listed company is prohibited from dealing in the securities of such company:

- at any time when he or she possesses inside information in relation to those securities;
- on any day on which its financial results are published;
- during the period of 60 days immediately preceding the publication date of the annual results; and
- during the period of 30 days immediately preceding the publication date of the quarterly results (if any) and half-year results.

This restriction on dealings also extends to dealings by, among others, a director's spouse and minor children.

In addition, the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) has civil and criminal regimes (Parts XIII and XIV of the SFO) in respect of market misconduct. In particular, the SFO defines various categories of 'insider dealing' in relation to a listed company including:

- a person connected with the issuer who has information that he knows is inside information in relation to the issuer:
  - deals in the issuer's listed securities or their derivatives (or those of a related corporation); or
  - counsels or procures another person to deal in such securities or derivatives, knowing or having reasonable cause to believe that the other person will deal in them; and

- a person connected with the issuer and knowing that any information is inside information in relation to the issuer, discloses the information, directly or indirectly, to another person, knowing or having reasonable cause to believe that the other person will make use of the information for the purpose of dealing, or of counselling or procuring another person to deal, in the listed securities of the issuer or their derivatives (or those of a related corporation).

There are various defences available under the SFO for insider dealing such as the 'market information' defence, the 'Chinese wall' defence and where the use of inside information was not for the purpose of securing or increasing a profit or avoiding or reducing a loss, whether for himself or herself, or another person.

In addition to insider dealing, the SFO also contains provisions relating to other forms of market misconduct including false trading, price rigging, stock market manipulation, disclosure of information about prohibited transactions and disclosure of false and misleading information inducing transactions.

### Legal issues

**11 | What additional legal issues arise if a counterparty to an OTC equity derivatives transaction is the issuer of the underlying shares or an affiliate of the issuer?**

An OTC equity derivatives transaction entered into between an issuer of the underlying shares and an affiliate of the issuer over the issuer's shares may also rise to 'connected transaction' issues. A connected transaction is a transaction entered into between the listed company and its 'connected person' (which includes, among others, a director, chief executive or substantial shareholder of the listed company or any of its subsidiaries as well as any connected subsidiary of the issuer). Unless such transaction falls within certain exemptions that are available under Chapter 14A of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited, disclosure requirements may apply to such transaction and approvals of the shareholders of the listed company may be required.

More generally, where an issuer is entering into an OTC equity derivatives transaction that provides it with a long position over its own shares, it should be mindful of any share repurchase issues as mentioned in 'Repurchasing shares' above. Further, there are often public policy considerations in relation to issuers entering into derivatives over its own shares. As such, an issuer would generally discuss the transaction structure with The Stock Exchange of Hong Kong Limited before entering into such a transaction.

### Tax issues

**12 | What types of taxation issues arise in issuer OTC equity derivatives transactions and third-party OTC equity derivatives transactions?**

Stamp duty will be payable upon physical settlement of an equity derivatives transaction in respect of Hong Kong stock. The rate of stamp duty payable is 0.2 per cent on the higher of the consideration or the value of the shares. An additional amount of HK\$5 is payable on the instrument of transfer.

Stamp duty relief is available for securities lending and borrowing transactions provided that such transactions fall within the conditions set out in the Stamp Duty Ordinance (Cap 117 of the laws of Hong Kong).

## Liability regime

13 | Describe the liability regime related to OTC equity derivatives transactions. What transaction participants are subject to liability?

See 'Restricted periods' and 'Liability regime'.

## Stock exchange filings

14 | What stock exchange filings must be made in connection with OTC equity derivatives transactions?

See 'Reporting obligations' and 'Legal issues'.

## Typical document types

15 | What types of documents are typical in an OTC equity derivatives transaction?

For OTC equity derivatives transactions, parties typically use standard derivatives documentation published by ISDA, being either the 1992 or the 2002 ISDA Master Agreement (entered separately or incorporated via a long-form confirmation) and its related credit support documentation (see 'Collateral arrangements' below), and the 2002 ISDA Equity Derivatives Definitions.

For repo transactions, parties typically use the standard form Global Master Repurchase Agreement published by the International Capital Markets Association, while for stock borrowing and lending transactions, the standard form Global Master Securities Lending Agreement is commonly used in Hong Kong.

Institutional lenders typically document margin loan transactions using their internal form of loan documentation. Such documentation is usually based on the standard forms published by the Loan Market Association or the Asia Pacific Loan Market Association.

## Legal opinions

16 | For what types of OTC equity derivatives transactions are legal opinions typically given?

Opinions relating to capacity and authority of the counterparties are typically given for OTC derivatives transactions. Enforceability opinions are also typically given for transactions that are not based on ISDA documentation (for transactions which are based on ISDA documentation, enforceability opinions are generally only given in relation to material bespoke aspects which are not covered by the ISDA commissioned opinions). Additional opinions and memoranda may also be given regarding specific regulatory issues and enforcement scenarios.

## Hedging activities

17 | May an issuer lend its shares or enter into a repurchase transaction with respect to its shares to support hedging activities by third parties in the issuer's shares?

It is not possible for an issuer to lend its own shares in Hong Kong and any repurchase of shares carried out by an issuer must comply with the laws and regulations relating to share repurchases.

## Securities registration

18 | What securities registration or other issues arise if a borrower pledges restricted or controlling shareholdings to secure a margin loan or a collar loan?

Rule 10.07 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited (SEHK Listing Rules) prohibits a 'controlling shareholder' from, among other things:

- within six months of listing, creating security over any shares of such listed company; and
- in the subsequent six months, creating security over shares of such listed company if, immediately following the enforcement of such security, that person would cease to be a controlling shareholder. A 'controlling shareholder' is any person who is or group of persons:
  - entitled to exercise or control the exercise of 30 per cent or more of the voting power at general meetings of the issuer; or
  - in a position to control the composition of a majority of the board of directors of the issuer.

Certain exemptions apply to Rule 10.07. For example, a 'controlling shareholder' may pledge the shares of such listed company owned by him or her in favour of an AI for a bona fide commercial loan, provided that certain conditions and disclosure requirements are complied with.

Separately, under Rule 13.17 of the SEHK Listing Rules, where a 'controlling shareholder' has pledged all or part of its interest in the shares of the listed company to secure such company's debts or to secure guarantees or other support of its obligations, such company must announce certain information including:

- the number and class of shares being pledged;
- the amounts of debts, guarantees or other support for which the pledge is made; and
- any other details that are considered necessary for an understanding of the arrangements.

A 'controlling shareholder' should also be mindful of any contractual restrictions or lock-up arrangement imposed on the shares.

## Borrower bankruptcy

19 | If a borrower in a margin loan files for bankruptcy protection, can the lender seize and sell the pledged shares without interference from the bankruptcy court or any other creditors of the borrower? If not, what techniques are used to reduce the lender's risk that the borrower will file for bankruptcy or to prevent the bankruptcy court from staying enforcement of the lender's remedies?

Broadly, yes. An enforceable and properly perfected first ranking Hong Kong law governed fixed security interest created by a Hong Kong incorporated borrower over shares located in Hong Kong can be enforced by the secured party (for example, by exercising its out-of-court power of sale) notwithstanding the commencement of Hong Kong law governed insolvency proceedings in respect of the borrower. See 'Risk' above regarding transaction avoidance provisions, the impact of the Financial Institutions (Resolution) Ordinance 2016 (Cap. 628 of the laws of Hong Kong) and the general moratorium under section 186 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32 of the laws of Hong Kong) (which, as indicated there, would not prevent an out-of-court enforcement over the borrower's assets).

The impact of other jurisdictions should be considered (for example, whether a Hong Kong incorporated borrower may be wound up under the laws of another jurisdiction and the impact of local law requirements on the enforcement of security over Hong Kong shares held in an account outside of Hong Kong).

## Market structure

20 | What is the structure of the market for listed equity options?

All listed equity options in Hong Kong are traded on The Stock Exchange of Hong Kong Limited (by or through an exchange participant) and are cleared through The SEHK Options Clearing House Limited, a wholly owned subsidiary of Hong Kong Exchanges and Clearing Limited.

Listed equity options (both puts and calls) are American-style and physically settled.

### Governing rules

21 | Describe the rules governing the trading of listed equity options.

The trading of listed equity options are governed by the Rules of The Stock Exchange of Hong Kong Limited (SEHK), the Options Trading Rules of the SEHK and the Operational Trading Procedures for Options Trading Exchange Participants of the SEHK. The clearing of listed equity options are governed by the Options Clearing Rules and the Operational Clearing Procedures of The SEHK Options Clearing House Limited.

## TYPES OF TRANSACTION

### Clearing transactions

22 | What categories of equity derivatives transactions must be centrally cleared and what rules govern clearing?

All equity derivatives traded on The Stock Exchange of Hong Kong Limited and Hong Kong Futures Exchange Limited are centrally cleared through The SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited, respectively.

OTC equity derivatives are currently not subject to mandatory clearing in Hong Kong.

### Exchange-trading

23 | What categories of equity derivatives must be exchange-traded and what rules govern trading?

All listed equity derivatives are traded on The Stock Exchange of Hong Kong Limited or Hong Kong Futures Exchange Limited.

There are currently no requirements for OTC equity derivatives to be traded on an exchange (the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) includes a (not yet in force) general framework for a platform trading obligation and, following a 2018 consultation, a trading determination process has been adopted by the Hong Kong Monetary Authority and the Securities and Futures Commission to determine the products that may in the future be subject to a platform trading obligation).

### Collateral arrangements

24 | Describe common collateral arrangements for listed, cleared and uncleared equity derivatives transactions.

For exchange-traded equity derivatives, the rules of The SEHK Options Clearing House Limited (SEOCH) and HKFE Clearing Corporation Limited (HKCC) (as applicable) require participants to provide margin (cash and/or securities) and reserve fund contributions. The types of eligible margin are specified in the rules and procedures of SEOCH and HKCC, and haircuts may vary for each type of eligible margin. Collateral arrangements between participants and their respective clients are negotiated bilaterally.

OTC equity derivative transactions are currently not subject to mandatory clearing in Hong Kong and are therefore typically entered into under standard (non-centrally cleared) ISDA documentation. In particular, an ISDA Master Agreement is generally entered into (either separately or incorporated via a long-form confirmation) together with credit support documents in the form of an ISDA Credit Support Annex (title transfer arrangement) and, in certain cases, a security interest arrangement (in the form of an ISDA Credit Support Deed or bespoke documentation).

### Exchanging collateral

25 | Must counterparties exchange collateral for some categories of equity derivatives transactions?

Yes. Pursuant to module CR-G-14 of the Supervisory Policy Manual of the Hong Kong Monetary Authority (HKMA), authorized institutions facing a 'covered entity' (broadly, subject to certain thresholds and exclusions, a financial counterparty, a significant non-financial counterparty or other designated entity) are subject to mandatory margining requirements in respect of, among other things, non-centrally cleared equity derivatives (the HKMA has proposed that non-centrally cleared single-stock options, equity basket options and equity index options be exempt until 3 January 2021, the public consultation for which was open until 25 June 2020). These requirements include variation margin and (subject to a phase-in based on average aggregate notional amount thresholds) initial margin (IM).

Separately, the Securities and Futures Commission has proposed and consulted upon similar mandatory margining requirements for licensed corporations. It is currently proposed that variation margin requirements will become effective on 1 September 2020 (it is proposed that non-centrally cleared single-stock options, equity basket options and equity index options will be exempt until 3 January 2021), with a phase-in of IM requirements, based on average aggregate notional amount thresholds, commencing on 1 September 2021.

See 'Collateral arrangements' above in respect of exchanged-traded equity derivatives.

## LIABILITY AND ENFORCEMENT

### Territorial scope of regulations

26 | What is the territorial scope of the laws and regulations governing listed, cleared and uncleared equity derivatives transactions?

As the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) does not contain a general restriction on territorial scope, the territorial application of each provision must be considered on its own terms. For example, while the SFO general prohibition on marketing can apply irrespective of the jurisdiction of incorporation of the person marketing, the prohibition does not apply to offers made solely to persons outside of Hong Kong.

In addition, certain laws and regulations relating specifically to non-centrally cleared OTC equity derivatives have extraterritorial application, including:

- mandatory margining provisions, which, for example, apply to non-centrally cleared derivatives that an overseas incorporated authorized institution (AI) enters into with a covered entity that are booked in the Hong Kong branch of the AI (with provision of substituted compliance). See 'Exchanging collateral' above.
- mandatory reporting requirements, which, for example, apply to OTC derivative transactions entered into by an overseas incorporated AI and booked in Hong Kong. See 'Reporting requirements' below.

As regards exchange-traded derivatives, the rules and procedures of The Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, The SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited apply to all of their respective participants.



## Registration and authorisation requirements

### 27 | What registration or authorisation requirements apply to market participants that deal or invest in equity derivatives, and what are the implications of registration?

The Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) prohibits a person from carrying on a business in a regulated activity (or holding himself or herself out as carrying on such a business) unless the person is a licensed corporation or is an authorized institution that is appropriately registered. The regulated activities 'dealing in OTC derivative products or advising on OTC derivative products' (Type 11) and 'providing client clearing services for OTC derivative transactions' (Type 12) in Schedule 5 to the SFO are not yet in operation. However, dealing in and/or advising on equity derivatives may constitute the regulated activities of 'dealing in securities' (Type 1), 'dealing in futures contracts' (Type 2), 'advising on securities' (Type 4), 'advising on futures contracts' (Type 5) and 'securities margin financing' (Type 8), unless an exception can be relied upon.

As regards exchange-traded derivatives, the rules and procedures of The Stock Exchange of Hong Kong Limited, Hong Kong Futures Exchange Limited, The SEHK Options Clearing House Limited and HKFE Clearing Corporation Limited impose requirements and obligations on their respective participants.

## Reporting requirements

### 28 | What reporting requirements apply to market participants that deal or invest in equity derivatives?

The mandatory reporting and related record-keeping obligations under the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules apply to authorized institutions (AIs), approved money brokers (AMBs), licensed corporations (LCs), recognized clearing houses (RCHs) and automated trade services – central counterparties (ATS-CCPs), subject to an exempt person relief for certain AIs, AMBs and LCs with small positions in OTC derivative transactions.

An AI, AMB, LC, RCH or ATS-CCP is required to report (to the trade repository of the Hong Kong Monetary Authority) OTC derivative transactions (as defined in the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong)) under all five asset classes (interest rates, foreign exchange, equities, credit and commodities) on a T+2 basis if:

- it is a counterparty to the transaction (for an overseas incorporated AI, the transaction must be booked in Hong Kong and for any ATS-CCP, the counterparty must be a Hong Kong incorporated entity); or
- the transaction is conducted in Hong Kong by:
  - an AI, AMB or LC on behalf of an affiliate; or
  - by the Hong Kong branch of an overseas incorporated AI on behalf of an overseas office.

## Legal issues

### 29 | What legal issues arise in the design and issuance of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares? What additional disclosure and other legal issues arise if the structured product is linked to a proprietary index?

The analysis in 'Liability regime' regarding sections 103 and 105 of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) also applies to structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares. Therefore, in the case of an offering of such products to the public in Hong Kong, authorization by the Securities and Futures Commission of any advertisement, invitation or document in respect of the offering of such products is required.

For structured products linked to a proprietary index, the issuer should consider any licensing issues that may arise from the use of such index. The issuer may need to enter into a licensing agreement or obtain other forms of consent from the proprietary owner of the relevant index to reference such index and/or include information relating to such index in the product documentation and offering documents.

An issuer of structured products linked to an unaffiliated third party's shares or to a basket or index of third-party shares should also consider whether adequate disclosure has been provided in relation to underlying shares and, as the case may be, the index. It is also not uncommon for issuers and dealers of such products to include conflicts of interest disclaimers in the product documentation as well as other disclaimers relating to the disclosure and underlying shares or index.

## Liability regime

### 30 | Describe the liability regime related to the issuance of structured products.

Issuances and marketing of structured products are subject to the SFO. Under section 103 of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO), a person commits an offence if he or she issues, or has in his or her possession for the purposes of issue, whether in Hong Kong or elsewhere, an advertisement, invitation or document which to his or her knowledge is or contains an invitation to the public to enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite any structured products, unless the issue is authorized by the Securities and Futures Commission under section 105 of the SFO or an exemption applies (e.g., offers solely to persons outside of Hong Kong and offers to professional investors).

For unlisted structured investment products offered to the public in Hong Kong, the Code on Unlisted Structured Investment Products (including the content requirements for offering documents in respect of an offering of Unlisted Structured Investment Products) must also be complied with.

Various offences and civil liabilities set out in the SFO are also relevant to the issuance of structured products. Examples are given below.

## Civil liability

- Section 108: civil liability for inducing others to invest money;
- section 277: disclosure of false or misleading information inducing transactions;
- section 281: civil liability for market misconduct;
- section 305: civil liability for contravention of Part XIV of the SFO; and
- section 391: civil liability for false or misleading public communications concerning securities and futures contracts.

## Criminal offences

- Section 107: offence to fraudulently or recklessly induce others to invest money;
- section 298: offence of disclosure of false or misleading information inducing transactions;
- section 300: offence involving fraudulent or deceptive devices;
- section 384: provision of false or misleading information; and
- section 390: liability of officers of corporations for offences by corporations, and of partners for offences by other partners.

Liability for an issuer of structured products may also arise under common law, for example, on the basis of misrepresentations.

## Other issues

### 31 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is convertible for shares of the same issuer?

The offering of convertible bonds to the public in Hong Kong is subject to the prospectus regime under Part 2 Division 1 of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap 32 of the laws of Hong Kong) (C(WUMP)O). Unless certain exemptions are available, any documents issued by or on behalf of the convertible bond issuer must be:

- authorised by the Securities and Futures Commission for registration; and
- registered with the Hong Kong Registrar of Companies in accordance with the requirements under the C(WUMP)O.

Typically, convertible bonds are not offered to retail investors. Issuers often issue convertible bonds to institutional and/or high net-worth investors in reliance of the professional investor exemption under the SFO. In addition, issuers may also rely on other exemptions set out in schedule 17 to the C(WUMP)O, such as:

- the total consideration payable in respect of the issuance is less than HK\$5 million;
- the minimum denomination of the convertible bonds being not less than HK\$500,000; and
- the convertible bonds are being offered to no more than 50 persons.

In terms of public disclosure, the issuance of convertible bonds by a listed issuer is often considered as material non-public price sensitive information of the listed issuer. As such, it is common practice for a convertible bond issuer that is listed on The Stock Exchange of Hong Kong Limited (SEHK) to publish announcements on the SEHK at the time of pricing and closing of the convertible bonds.

For Hong Kong dollar-denominated convertible bonds in registered form issued by a Hong Kong incorporated company, stamp duty would be payable in respect of the transfer of such bonds. Hong Kong stamp duty is also payable on any purchase and sale of shares delivered to the investors upon conversion of the convertible bonds for as long as the transfer thereof is required to be registered in Hong Kong.

Disclosure obligations under Part XV of the Securities and Futures Ordinance (Cap. 571 of the laws of Hong Kong) (SFO) would be applicable if an investor holds voting rights in the listed company beyond the applicable thresholds under Part XV of the SFO. See 'Reporting obligations' above.

For convertible bond offerings to institutional investors, offering circulars are prepared using publicly available information, annual reports and financial statements of the issuer. Independent auditors of the issuer would typically provide comfort letters to give comfort on the financial information contained in the offering circular.

### 32 | What registration, disclosure, tax and other legal issues arise when an issuer sells a security that is exchangeable for shares of a third party? Does it matter whether the third party is an affiliate of the issuer?

See 'Other issues' above. The issues relating to convertible bonds are equally applicable to exchangeable bonds. Where the underlying shares are shares of a third party that is not an affiliate of the issuer, the relevant offering circular usually only contains limited information on such third party. The investors typically rely on publicly available information of the third party.

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## UPDATE AND TRENDS

### Recent developments

#### 33 | Are there any current developments or emerging trends that should be noted?

See 'Exchanging collateral' relating to the proposed mandatory margining requirements for licensed corporations. In addition, the legislative development of the OTC derivatives regulatory regime in Hong Kong is ongoing.

For convertible bonds, there has been an increased prevalence of private placements in the market, which allow issuers a shorter execution timetable to carry out a transaction and the ability to seize a pricing opportunity where the market is volatile.

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