SFC: 11 Oct 2008

Questions from the LegCo Secretariat for the Special House Committee Meeting on 13 October 2008

Question 1: Are there any legal provisions governing the use of the terms, "bond" and "mini-bond"?

No, we are not aware of any legal provision governing the use of the terms 'bond' and "mini-bond". However, it is an offence under the Companies Ordinance and the Securities and Futures Ordinance if the offering documents or marketing materials contain information that is false, misleading or deceptive.

Question 2: What are the market derivative products involved in the sale of Lehman Brothers financial products ("financial products")?

The SFC has authorised for registration prospectuses for credit-linked, equity-linked and fund-linked retail structured notes that are Lehman Brothers related.

Question 3: How do these financial products operate, such as CDO (collateralized debt obligations), CDS (credit default swap), credit-linked notes and retail structured notes?

Collateralized debt obligation (CDO) is a security backed by a pool of bonds, loans and other assets. Different CDOs represent different types of debt and credit risks. CDOs can come in different tranches of the same pool carrying different levels of risk. The higher the risk, the more the CDO pays.

A **credit default swap** is designed to transfer credit exposure between 2 parties. The buyer of the CDS pays a fee and receives credit protection while the seller of the CDS guarantees the credit worthiness of the reference security. By doing so, the default risk of the reference security is transferred from the buyer of the CDS to the seller of the CDS.

A **credit linked note** (CLN) is a structured debt instrument of which payments of interest, principal or both are affected by the occurrence of "credit events" of a single company or a group of companies. What constitutes a credit event depends on the technical definitions applicable to a particular issue and typically includes "failure to pay", "bankruptcy" or "restructuring".

A **retail structured note** is a generic term to describe a wide range of structured notes sold to retail investors.

Question 4: What parties are involved in these financial products and what are their roles, returns and risks borne in these financial products? Examples of such parties are "the trustee", "the custodian", "the principal paying agent", "the calculation agent", "the determination agent", "the registrar", "the arranger", "the swap counterparty", "the forward counterparty", "the swap guarantor", "the issuer", "the market agent", "the dealer", "the distributor", "the structured investment vehicle", "holders of mini-bonds" and "secured creditors".

The number of parties involved varies depending on the type and structure of the product. In general:

- The **issuer** is the entity who issues the product and the prospectus containing the offer of the product;

- The **holder** of a note is its registered owner (i.e. the distributor who holds the note in an account with one of the clearing houses for the investors) although the term is generally used to refer to the investors;

- The **trustee** acts as the representative of note holders and has the power to enforce the rights of the note holders under the notes including enforcing the security over the collateral;

- The **registrar** maintains a register for each series of notes issued under the programme;

- The **principal payment agent** is primarily responsible for accepting payments from the issuer and in turn making payments interest, principal or redemption amounts to note holders;

- The **custodian** will safe keep the underlying securities in respect of the notes in favour of the trustee;

- The **calculation agent** is responsible for the calculation of any rate or amount (including but not limited to interest rates and interest amounts) in relation to the notes;

- The **determination agent** is responsible for the determination of whether certain specified events (e.g. a credit event) have occurred in respect of the notes;

- A **distributor** is responsible for distributing (i.e. marketing and selling) of notes to investors;

- A **dealer** will be asked to make a bid for the reference obligation to be sold in a credit event. The highest bid price from such dealers will be used in the calculation of the credit event redemption amount.

- An **arranger** is responsible for putting the whole transaction and all the relevant parties (e.g. distributors) together. In the case of Minibonds, it was also responsible for selecting the collateral;

- A **market agent** provides liquidity and secondary trading for the notes;

- A **structured investment vehicle** generally borrows money by issuing shorter term papers and uses the proceeds to invest in longer term assets with higher yield. The shorter term papers are continuously renewed or rolled over. The SIV earns profits on the spread between the yield of the longer term assets and the interests that it has to ay on the short term paper. The SIV may use leverage to enhance returns.

- **Secured creditors** are those creditors who have the benefit of a security interest over some or all of the assets of the debtors.

- A **swap counterparty** is the counterparty to the swap transaction which is being referred to.

- A **swap guarantor** guarantees the liability of the swap counterparty in respect of the swap transaction.

- A **forward counterparty** is the counterparty to the forward transaction which is being referred to.

Question 5: What is the collateral or the underlying asset for the "mini-bonds"?

- The collateral for each Minibond series is segregated. It is held by the custodian subject to security in favour of the trustee.

- Each series has different security arrangement and information about these arrangements were available as display documents at the offices of the arranger (i.e. Lehman Brothers Asia Limited) before the collapse of Lehman Brothers.

- For instance, the collateral for the latest series of Minibond (issued in May 2008) was CDOs that had a AAA rating as at the date of the prospectus.

- The trustee has also agreed to make collateral information available to distributors.

Question 6: Are there any restrictions on the purchase and sale of these financial products?

- In general, there is no restriction on who can buy financial products. However, as stated in the Minibond prospectus, not every financial product is suitable for every investor. Investors should understand the risks and returns of the financial product and make their investment decisions based on their understanding of the product and in light of their individual financial position and investment objectives.

- Generally, only licensed or registered persons can sell financial products in the form of securities and futures products to retail investors.

- Licensed and registered persons are required under the “Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission” to conduct “know your client” exercise when selling financial products. The objective is for licensed or registered persons to have a reasonable assessment of suitability. When making a recommendation or solicitation, a licensed or registered person should ensure the suitability of the recommendation or solicitation for the client is reasonable in all the circumstance. In the case of derivative products, licensed/registered persons should ensure the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risk and bear the potential losses.

- The SFC has provided guidance on this issue of suitability in an FAQ published in 2007. The FAQ elaborates the SFC's expected standard of compliance with the Code of Conduct in assessing suitability, including

    - risk/return profile matching,
    - "know your client" requirements,

- that investment advisers should not recommend products which they do not understand,
- extra care in advising elderly and unsophisticated clients, and
- supervision by senior management.

- In the case of public offers of financial products, issuers are required to comply with the prospectus requirements under the CO or the applicable provisions under the SFO, as the case may be.