SC Ref.No.SC(1)-S47

SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

RESPONSES TO THE FOLLOW-UP QUESTIONS RAISED BY THE SUBCOMMITTEE ON 21 JULY 2009

28 July 2009

Part I - Follow-up questions raised by the Subcommittee on 21 July 2009

1. **With reference to the attached flow charts on the authorization of prospectuses and marketing materials relating to debentures, please use Minibonds series 27, 34 and 35 and Constellation Notes series 44, 56 and 58 as examples and indicate in the left-hand margin and vis-à-vis each procedural step the level of officer(s) of the Prospectus Team responsible for the step in question. Please also indicate the changes, if any, in the level of responsible officer(s) since April 2003.**

1.1 As set out in paragraph 2.1 of my written statement dated 7 July 2009, the Prospectus Team generally comprises a senior director who supervises, assesses priorities, oversees and monitors the work in progress, and a director together with an associate director, senior managers and managers who are responsible for the day-to-day transaction management. Using the flowcharts contained in Appendices 4 and 5 to Mr Martin Wheatley's written statement dated 10 June 2009, I highlight in italics in Annexes 1 and 2 respectively the level of officers responsible for (a) reviewing and authorising the registration of prospectuses and (b) reviewing and authorising the issue of marketing materials. W13(C)

1.2 The level of officers responsible for the review and authorisation process has remained unchanged since April 2003, except that the position of senior director was vacant from April 2003 to end of December 2004.

2. **The number of Securities and Futures Commission (SFC)'s staff possessing qualifications in actuarial science and finance, and the occasion(s), if any, where the Prospectus Team has sought the advice/assistance from professionals in such fields in other divisions within SFC when vetting/authorizing prospectuses and marketing materials relating to Minibonds and other Lehman Brothers (LB)-related structured financial products since 2007.**

2.1 Actuarial science is the discipline that traditionally and primarily applies mathematical and statistical methods to assess known risks in the insurance industry. In reviewing prospectuses, reviewers first check precedents, consult any relevant internal practices or policy and to seek to ensure that, on the basis of information provided by the issuers or its advisers, there is disclosure of sufficient particulars and information about product features and risks in prospectuses as at the time of issue, so as to enable a reasonable person to form an informed investment decision. The question is what are the risks involved and whether their existence and nature have been adequately disclosed. It does not directly relate to what actuaries do.

2.2 Notwithstanding the above, the Subcommittee may wish to note that from April 2003 onwards, various divisions of the SFC, including the Corporate Finance Division ("CFD"), have employed and retained chartered financial analysts ("CFA"). CFAs generally have knowledge about valuation methodologies of financial products. The Prospectus Team has sufficient working knowledge about structured products to review prospectuses and marketing materials, which do not involve commercial valuation of products. Please also see paragraph 2.7 of my written statement dated 7 July 2009 about training of members of the Prospectus Team which covered credit-linked investment products, asset-backed securities, collateralised debt obligations ("CDOs"), impact of sub-prime mortgages, and other structured products such as accumulators. Colleagues in other divisions also possess knowledge about, and working experience in, different aspects of the financial market, ranging from financial products, quantitative analysis, risk management to market operations. All SFC divisions work closely together to discuss and examine market issues. W17(C)

3. Before the collapse of LB, whether the Executive Director (Corporate Finance Division) (ED/CFD) of SFC raised (a) any concerns about the sale of complicated structured financial products to retail investors to top management (such as the Chief Executive Officer) or at internal meetings with other heads of divisions; and (b) any suggestions at such meetings to improve the co-ordination within SFC so as to enhance SFC's regulatory work over the sale of such products.

3.1 I became the Executive Director ("ED") of CFD in August 2006, after the SFC's issue in March 2006 of the document "Regulatory Challenges and Responses". Accordingly, SFC's senior management was already aware of the regulatory challenge that there was increased exposure of retail clients to complex[1] and structured products and that there would be a risk if investors did not properly understand these products or if they were not being properly advised. In this regard, I was involved in the top management discussions concerning corporate plans in response to the regulatory challenges. In addition, I took part in the top management discussions of the report on findings of the second round of thematic inspection conducted in 2006, culminating in the SFC's issue of guidance in May 2007 on requirements relating to the suitability of advice in the Code of Conduct ("2007 FAQs"). I also participated in the top management discussion of the 2007 FAQs. Following the publication of the structured product investor survey in November 2006 and the 2007 FAQs, the SFC stepped up its investor education efforts – please refer to paragraphs 79 and 80 of Mr Martin Wheatley's written statement dated 10 June 2009 for further information. S23 M4 S25

3.2 From time to time, I participated in top management discussions about corporate and product applications, topical issues and complaints received in respect of the sale of investment products. These included macro developments, whether in global financial markets, high-level policies and decisions of authorities overseas and developments relating to individual institutions, which may have implications on the financial markets and investment products in Hong Kong. These discussions include, for example, Phase 3 Companies Ordinance ("CO") amendments recommendations after receiving public responses in the consultation and distribution mechanism of prospectuses of structured products.

3.3 Separately, the Prospectus Team would approach senior management including myself to share developments abroad that may have implications for public offers of unlisted structured products in Hong Kong. Examples include:

1. In March 2008, the Prospectus Team shared with senior management observations made by the UK Treasury Committee as set out in its "*Financial Stability and Transparency – Sixth Report of Session 2007-08*". These include (a) investors placing too much reliance on credit ratings; potential conflicts of interest and what credit rating agencies should do to regain public trust and confidence; (b) investors' lack of understanding of product risks and lack of due diligence undertaken before investing and (c)

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1 On the question of product complexity, it should be noted that there is no common or generally accepted standard for complexity as different investors may hold different views on product complexity depending on, for instance, their knowledge and experience, financial situation and objectives.

the Governor of the Bank of England commenting that product regulation was not favoured by the committee;

2. Following the tightening by Norway's Financial Supervisory Authority in March 2008 of rules restricting financial institutions from selling structured products to retail investors which the authority believed were not always aware of investment risks; the Prospectus Team monitored and updated senior management of its developments;

3. In view of widespread concerns from early 2008 about the role of credit rating agencies in structured finance markets and liquidity of CDOs, the Prospectus Team asked credit-linked note ("CLN") issuers whose collateral would comprise rated CDOs to include additional disclosures – see paragraphs 3.9 and 3.10 of my written statement dated 7 July 2009. W17(C)

4. The means that ED/CFD had used, before the collapse of LB in September 2008, to ascertain whether the frontline staff of intermediaries had relied on prospectuses or on marketing materials to explain the nature and risks of structured financial products to prospective investors.

4.1 The Prospectus Team and I were aware of the findings of the structured products investor survey published in November 2006, in particular the observation that prospectuses contained too much jargon. In this regard, please see paragraphs 4.1 to 4.9 of my written statement dated 7 July 2009. The Subcommittee may also wish to note that with the Prospectus Team's efforts, the percentages of prospectuses adopting plain language increased from 2005 to 2008 as follows: W17(C)

- 2005 – 44%
- 2006 – 85%
- 2007 – 94%
- 2008 – 100%

4.2 In addition, to clarify certain requirements under the Code of Conduct, the SFC has issued the 2007 FAQs. Amongst other things, it is stated that: S1-Appendix 11

1. investment advisers should conduct product due diligence and not recommend investment products which they do not understand;

2. investment advisers should make their own enquiries and obtain full explanations from product issuers about the risks inherent in the investment products. It is not advisable for them to rely on prospectuses or marketing materials as necessarily self-sufficient and self-explanatory;

3. it is not enough for investment advisers to hand over prospectuses, ask the client to read them, or merely read the documents to the client; and

4. investment advisers should use simple and plain language, and in a language that the client can easily understand – the explanations must be fair and not misleading.

4.3 As mentioned in paragraphs 3.3 and 3.5 of my written statement dated 7 July 2009, when reviewing a prospectus, reviewers first check precedents, consult any relevant internal practices or policy and to seek to ensure that, on the basis of information provided by the issuers or its advisers, there is disclosure of sufficient particulars and information about product features and risks in prospectuses as at the time of issue, so as to enable a reasonable person to form an informed investment decision. In this regard, it should be noted that investment advisers have a duty to act fairly, diligently, and with integrity, and to comply with the requirements under the Code of Conduct. W17(C)

4.4 In any event, on the same day as the SFC published its findings of the structured product investor survey (i.e. 28 November 2006), a Dr Wise article entitled "Retail Structured Notes – Buyer Beware" (attached at Annex 3) was also published to remind investors that they should not rely on marketing materials, that they should read all offering documents before deciding to invest and that they should be aware of and be prepared for the worst-case scenario. A circular was also sent to all issuers of unlisted structured products to alert S25

them to the findings of the survey and suggest them to inform their selling agents and distributors of the findings. There were also other investor education efforts on structured products – see paragraphs 71 to 80 of Mr Martin Wheatley's written statement dated 10 June 2009 for further information. W13(C)

Part II - The follow-up questions raised by Mr LEUNG Kwok-hung on 21 July 2009

1. You are an experienced lawyer. Would you please explain clearly the similarities and differences between "supervise," "monitor" and "regulate" according to your understanding? Please illustrate with examples from the regulation of Lehman structured products.

1.1 The Subcommittee's order dated 23 June 2009 issued to me requires me to give evidence on the following areas of study:

(a) authorisation of prospectuses and marketing materials relating to debentures, particularly LB-related Minibonds and structured financial products; and

(b) disclosure of information relating to the nature and risks of structured financial products to investors.

1.2 I assume the question on the meaning of the words "supervise, monitor and regulate" relates to the use of those terms in the context of section 5(1)(b) of the Securities and Futures Ordinance ("SFO"). As such, please refer to paragraphs 4.6 to 4.11 of the "Responses to the follow-up questions raised by the subcommittee on 26 June 2009" submitted by Mr Martin Wheatley on 7 July 2009. In the context of Minibonds, SFC's power to authorise prospectuses under the CO relates more to "regulate". Due to the "snapshot" nature of the CO provisions, SFC's powers under the CO do not directly relate to "supervise" and "monitor", which relate more to conduct regulation (e.g. the second, third and fourth pillars, namely, conduct regulation to ensure suitability, licensing and intermediaries supervision). S37

1.3 In the context of Minibonds, my remit as ED of CFD/SFC covers disclosure regulation – i.e., authorisation of prospectuses and marketing materials.

2. I note that none of the members of the Prospectus Team holds a degree in finance or actuarial science, and most of them are accounting or law degree holders. When they examine prospectuses, do they possess sufficient knowledge to determine whether the prospectuses have made adequate risk disclosure?

2.1 Please refer to my response to Question 2 in Part I above.

3. Does the Prospectus Team examine prospectuses only in accordance with the requirements listed in Schedule 3 to the Companies Ordinance and use such information as the basis for their decision to approve the prospectuses?

3.1 When reviewing draft prospectuses, reviewers check that the document contains the information specified in the Third Schedule to the CO which sets out the statutorily prescribed disclosures. Apart from the specific matters required to be set out in the prospectus by applicable paragraphs in the Third Schedule, paragraph 3 of the Third Schedule requires the issuer to provide "*sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them.*"

3.2 Reviewers seek to ensure that this requirement, as well as all other requirements set out in the Third Schedule, are complied with, and in doing so ask for, in light of their understanding of the nature and risks of the product based on the prospectus submitted by the issuer and the information requisitioned from the issuer and their advisers, clarifications and further information from such issuer and advisers. Because of the width of paragraph 3 of the Third Schedule, information which is relevant to the product in question would not fall outside the purview of the review process under paragraph 3.

3.3 *In addition to the Third Schedule, the CO also prescribes other prospectus requirements such as the requirement to include a statement in the following form or a form to the like effect:*

"*IMPORTANT*
If you are in any doubt about any of the contents of this prospectus, you should obtain independent professional advice."

3.4 See for example section 342 of the CO and the Eighteenth Schedule to the CO.

3.5 Apart from the Third and Eighteenth Schedules, reviewers also need to take into account the requirements in sections 44A, 44B, 342, 342B and 342C of the CO (please refer to the CO compliance checklist in Appendix A to my written statement dated 7 July 2009).

3.6 In reviewing draft prospectuses, reviewers also check precedents and consult any relevant internal practices or policy. There has been internal guidance since 2005 on points to note when reviewing prospectuses and marketing materials. A summary of points compiled from this internal guidance is attached at Appendix C to my written statement dated 7 July 2009. Please refer to paragraphs 3.2, 3.4 and paragraphs 3.5 to 3.10 of the statement. W17(C)

4. **The information required by Schedule 3 to the Companies Ordinance is for the most part targeted at companies with business results. The Minibond [issuing] companies, however, are newly formed companies that are mostly unable to provide the information required by Schedule 3 to the Companies Ordinance. Therefore, with such limited information, salespersons and investors would find it difficult to analyse the risk profile of Minibonds to determine whether there is adequate disclosure, do you agree?**

4.1 Under the CO, there is no prohibition on the use of special purpose vehicles ("SPVs") as an issuer of debentures. Prior to the collapse of Lehman Brothers Holdings Inc. ("LBHI"), the use of SPVs in collateralised structures such as asset securitisation transactions was international practice.

4.2 If a financial product falls within the legal definition of "debenture" in section 2 of the CO, the prospectus containing the relevant offer must be authorised and registered before the product can be offered to the public in Hong Kong. The issuer (whether incorporated in or outside Hong Kong) has to prepare a prospectus which complies with the applicable requirements of the CO (see in particular sections 38(1)/342(1), 38(1A)/342(2A), 38D/342C of, and the Third Schedule to, the CO). Paragraph 3 of the Third Schedule to the CO requires that the prospectus contains "*sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them.*"

4.3 The issuer of Minibonds is Pacific International Finance Limited ("PIFL"). The programme prospectus issued by PIFL (page 13 of the programme prospectus dated 14 April 2008) states that PIFL was registered and incorporated on 9 March 2000 under the Companies Law (1998 Revision) (now the Companies Law (2007 Revision)) of the Cayman Islands.

4.4 The programme prospectus states that PIFL's business is limited to issuing notes under its secured continuously offered note programme. It has no other borrowings, indebtedness in the nature of borrowings, loan capital outstanding or created but unissued (including term loans), hire purchase commitments, guarantees or material contingent liabilities. PIFL did not propose to engage in any businesses, and, unlike investments in listed companies where investors look for returns on their investments based on profits to be made by the company concerned, business results of PIFL (past or future) would not be a relevant feature. The question is the assessment of the risk involved in a proposed investment in Minibonds and whether there had been adequate disclosure of the relevant risks for this assessment to be made, with the assistance of intermediaries acting in compliance with the Code of Conduct.

4.5 The programme prospectus states that so long as any of the notes remain outstanding, PIFL may not incur any other debt or engage in any business, other than issuing notes and entering into transactions contemplated by its note programme.

4.6 The Minibond prospectuses also state clearly that:

- the total principal amount of the notes issued by PIFL will be equivalent to the principal amount of the collateral purchased with the proceeds of issue of the notes;

- the collateral is segregated and earmarked for Minibond investors and is not available to meet any debts owing to other creditors (e.g. investors of other series);

- the collateral is held by an independent trustee;

- PIFL has no significant assets (other than the collateral and the swap arrangements on which the notes are secured);

- PIFL has to rely on receiving money or securities due under the collateral and the swaps in the right amounts and at the right time if it is to perform its payment obligations under the notes (i.e. the source of payment of interest and repayment of principal of the notes comes from the collateral and the swap premium);

- Investors' claims are limited in all circumstances to the value of the collateral and any amounts due to PIFL under the swap arrangements.

4.7 Please also refer to items 5 and 6 of Appendix F to my written statement dated 7 July 2009 for information as to where in the prospectuses for the outstanding Minibond series the disclosures regarding the thinly capitalised nature of PIFL and the limited recourse nature of Minibonds can be found. W17(C)

4.8 It is stated in the 2007 FAQs that intermediaries, in discharging their obligations under the Code of Conduct, should M4

- conduct product due diligence in selecting appropriate investment products for their clients and should not recommend products which they do not understand, and

- make their own enquiries and obtain full explanations from product issuers about the risks inherent in the investment products. It is not advisable for intermediaries to rely on prospectuses or marketing materials as necessarily being self-sufficient and self- explanatory (see Question 3 in the 2007 FAQs).

5. As can be seen from the investor education information (see attachment) issued by the SFC on 29 July 2003, structured products are very complicated. Please indicate which provisions in Schedule 3 to the Companies Ordinance are meant to regulate the risk disclosure of [products] with such complicated structures?

5.1 A disclosure-based regime, as opposed to a regime under which products are regulated, is adopted in major jurisdictions. It is one where the prospectus for an issue discloses sufficient details on product features and risks for an individual to form a balanced view of the product at the time of the issue of the prospectus (see paragraph 3 of the Third Schedule to the CO referred to in the response to Question 3 above). Please see Appendix C to my written statement dated 7 July 2009 "Summary of points to note when reviewing prospectuses and marketing materials" which is internal guidance as to, amongst others, how we apply provisions of the Third Schedule to structured products. This is coupled with the obligation of the intermediary to properly explain the product after its own product due diligence in addition to the disclosures in the prospectus, and to ensure that it is suitable taking account of the individual's circumstances. W17(C)

5.2 If a financial product falls within the legal definition of "debenture" in section 2 of the CO, the prospectus containing the relevant offer must be authorised and registered before the product can be offered to the public in Hong Kong. The issuer (whether incorporated in or outside Hong Kong) has to prepare a prospectus which complies with the applicable requirements of the CO (see in particular sections 38(1)/342(1), 38(1A)/342(2A), 38D/342C of, and the Third Schedule to, the CO).

5.3 In any event, paragraph 3 of the Third Schedule to the CO, which requires the disclosure of "*sufficient particulars and information to enable a reasonable person to form as a result thereof a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company at the time of issue of the prospectus, taking into account the nature of the shares or debentures being offered and the nature of the company, and the nature of the persons likely to consider acquiring them*". Regardless of the complexity of a product, the amount, nature and degree of particulars and information necessary to comply with this requirement is a question of fact in each case and would be relevant to disclosures in prospectuses.

6. In respect of the requirements in these provisions, are the disclosures made accordingly sufficient enough to enable the salespersons and investors to analyse related risks and make reasonable judgements?

6.1 Please refer to my response to Questions 4 and 5 above.

7. Do you and your department have discretionary powers over the adequacy and standards, such as those related to risk disclosure, of the information required under Schedule 3 to the Companies Ordinance? Please specify the key elements of such discretionary powers.

7.1 The existing legal framework under the CO does not prohibit or restrict the type of financial products which may be sold to the public in general based on the level of complexity or risk of the product. Accordingly, the SFC does not have the power to refuse to authorize the registration of the prospectus for a financial product simply because, for example, we believe that it would be too complex a product for some investors to understand or too risky for some investors' portfolios.

7.2 Under section 38D(5) of the CO, the SFC may authorise the registration of a prospectus or refuse to authorise such registration. Pursuant to section 38D(9) any person aggrieved by the refusal to authorise the registration of a prospectus under section 38D may appeal to the court and the court may either dismiss the appeal or order that the registration of the prospectus be authorised by the SFC.

7.3 If a prospectus satisfies all the requirements in the CO – in particular, the requirements in the Third Schedule to the CO, and sections 44A, 44B, 342, 342B and 342C of the CO, then unless we have legal grounds which the court will regard as valid to refuse authorisation, the SFC has no power to refuse authorization of the prospectus for registration.

8. Does the SFC have clear internal guidelines for exercising such discretionary powers? Please provide the guidelines.

8.1 Please see my response to Question 7 above.

9. Do you agree that, for the protection of investor interests, Schedule 3 to the Companies Ordinance should be amended to enhance the disclosure requirements for this type of innovative financial products?

9.1 One of the reform initiatives to be taken forward is the proposal to transfer the regulation of public offers of structured notes from the CO to Part IV of the SFO. In view of the financial crisis and the current public sentiment, the SFC believes that there is merit to take forward the reform initiatives. It is believed that after the amendment of the relevant provisions of the CO, the regulation of public offers of structured products under Part IV of the SFO through product codes will rationalise the current public offering regime in Hong Kong.

9.2 For the reasons set out in our report dated 31 December 2008 to the Financial Secretary, the proposed code would be premised on the two pillars (of the six pillars) in our regulatory framework in the offering of investment products – namely disclosure-based principles and the suitability obligations that an intermediary has to discharge in recommending products to or soliciting subscriptions from investors. Whilst the product code that the SFC proposes for authorising structured products for public offerings would seek to set out certain structural features and codify the disclosure requirements applicable to structured products offered to the public in Hong Kong, these measures are not and cannot serve to guarantee that an authorised product is failure-proof. S36

9.3 It is proposed that a consultation paper on the proposed product code will be published by the SFC for public consultation in the third quarter of 2009.

10. What disclosure requirements should be added?

10.1 Please see my response to Question 9 above.

11. To protect investor interests and to better execute prospectuses examination, do you agree that the Prospectus Team should have members who are knowledgeable in finance, actuarial science and different types of risks associated with this kind of complicated and innovative financial products to determine whether there is adequate disclosure?

11.1 Please refer to my response to Question 2 of Part I above.

12. For the protection of investor interests, do you agree that bond issuers with no guarantee from parent company and no business results should state in headlines in their prospectuses, in exact or similar wordings, that "this company has no previous business results as reference"?

12.1 Please refer to my response to Questions 4, 9 and 10 above.

13. Have the SFC, you and your department ever suggested to policy-making officials that the law should be amended to require more focused disclosures to be made in respect of the bonds issued by these newly-established bond issuers that have no business results? How did they react?

13.1 Please refer to my response to Questions 4, 9 and 10 above.

14. **Why didn't you and your department invite personnel within the SFC who are more knowledgeable in CDO, CDS and various types of swap to participate in analysing the adequacy of risk disclosure made in the prospectuses of structured products?**

14.1 Please see generally my response to Question 2 in Part I above. Please also refer to Appendix D to my written statement dated 7 July 2009 for information regarding where in the prospectuses of outstanding Minibond series the following disclosures are set out: W17(C)

(a) early redemption of the notes following termination of swap arrangements due to e.g. certain insolvency-related events;

(b) early redemption of the notes due to CDO collateral writedown;

(c) the non-principal protected nature of the notes; and

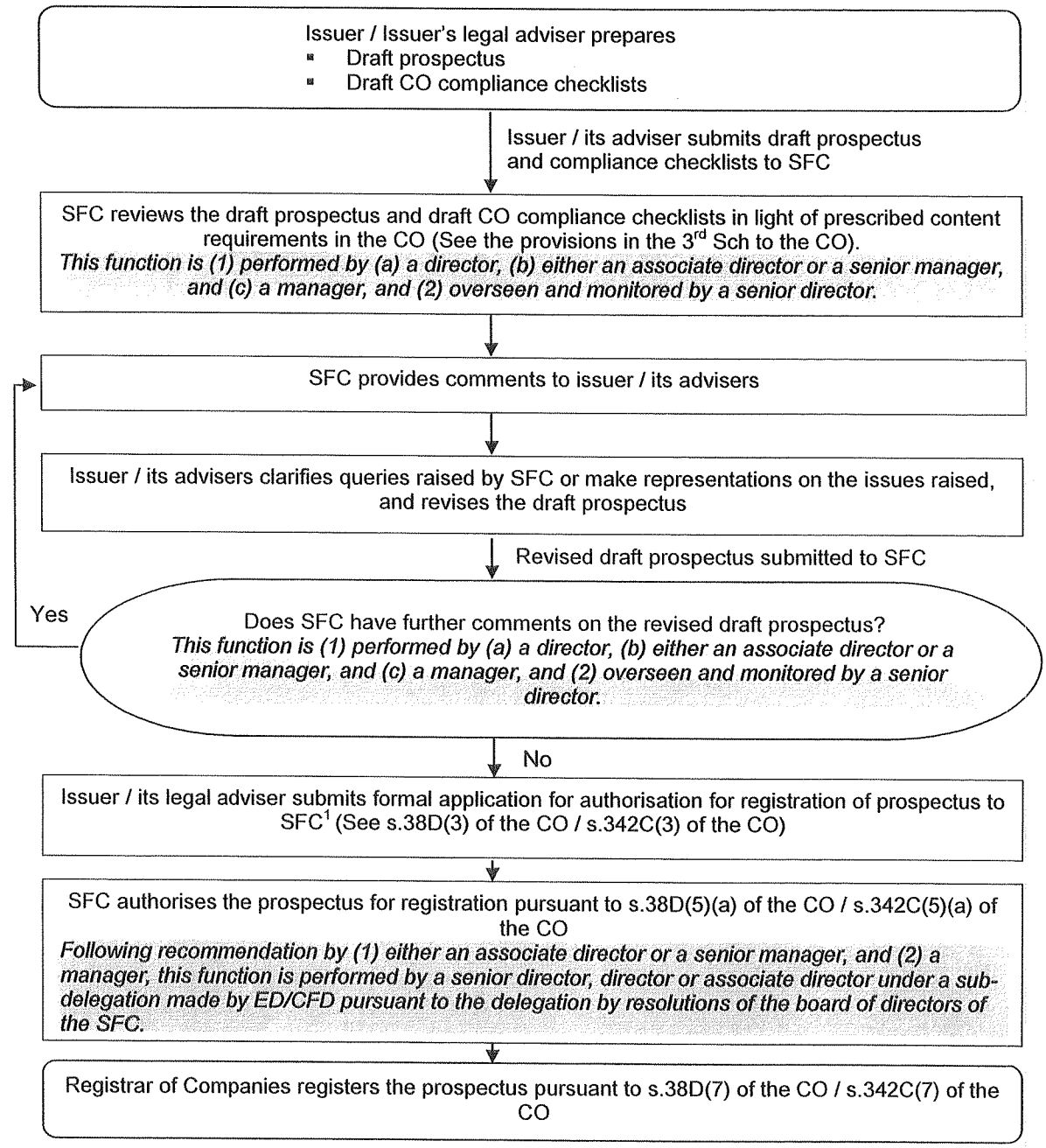
(d) the warning that investors could lose part, and possibly all of their investment.

14.2 It may also be worth noting that it was not an event of default under the CDO collateral that triggered early redemption of the affected Minibond series (i.e. series 10-36). It was the collapse of LBHI, once the fourth largest Wall Street investment bank, as swap guarantor that caused these Minibonds to be terminated early. I believe the Prospectus Team has sufficient working knowledge about structured products to review prospectuses and marketing materials. We do not believe it is possible to guarantee that products or financial institutions are failure-proof.

Annex 1

PROCEDURE FOR REGISTRATION OF PROSPECTUSES

Credit-linked notes and Equity-linked notes are structured as "debentures" as defined in section 2 of the CO. Hence, public offers of CLNs and ELNs are regulated under the prospectus regime. Below is an illustration of the steps involved for registration of prospectuses.



[1] The formal application encloses the following documents:

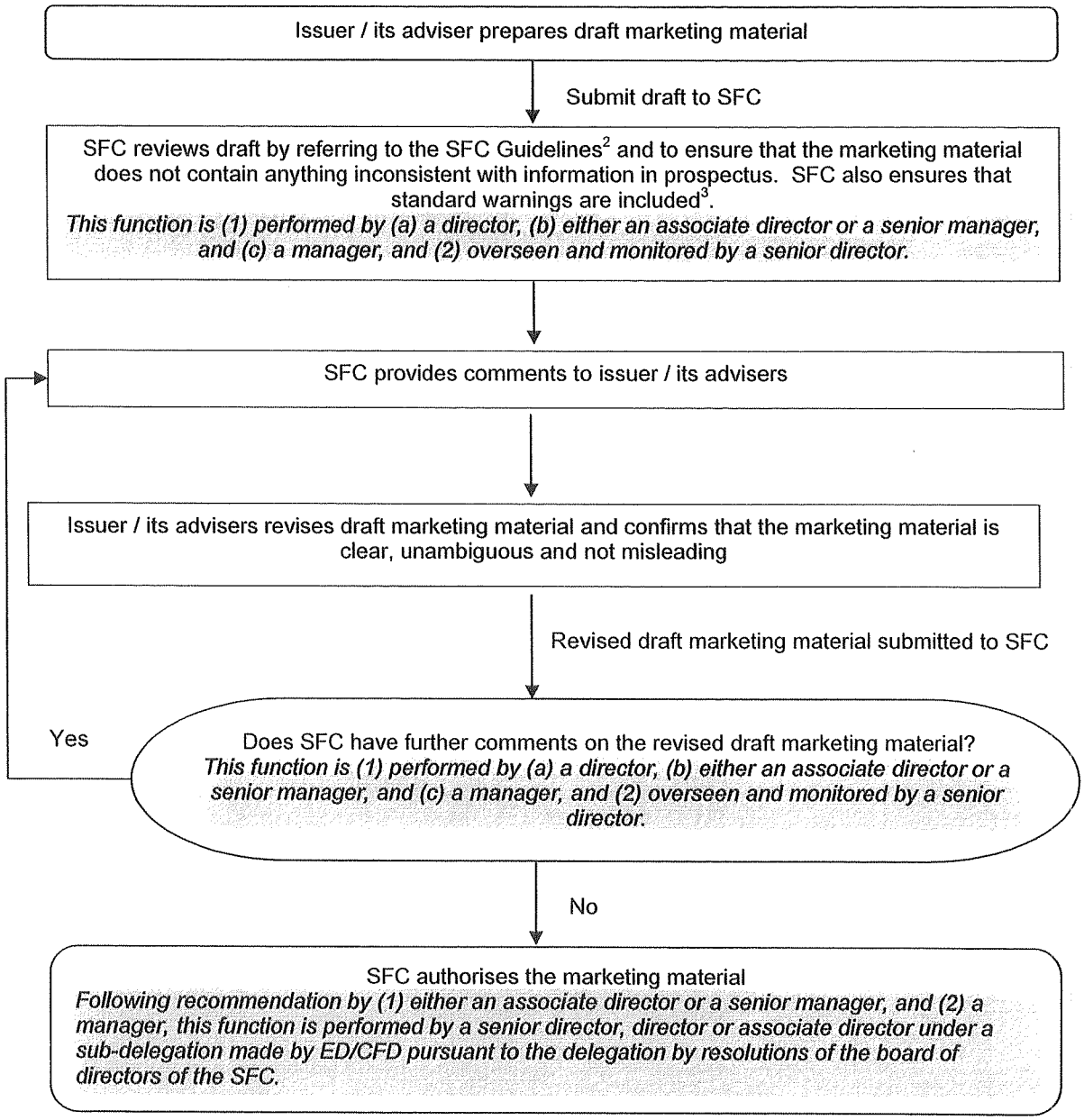
(a) two copies of the prospectus signed by every director or proposed director (in case of a company incorporated in Hong Kong) or certified by 2 directors as having been approved by board resolution (in the case of a company incorporated outside Hong Kong) or by their respective agents authorised in writing;

(b) completed compliance checklists;

(c) any requisite consent to the issue of the prospectus - e.g. auditor's consent where the prospectus contains an auditor's report.

Annex 2

PROCEDURE FOR SEEKING AUTHORISATION OF MARKETING MATERIAL RELATING TO DEBENTURES (INCLUDING STRUCTURED NOTES)



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2 *Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO*

3 Standard warnings are included in each of the marketing materials – for example: **S1-Appendix 1**

- investment involves risks (and where applicable, non-principal protection);
- prospective investors should read the relevant offering documents for detailed information about the issuer/guarantor and the offer before investing;
- the material does not constitute an offer or an invitation to induce an offer;
- the offer is made solely on the basis of the information contained in the offering documents and applications will only be taken on the basis of the offering documents; and
- SFC's authorisation of the marketing material does not imply the SFC's endorsement or recommendation of the products and the SFC accepts no responsibility for the contents of the marketing material.

Retail Structured Notes - Buyer Beware

November 2006

Key Messages:

Before placing an order for any retail structured note, an investor should:

read all offering documents - marketing materials do not have full information;

understand that a note linked to a basket of shares is riskier than one linked to a single share; and

be aware of and prepared for the worst-case scenario.

As it was raining heavily last Sunday evening, I had to cancel an outdoor lawn-bowling practice with my teammates, James, Christopher and William, all of whom are creative executives in advertising agencies. We went for reflexology instead, as William had never tried and would appreciate company for his first visit.

Warm, relaxing footbaths were brought to us soon after we were seated comfortably in massage couches in a secluded area. William spotted a glossy leaflet about reflexology lying on the magazine rack next to him and decided to study it before his reflexologist arrived to begin "working" on his feet.

Seeing that William had settled down nicely, James commented, "These leaflets are similar in style to those we prepare for issuers advertising retail structured notes. Short and glossy with punchy banner headlines."

"Those headlines always catch my eye, especially those figures stating the maximum potential return," James exclaimed, "but I always read on to better understand the fundamentals, whether my capital is protected and what risks are associated with it."

At this point, James and Christopher asked for my advice. "You are indeed becoming more prudent", I replied. "The notes market is more sophisticated nowadays and there are a variety of structures to suit different investment objectives and risk appetites."

"For instance," I continued, "using a basket of shares as the underlying asset is now commonplace.

Return on these equity-linked notes typically depends on the performance of the underlying shares on specified dates. For those who hold a neutral to bullish view and believe that all underlying shares will close at or above a specified level (usually known as strike prices) on pre-determined dates in the future, they will get their principal back in cash, together with periodic interest payments, if their forecasts turn out to be correct. However, if the closing price of any share in the basket is below its strike price, investors will receive shares in the worst performing company on maturity. The value of these shares could be substantially lower than the amount they originally invested."

I added, "Daily accrual notes, with the interest amount linked to the daily performance of the underlying asset during specified observation periods, are also becoming increasingly popular."

Christopher then asked for more information on how daily accrual notes work, as his colleagues had told him that he could get a competitive return by investing in these products.

"For example," I continued, "suppose it is an investor's opinion that all underlying shares in the basket will continue trading at or above their respective strike prices, which are usually fixed as a percentage of the initial prices, and the investor is also prepared to take delivery of the worst performing share in the basket if its closing price on the final valuation date is below its strike price. In this case, the investor invests in a daily accrual note.

The amount of interest payable in respect of an observation period will be calculated by reference to the number of trading days during such period on which all underlying shares close at or above their respective strike prices, as compared with the total number of trading days during such period. No interest will accrue on those trading days during an observation period on which any of the underlying shares closes below its strike price."

"Wow," said James, "that is a much more complex structure than I imagined. How can you work out your likely return?"

At this point, I took out my personal organiser and started showing them a hypothetical example* of how interest amounts are determined:

"Let's assume that (i) the principal amount of a non-callable note is HKD50,000; (ii) the interest rate is 8% per annum; and (iii) the term of the note is 12 months with 6 observation periods." I then showed them the following table:

Observation period	Total no. of trading days in the observation period	No. of trading days in the observation period on which the closing prices of all the underlying shares are at or above their respective	Interest rate payable in respect of the observation period	Interest amount payable in respect of the observation period

strike prices				
1	40	28	8% *2/12*28/40 = 0.93%	HKD50,000*0.93% = HKD465
2	40	24	8% *2/12*24/40 = 0.8%	HKD50,000*0.8% = HKD400
3	38	0	8%*2/12*0/38 = 0%	HKD50,000*0% = HKD0
4	44	18	8% *2/12*18/44 = 0.55%	HKD50,000*0.55% = HKD275
5	40	38	8% *2/12*38/40 = 1.27%	HKD50,000*1.27% = HKD635
6	42	42	8% *2/12*42/42 = 1.34%	HKD50,000*1.34% = HKD670
		Total	**4.89%**	**HKD2,445**

"Further, let's assume that, on maturity, the investor receives 100% of the principal in cash, because all underlying shares close above their respective strike prices. In this example, the total return is just 4.89% over the 12-month term of the note. You have to be aware that the actual return on these daily accrual notes can be much less than the stated per annum rate if you don't forecast movements in the underlying shares correctly."

I also reminded them that it is possible for investors to be stuck with an investment that (i) pays no interest during the life of the note and (ii) results in their taking delivery of shares in the worst performing company, if any underlying share within the basket closes below its strike price on all valuation dates.

"Ouch", William suddenly cried out. Not knowing whether he was reacting to the therapy or our conversation, we all glanced at him in bewilderment. William then clarified that he was commenting on what I had just told James and Christopher. William went on to say, "It would definitely be painful to be stuck with the worst case scenario if you are not prepared for it. We should read all the offering documents, as only limited information can be found in marketing materials."

"Absolutely", I agreed. "It is imperative that you do not simply rely on the marketing materials. Detailed information about the issuer and the payout mechanism of the notes are set out in the offering documents. You must read these documents thoroughly; in particular pay attention to the

sections regarding (i) how the notes work; (ii) the risk factors and (iii) any hypothetical examples to ensure that you fully understand the nature of the product and the risks involved.

For instance, those who invest in notes linked to a basket of shares need to appreciate that they are subject to a greater risk than those who invest in notes linked to a single share, since they are exposed to the price fluctuations of a greater number of shares. In addition, they should realise that they will not benefit from the strong performance of the other shares in the basket if the closing prices of the worst performing share continue to stay below its strike price on valuation dates.

We must always bear in mind what the worst-case scenario could be. Investors who buy equity linked notes must be prepared to receive shares in the worst-performing company upon maturity, the value of which could be substantially lower than the original investment amount."

Before we knew it, our reflexology sessions were over. We all felt rejuvenated and energised. "Let's go to dinner," William gestured with his head, "my treat."

"What a wonderful way to wrap up a rainy Sunday", I thought to myself as we headed towards the cashier.

** The example is purely hypothetical and for illustrative purposes only. It must not be relied upon as any indication of what the performance of any note might actually be.*

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