



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

**WRITTEN STATEMENT OF MR BRIAN HO
EXECUTIVE DIRECTOR,
CORPORATE FINANCE DIVISION –
SECURITIES AND FUTURES COMMISSION**

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GENERAL REMARKS

The letter from the Clerk to the Subcommittee dated 23 June 2009 raises a number of questions which I have been asked to address. The replies to these questions are set out below. I have responded to the questions raised by the Subcommittee to the best of my knowledge and belief.

SPECIFIC QUESTIONS

Key responsibilities of ED/CFD

Q1 Please provide information on the role and responsibilities of ED/CFD (including the performance of any statutory functions) and the functions and areas of work of CFD.

- 1.1 The role and responsibilities of the executive director of the Corporate Finance Division (“CFD”) of the Securities and Futures Commission (“SFC”) are to direct, manage and supervise CFD which comprises four teams:
- (a) **takeovers team** – which administers the Codes on Takeovers and Mergers and Share Repurchases;
 - (b) **listing policy team** – which oversees the listing-related functions of The Stock Exchange of Hong Kong Limited (“SEHK”) as a matter of policy, including an annual audit of the listing function of the SEHK;
 - (c) **dual-filing team** – which administers the “dual-filing regime” for listed equity initial public offerings (“IPOs”) under section 6 of the Securities and Futures (Stock Market Listing) Rules; and
 - (d) **prospectus team** – which authorises offering documents and marketing materials (relating to unlisted shares and debentures and equity-linked investments) under the Companies Ordinance (“CO”) and the Securities and Futures Ordinance (“SFO”). This team is also responsible for law reform initiatives relating to the prospectus regime under the CO and for regulating under the Listing Rules any listed companies whose circumstances preclude the SEHK from doing so – this latter function was transferred to the listing policy team as from October 2008.
- 1.2 I became the executive director of CFD on 28 August 2006. Between October 2000 and August 2006, I held the position of a senior director of CFD as head of the Takeovers Team.



Staffing support

Q2 Regarding the staffing of CFD responsible for vetting prospectuses and marketing materials of structured financial products, please provide the following information:

(a) The organizational structure and staffing of CFD, and the number and ranking of staff responsible for vetting the draft prospectuses and marketing materials of structured financial products for each year between April 2003 and 14 September 2008;

2.1 Those responsible for reviewing prospectuses and marketing materials in respect of proposed public offers of unlisted debentures ("Prospectus Team") generally comprise 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. Administrative staff was also available to provide secretarial and general support.

2.2 The number of executive staff within the Prospectus Team responsible for the day-to-day transaction management for each year from 2003 to 2008 is set out below:

Year	Number of Executive Staff in the Prospectus Team
2003	5 (note 1)
2004	6 (note 2)
2005	7 (note 3)
2006	9
2007	10
2008	10

Note 1: 4 other executive staff assisted the Prospectus Team from time to time

Note 2: 2 other executive staff assisted the Prospectus Team from time to time

Note 3: 2 other executive staff assisted the Prospectus Team from time to time

(b) The number of (i) prospectuses and (ii) marketing materials of financial products authorized between April 2003 and 14 September 2008, with a breakdown of such products (e.g. credit-linked notes (CLN) and equity-linked notes (ELN));

2.3 A total of 479 prospectuses (comprising programme and issue prospectuses) and 1,184 pieces of marketing materials of structured notes were authorised for issue by the Prospectus Team between April 2003 and September 2008 details of which are as follows:

Year	Commodity Linked		Credit Linked		Equity Linked	
	Issue Prospectus	Marketing Materials	Issue Prospectus	Marketing Materials	Issue Prospectus	Marketing Materials
2003	0	0	4	0	6	0
2004	0	0	15	4	38	30
2005	0	0	21	104	64	312
2006	2	11	18	93	33	207
2007	0	0	16	85	30	125
2008	0	0	3	21	16	58



Year	Fund Linked		Index Linked		Hybrid (note 4)	
	Issue Prospectus	Marketing Materials	Issue Prospectus	Marketing Materials	Issue Prospectus	Marketing Materials
2003	0	0	0	0	0	0
2004	0	0	2	0	3	0
2005	1	3	1	8	5	19
2006	2	12	5	36	0	0
2007	3	18	2	9	2	9
2008	2	14	0	0	2	6

Note 4: "Hybrid" means a structured note the interest and redemption amount of which are, amongst other things, linked to the performance of different asset classes.

(c) SFC has proposed in its budget of 2009-10 a net increase of five new posts to step up review of new applications for authorization of offering documents for retail products under the Securities and Futures Ordinance (SFO) (Cap.571) and surveillance of advertisements of investment products, and review of the regulatory framework for investment products and product disclosure documents (paragraph 3.11 of S19). How will the work in these areas be "stepped up" following the increase in manpower?

2.4 The five new posts proposed are five new non-executive junior professional positions in the Policy, China and Investment Products Division ("PCIP"), which is outside CFD.

2.5 As stated in the Chief Executive's 2008-09 Policy Address, one of the major projects to be undertaken by the SFC (PCIP) is to review the Code on Unit Trusts and Mutual Funds.

(d) What are the qualifications and experience required of the staff responsible for vetting offer documents and marketing materials of structured financial products? What types of training is provided for these staff?

2.6 Members of the Prospectus Team have (a) university degrees in law, accountancy or other disciplines; (b) qualifications from relevant professional bodies in law or accounting, and (c) 5-18 years of working experience.

2.7 Members of the Prospectus Team have generally attended on-site and/or external presentations, seminars, workshops and training courses in order to keep abreast of market developments and product trends. They covered various topical issues including credit-linked investment products; asset-backed securities; collateralised debt obligations ("CDOs"), the impact of sub-prime mortgages, and equity accumulators. Managerial training programmes and communication training classes were also provided to these staff.



Authorization of prospectuses and marketing materials relating to debentures (including Lehman Brothers-related structured notes)

- Q3. It is noted that CFD reviews the draft prospectus and marketing materials of debentures (including credit-linked notes and equity-linked notes) according to the prescribed content requirements under the Third Schedule of the Companies Ordinance (CO) (Cap.32). Please provide the following information:**
- (a) the time normally required to complete the vetting process of (i) the draft prospectuses for a CLN and an ELN and (ii) the marketing materials for a CLN and an ELN;**
- 3.1 Subject to (a) the quality of the draft documents submitted to CFD and (b) the response time taken by the issuers and their advisers in addressing queries or comments raised during the review process, the review process may generally take from 3 to 8 weeks.
- (b) since April 2003, whether the draft prospectuses and marketing materials of LB-related structured financial products have been vetted in accordance with a manual or checklist; if yes, please provide a copy of such a manual/checklist; and**
- 3.2 When reviewing a prospectus, reviewers first check precedents, that the document contains the information specified in the Third Schedule (“Third Schedule”) to the CO, and consult any relevant internal practices or policy (refer to paragraph 3.4 below) . To facilitate our review process, a structured note issuer or its legal adviser typically submits a completed CO compliance checklist(s) to demonstrate how they have complied with the Third Schedule requirements. The checklist(s) in essence contain(s) the relevant CO provisions prescribing the disclosure requirements and a blank copy of this compliance checklist is attached at **Appendix A**.
- 3.3 In reviewing marketing materials, reviewers first check precedents and refer to its published and gazetted *Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO* (“CO Marketing Guidelines”) a copy of which is available on the SFC’s official website and attached at **Appendix B** with which issuers are required to comply. Amongst other things, the CO Marketing Guidelines require that the marketing materials must not contain anything that is inconsistent with the information contained in the prospectus, and that the contents must not be false, biased, misleading or deceptive¹. Reviewers also check to see if appropriate warnings are included in the marketing materials.
- 3.4 There has also been internal guidance since 2005 on points to note when reviewing prospectuses and marketing materials. For purposes of facilitating Subcommittee members’ understanding of the guidance, a summary of points compiled from this internal guidance is attached at **Appendix C**.
- (c) what were the key issues that CFD staff had to take into consideration when vetting the draft prospectuses and marketing materials of LB-related structured financial products? Have there been any changes in such considerations between April 2003 and 14 September 2008?**

¹ See paragraph 3.03 of the CO Marketing Guidelines.



- 3.5 In addition to what I have described in paragraphs 3.2 to 3.4 above, reviewers 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 as a result of reading the particulars and information a valid and justifiable opinion of the shares or debentures and the financial condition and profitability of the company in question, 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. The key disclosures, including that the notes would be early terminated following the insolvency of LBHI, are contained in the Minibond prospectuses. **Appendix D** indicates where in the prospectuses for the outstanding Minibond series the relevant disclosures can be found.
- 3.6 In 2005, some issuers of structured notes started to publish prospectuses in plain language. CFD was supportive of this initiative and reviewed these prospectuses with a view to making them more reader-friendly and comprehensible.
- 3.7 Reviewers have in the past requested issuers of structured notes to address in prospectuses matters of significant market concerns with a view to helping prospective investors to better understand possible risks related to the product.
- 3.8 For instance, following the outbreak of the sub-prime crisis in mid-2007, reviewers requested issuers whose credit linked notes would be secured on CDOs to state in the prospectuses whether such CDOs would consist of or include asset-backed securities linked to sub-prime mortgages or mortgage-backed securities.
- 3.9 Separately, in view of the widespread concern from early 2008 about the role of credit rating agencies in structured finance markets, and as suggested by the International Organisation of Securities Commissions, reviewers asked issuers of credit linked notes whose collateral would comprise rated CDOs to include additional disclosures to address the common mis-conception that a security with a high credit rating is always liquid with low price volatility and therefore a sound investment.
- 3.10 Additional disclosures to the effect that (1) a credit rating is not a recommendation; (2) a high credit rating is not indicative of high liquidity and/or low market volatility; and (3) there could be conflict of interest between an issuer and credit rating agencies which may affect investors' return on the notes were subsequently included in prospectuses of these credit linked notes.
- (d) Who is/are the approving authority for authorizing the draft prospectuses and marketing materials of LB-related structured financial products?**
- 3.11 (1) Sections 38D(5) and 342C(5) of the CO and (2) section 38B(2A)(b) of the CO and section 105(1) of the SFO empower the SFC to authorise prospectuses for registration, and the publication or issue of marketing materials relating to prospectuses respectively. On or about the commencement of the SFO and the Companies (Amendment) Ordinance 2004, pursuant to section 10(1) of the SFO and resolutions of the board of directors of the SFC, the functions of the SFC relating to authorisation of prospectuses and marketing materials have been delegated to each Executive Director of the SFC. In addition, pursuant to section 10(3) of the SFO and resolutions of the board of directors of the SFC, the SFC authorised each Executive Director to sub-delegate such functions to any employee as he or she considers necessary for the efficient discharge of functions if such functions are carried out by



his or her Division. Any sub-delegation to an employee is to an employee within that Division who occupies a post at the level of Senior Manager or above. Accordingly, the functions relating to prospectus authorisation (which are carried out by CFD) have been sub-delegated to Senior Director, Director and Associate Director of CFD.



- Q4. Since 2006, SFC has identified as one of its regulatory challenges the increased exposure of retail clients to complex and structured products (p.6 of S23). According to the findings of SFC's Structured Product Investor Survey (p.13 of S25) released in November 2006, a considerable number of investors said that the offering documents contained too much jargon or the product concept was too complicated. In vetting of the draft prospectuses and marketing materials of structured financial products, such as LB-related structured product, what measures, if any, were taken by CFD to address the aforesaid regulatory concerns? Have such measures brought about any improvement?**
- 4.1 As mentioned in Mr Martin Wheatley's written statement which was sworn in on 23 June 2009, the SFC vigorously exercises its statutory mandate to promote investor education – educating and empowering investors to protect themselves is a top priority. The SFC strives to keep investors educated, informed, and alert to the risks of investing. This includes promulgating a proper investment attitude, promoting better understanding about the markets, products and investment risks and factors they should consider in making their investment decisions. The 2006 survey was conducted as part of the SFC's efforts in pursuing this statutory mandate.
- 4.2 CFD as a matter of practice urged structured notes issuers to use plain language in prospectuses to facilitate prospective investors' understanding of the key features and risks of their products. With assistance from CFD, the SFC stepped up its investor education initiatives in explaining product features and risks, clarifying misconceptions and reminding investors to ask the right questions when considering potential investments. These include, on the day the survey findings were published on the SFC's website, (1) a press release summarising the findings; (2) and a Dr Wise article on retail structured notes and an accompanying press release; and (3) a circular to all issuers of unlisted structured products alerting them to the findings of the survey and suggesting that they inform their distributors of the findings and remind those distributors to ensure that prospective investors understand their structured products, including the underlying risks.
- 4.3 Following the survey and in view of the increasing availability of these products in the market, the SFC continued to enhance its investor education efforts on complex structured products, in particular in relation to equity-linked products because our research indicated that the issue size of equity-linked products was much greater. Subsequently, our Retail Investor Survey which was conducted last summer and published in December 2008 found that of those surveyed relatively few investors wrongly perceived such products as a long-term investment or a tool to help them preserve their capital.
- 4.4 In addition to disclosures and investor education, the SFC's regulatory regime also rests on conduct regulation to ensure suitability. As mentioned in Mr Martin Wheatley's written statement, the SFC's regulatory regime rests on 6 elements – (a) disclosure; (b) conduct regulation to ensure suitability; (c) licensing / registration of intermediaries and their representatives; (d) supervision of intermediaries; (e) investor education and (f) enforcement action against those who do not comply with the requirements. For further information about these 6 elements, please refer to paragraphs 11 to 90 of the said statement.
- 4.5 "The suitability rule is designed to address the lack of sophistication of retail investors, who, irrespective of the level of risk disclosure, may not be able to adequately



analyse their investment needs or develop strategies to achieve their investment goals."² Accordingly, regulating intermediary conduct at the point of sale is essential – only at this point is it possible to understand the investment objectives and risk profile of a particular investor and to determine whether a particular product is suitable for him.

- 4.6 Over the last 3 years, the SFC has conducted approximately 140 onsite inspections of licensed corporations (“LCs”) each year. These inspection teams are also responsible for conducting specific thematic inspections of LCs to look into topical issues or concerns over particular market practices.
- 4.7 In particular, the report on the thematic inspection of selling practices of licensed investment advisers issued by the SFC in February 2005 (“the 2005 Report”) sets out the regulatory concerns at the time and identifies areas of unsatisfactory practice noted during the review. The 2005 Report explained at paragraph 20 that investors had complained that the nature of and the risks associated with a financial product were not adequately explained by intermediaries and that on occasions, risks associated with products were misrepresented, so that they were led to believe that they were investing in a lower risk product when, if properly described, the product was higher risk and therefore not suitable for conservative investors.
- 4.8 A second round of thematic inspection of selling practices of licensed investment advisers was conducted in 2006 with a view to assessing the prevailing selling practices adopted by 10 other licensed investment advisers and reviewing whether any improvement had been made since the issuance of the 2005 Report. This second thematic review revealed similar issues and deficiencies. The SFC has since taken appropriate enforcement action in relation to 5 of these 10 investment advisers covered in this thematic review.
- 4.9 To help raise the standard of the industry, the SFC issued guidance in May 2007 on requirements relating to the suitability of advice in the Code of Conduct for Persons Licensed by or Registered with the SFC (“Code of Conduct”). Amongst other things, investment advisers were reminded of their duties to (a) conduct product due diligence including the nature of the underlying investments; (b) provide reasonably suitable recommendations by matching the risk return profile of each product with the personal circumstances of each client to whom it is recommended; and (c) not use high-pressure or unfair techniques to force or entice any client to make hasty investment decisions. Investment advisers were asked to make their own enquiries and obtain full explanations from product issuers about the risks inherent in the investment products. It is also not advisable for investment advisers to rely on prospectuses and marketing materials as necessarily being self-sufficient and self-explanatory. The second thematic review report was also issued in the same month.

² *Financial Markets and Investment Products: Promoting competition, financial innovation and investment*, Corporate Law Economic Reform Program, Proposals for Reform: Policy Statement no 6, Australian Treasury, 1997, p 102.



- Q5. It is noted from Appendixes 4 and 5 of W13(C) that CFD may raise queries or provide comments to issuers on the draft prospectuses and marketing materials of their investment products. Please advise whether CFD has raised any queries or comments to the issuers regarding the draft prospectuses and marketing materials of the following products:**
- (a) the first Minibonds series whose prospectus/marketing materials were authorized by SFC, and Minibonds series 27, 34 and 35; and**
 - (b) the first Constellation Notes series whose prospectus and marketing materials were authorized by SFC, and Constellation Notes series 44, 56 and 58.**
- 5.1 Reviewers have raised queries and commented on all Minibond prospectuses. In addition, from series 16 onwards (being the first series of Minibonds where marketing materials were submitted to the SFC for authorisation), the SFC also raised queries and commented on the marketing materials.
- 5.2 Reviewers have raised queries and commented on all prospectuses for Constellation notes series. In addition, starting from series 10 and 11 (being the first series of Constellation notes where marketing materials were submitted to the SFC for authorisation), the SFC also raised queries and commented on the marketing materials.
- 5.3 Examples of queries and comments made by the SFC on the draft prospectuses and marketing leaflets are set out in **Appendix E**. Please also refer to my response to Question 6 below for information about differences in features of Minibonds and Constellation notes respectively.



Q6 Please explain the differences, if any, in the information (both contents and presentation) disclosed in the prospectuses and marketing materials of (a) the first Minibonds series and the later Minibonds series 27, 34 and 35, and (b) the first Constellation Notes series and the later Constellation Notes series 44, 56 and 58.

(a) Minibonds

Differences in Features of Minibonds

- 6.1 The various series of Minibonds can roughly be divided into three groups in terms of their features: (i) Series 1, (ii) Series 2 to 9 and (iii) Series 10 to 36.
- 6.2 Series 1 - Pacific International Finance Limited (“Issuer”) issued notes and used (i) the proceeds from the issue of the notes to purchase the underlying securities (US\$ fixed rate notes guaranteed by Hutchison Whampoa Limited) which were held by an independent trustee, and (ii) the interest income and principal repayment from the underlying securities to pay interest and principal repayment due under the notes via swap arrangements with Lehman Brothers Special Financing Inc. (“LBSF”). The swap arrangements are guaranteed by Lehman Brothers Holdings Inc. (“LBHI”).
- 6.3 Series 2 to 9 - the payment of interest and repayment of principal of the notes are subject to no credit event occurring to any of the reference entities specified in the prospectuses and no other redemption event occurring prior to the maturity date. The underlying securities used as collateral to back each of series 2 to 9 were guaranteed by LBHI. Such collateral was also held by an independent trustee. In respect of series 9, there were swap arrangements with LBSF acting as swap counterparty and LBHI as swap guarantor.
- 6.4 Series 10 to 36: the payment of interest and repayment of principal of the notes are subject to no credit event occurring to any of the reference entities specified in the prospectuses and no other redemption event occurring prior to the maturity date. However, instead of using securities guaranteed by LBHI as collateral. The Issuer used the proceeds from the issue of the notes to purchase AAA-rated CDO securities (at the date of purchase of such securities) as collateral to secure the notes. Such collateral was also held by an independent trustee. The criteria for choosing the collateral for each series are set out in the issue prospectus and the collateral is purchased on or after the issue date of the notes. For each series, there were swap arrangements with LBSF acting as swap counterparty and LBHI as swap guarantor.

Differences in Presentation and Contents of Information in Minibond Prospectuses

- 6.5 A single standalone prospectus is used for each of series 1 to 8. In respect of series 1, there was a standalone prospectus for the first tranche (supplemented by a supplemental prospectus) and another standalone prospectus for the second tranche. From series 9 onwards, pursuant to the guidelines on using a “dual-prospectus” structure to conduct programme offers of shares or debentures requiring a prospectus under the CO published in February 2003 which was subsequently entrenched in the Twenty-First Schedule to the CO following the coming into force of the Companies (Amendment) Ordinance 2004 on 3 December 2004, the Issuer adopted the dual prospectus approach (i.e. using a programme prospectus (“PP”) and an issue prospectus (“IP”). The PP contains, among other things, generic information about the Issuer, the other counterparties, the note programme, the



master terms and conditions of the notes, general risk factors and other information such as taxation of the notes. The IP contains, among other things, offer-specific information such as features of the notes, interest rates, tenors, information about the collateral, the swap arrangements, investment risks, and a form of the pricing supplement.

- 6.6 The prospectuses for series 1 to 17 adopted a more lengthy and legalistic approach. From series 18 onwards, the Issuer adopted the “plain language” approach whereby the Issuer presented information in a less legalistic and simpler way in the prospectuses.
- 6.7 The table attached at **Appendix F** sets out a brief comparison between the contents of the prospectuses for Minibond series 1, 27, 34 and 35. For further or other information, please refer to the relevant prospectuses.

Differences in Presentation and Contents of Information in Minibond Marketing Materials

- 6.8 The existing section 38B(1) of the CO, which came into effect on 3 December 2004, prohibits the publication of any advertisement in relation to a prospectus unless (i) it has been authorised by the SFC under section 105 of the SFO, (ii) it is an extract from or abridged version of a prospectus which is authorised by the SFC under section 38B(2A)(b) of the CO, or (iii) it is otherwise exempted under section 38B(2) of the CO.
- 6.9 Before the effective date of the aforementioned legislative amendments, marketing materials in respect of structured notes were generally issued by intermediaries pursuant to section 103(2)(a) of the SFO (and prior to the commencement of the SFO on 1 April 2003, section 4(3)(a)(i) of the now repealed Protection of Investors Ordinance) without prior SFC authorisation.
- 6.10 Marketing materials in respect of series 16 were the first set of marketing materials submitted to the SFC for authorisation under the new advertising regime. The marketing leaflets for Series 16, 27, 34 and 35 all contain the following information -- (i) investment involves risks and that the notes are not principal protected; (ii) redemption at maturity is subject to the non-occurrence of credit or other redemption events; (iii) collateral arrangements and the limited recourse nature of the notes; (iv) prospective investors should read the prospectuses before deciding to invest; (v) responsibility statement and (vi) prospective investors should contact a distributor.
- 6.11 There is also additional information about the CDO collateral in the main text of the section headed “Summary of Terms” in the leaflets for the later series e.g. that CDOs would be a significant component of the risk and return profile of the notes. In addition, following the outbreak of the sub-prime crisis in mid-2007, it is stated that the CDOs would not be linked to asset-backed or mortgage-backed securities. Separately, readers were also reminded that there may be a limited, or no, secondary market for the notes.
- 6.12 Further information about the key differences in the contents of the marketing leaflets in respect of Series 16, 27, 34 and 35 is attached at **Appendix G**. For detailed or other information, please refer to the relevant prospectuses.



(b) Constellation notes

Differences in Features of the Constellation Notes

- 6.13 The issuer is Constellation Investment Ltd. (“Constellation”). The various series of Constellation Notes can roughly be divided into three main groups: (i) Series 1 to 4 and Series 6 to 13 (credit-linked notes), (ii) Series 14 to 50 and Series 55 to 85 (credit-linked notes) (iii) Series 5 and Series 51 to 54 (equity-linked notes).
- 6.14 All Constellation Notes are credit-linked notes except for Series 5 and Series 51 to 54, which are equity-linked notes. These equity-linked notes are secured by bank deposits and swap arrangements with DBS Bank Ltd acting as swap counterparty.
- 6.15 Series 1 to 4 and Series 6 to 13 used either bank deposits or corporate/government bonds as collateral. All remaining credit-linked series of Constellation Notes used AAA-rated CDO securities (at the time of purchase of such securities) as collateral. The selection criteria for choosing the collateral for each series are set out in the issue prospectus and the collateral is purchased after the date of the prospectus. For each series, there were swap arrangements with DBS Bank Ltd acting as swap counterparty.

Differences in Presentation and Contents of Information in Constellation Notes Prospectuses

- 6.16 Constellation adopted the dual prospectus approach (i.e. using a PP and an IP from series 1 onwards. The PP contains, among other things, generic information about the Issuer, the other counterparties, the note programme, the master terms and conditions of the notes, general risk factors and other information such as taxation of the notes. The IP contains, among other things, offer-specific information such as features of the notes, interest rates, tenors, information about the collateral, the swap arrangements, investment risks, and a form of the pricing supplement.
- 6.17 The prospectuses for series 1 to series 46 adopted a more lengthy and legalistic approach. From series 47 onwards, Constellation adopted the “plain language” approach whereby the Issuer presented information in a less-legalistic and simpler way in the prospectuses.
- 6.18 The table attached at **Appendix H** sets out a brief comparison between the contents of the prospectuses for Constellation Notes Series 1, 44, 56 and 58. For further or other information, please refer to the relevant prospectuses.

Differences in Presentation and Contents of Information in Constellation Notes Marketing Materials

- 6.19 Paragraphs 6.8 and 6.9 apply to marketing materials in respect of Constellation Notes.
- 6.20 Marketing materials in respect of series 10 & 11 were the first set of marketing materials submitted to the SFC for authorisation. The marketing leaflets for Series 44 and 56 & 58 all contain the following information -- (i) investment involves risks and that the notes are not principal protected; (ii) redemption at maturity is subject to the non-occurrence of credit or other redemption events; (iii) collateral arrangements and the limited recourse nature of the notes; (iv) prospective investors should read the prospectuses before deciding to invest; (v) responsibility statement and (vi) prospective investors should contact a distributor.



6.21 Further information about the key differences in the contents of the marketing leaflets in respect of Series 10 & 11, 44 and 56 & 58 is attached at **Appendix I**. For detailed or other information, please refer to the relevant prospectuses.



Q7. As stated in the "Issues raised by the Lehman Minibonds crisis – Report to the Financial Secretary" (Review Report) (p.48 of LC Paper No. CB(1)552/08-09(01)), SFC, in authorizing the prospectuses and marketing materials of investment products, focused on whether there was adequate disclosure but did not verify the accuracy of the information provided by product issuers. According to SFC's Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO (Guidelines on Materials for Debentures) (paragraph 3.03 of S1-Appendix 1), the contents of such materials must not be false, biased, misleading or deceptive. In this connection, please explain how SFC can ensure that the contents of the draft prospectuses and marketing materials comply with the requirements stated in paragraph 3.03 of the Guidelines?

7.1 The SFC is not in a position to verify the accuracy and completeness of the information provided to it by the product issuer. Sections 40 and 40A of the CO provide that directors of the issuer company are subject to civil and criminal liability for untrue statements (including material omissions) in the prospectus. Each prospectus also contains a statement(s) to the effect that the issuer's directors collectively and individually accept full responsibility for the accuracy of the information contained in the prospectus, and that the SFC is not responsible for the contents of the prospectus. The directors confirm, having made all reasonable enquiries, that to the best of their knowledge and belief the issue prospectus and the programme prospectus, when read together, contain no untrue statement (including a statement which is misleading in the form and context in which it is included and including a material omission). It is therefore the responsibility of the issuer, its directors and their advisers to ensure compliance with the applicable legal and regulatory requirements and that the prospectus and marketing materials do not contain untrue statements. It is also the responsibility of the issuer to comply with the CO Marketing Guidelines.

7.2 As mentioned in the Report of the Securities Review Committee published in May 1998 (commonly known as the Hay Davison Report), "there are doubts about the effectiveness of pre-vetting, as a pre-vetting authority cannot be expected to check the accuracy or completeness of an offer document in any meaningful way. The fact that a document has been pre-vetted may therefore give investors a false sense of security."

7.3 The CO Marketing Guidelines do not apply to prospectuses. The contents requirements for prospectuses are prescribed in the Third Schedule to the CO. Insofar as marketing materials are concerned, where such marketing materials contain extracts from the relevant prospectus, reviewers would check the relevant parts of the prospectus. Reviewers also ask for, in light of our 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, justifications for the marketing slogans. Reviewers may also comment on the following aspects of marketing materials:

(a) appropriate legends, such as "investment involves risks" and "prospective investors should read the relevant prospectuses before deciding to invest" are included; and

(b) the presentation of marketing materials including font size and legibility, and



- (c) where a product is not principal protected, that the warning statement “the notes are not principal protected” is prominently set out.



- Q8. Between April 2003 and 14 September 2008, did SFC receive any complaints about false, biased, inaccurate, misleading or deceptive information provided in the prospectuses and marketing materials of investment products? Were any of such complaints related to LB-related products? What follow-up actions had been taken on substantiated complaints? Please explain, with examples, the type of information that is regarded by SFC as "misleading" and "biased"?**
- 8.1 According to SFC's complaint records, between April 2003 and 14 September 2008, there were 15 complaints alleging false, biased, inaccurate, misleading or deceptive information in offer documents and marketing materials of investment products. 3 cases were related to structured notes, of which 1 related to Minibond.
- 8.2 In that one complaint on Minibond which was received in 2007, the complainant alleged that there was no disclosure of the risks of the underlying collateral in the marketing materials, and that the prospectus was too technical to understand. The SFC noted that (i) the type, nature of, and the risks associated with the collateral have already been set out in the marketing leaflet, (ii) there was warning in the marketing leaflet that investors should read the prospectuses before making investment decisions; (iii) the prospectuses contained disclosure on the type and selection criteria of, and risks involved in connection with, the collateral; and (iv) the marketing leaflet is designed to raise investors' interest in an offer and cannot, and do not, replace prospectuses and therefore will not contain all relevant information for investors to make an informed investment decision. Accordingly, the SFC responded to the complainant based on the preceding observations.
- 8.3 In any event, the prospectus presents information as at the date of the document in a "snapshot" manner – paragraph 3 of the Third Schedule to the CO provides that the prospectus must specify "*sufficient particulars and information to enable a reasonable person to form a valid and justifiable opinion...at the time of the issue of the prospectus, ...*".
- 8.4 It is difficult to generically define the type of information which the SFC would regard as "misleading" and "biased", without looking at the particular circumstances of each case. In general, the SFC requires marketing materials to give balanced information of a product's features and risks. For example, if a non-principal protected product is described in the marketing leaflet as principal protected, the SFC would regard it as "misleading", and indeed downright "false". Another instance where the SFC would regard a marketing leaflet as potentially misleading would be where the return (in percentage terms) of a product includes the principal amount e.g. a return of 109% is stated on the cover of the leaflet where the maximum potential return is 9%.



Q9. As evidenced in the marketing materials of the Minibonds and Constellation Notes series, the offer of free gifts was common. When vetting such marketing materials, has CFD raised any regulatory concerns over the extensive offer of free gifts? Does CFD have any guidelines on the offer of free gifts to investors? If yes, please provide the details. If no, the reasons.

9.1 The overarching principle that applies to all marketing materials of investment products is that they should not be false, biased, misleading or deceptive and should carry appropriate risk warning statements. In reviewing and authorising marketing materials for unlisted structured notes offered to the public, reviewers would refer to the CO Marketing Guidelines. The CO Marketing Guidelines reaffirm the above overarching principle and provide for certain statements to be included in marketing materials.

9.2 Whilst there is nothing under the current law that prohibits the use of bonus gifts in public offerings of structured notes, reviewers would require the issuer to ensure the above overarching principle is met, and that information about the gifts should not be set out at the expense of cluttering the space which would otherwise be used to describe the notes.

9.3 The propriety or the conduct to be observed in respect of offers of bonus gifts supplied by intermediaries is a matter of conduct regulation. As mentioned by Mr Martin Wheatley in his testimony on 23 June 2009, the SFC will investigate if we receive complaints to the effect that bonus gifts are used as part of high-pressure selling tactics. The intermediaries' senior management should ensure that their front line sales staff are provided with adequate training.



Q10. As specified in paragraph 3.04 of SFC's Guidelines on Materials for Debentures (S1-Appendix 1), "[t]he font size of all warning statements and legal legends in the materials must be at least 40% of the font size that predominates in the materials and must not be presented in a style that is designed to reduce their impact". With reference to the warning statement that "[t]he Notes are not principal protected" as appeared in the leaflets for Minibond series 17, 18 and 35, please advise on the following :

(a) Since the launch of Minibonds series 18, the warning statement has been printed in a larger font size and in a more eye-catching position in the product leaflets. Was such a presentational change made by the issuer on its own accord or at the request of SFC?

10.1 Minibonds series 16 (issue prospectus dated 31 December 2004) was the first series of Minibonds where the marketing materials were authorised by the SFC. This is because the Companies (Amendment) Ordinance 2004 came into effect and the revised section 38B of the CO provided for SFC authorisation of marketing materials from 3 December 2004. Prior to that date marketing materials did not require approval from the SFC but were generally issued by intermediaries using exemptions from section 103 of the SFO. The marketing leaflet for Minibonds series 16 contained the statement that "*The Notes are not capital protected investments. There is no assurance that investors will receive the principal amount of the Notes at maturity.*" in the disclaimer section of the leaflet.

10.2 Beginning from Minibonds series 17, the warning statement that "The Notes are not principal protected" has been printed in a larger font size and in a more eye-catching position beneath the graphic in the marketing leaflet. The presentational change was made at the request of reviewers.

(b) Between April 2003 and 14 September 2008, did SFC issue any additional guidelines to issuers with regard to the use of warnings on the risks of the aforesaid products (or other series of LB-related structured products)?

10.3 Other than the CO Marketing Guidelines, the SFC did not issue any additional guidelines to issuers between April 2003 and 14 September 2008 with regard to the use of warnings on the risks of credit linked notes.



Q11. According to "An English-Chinese Glossary of Securities and Financial Terms" published by SFC on its website, the Chinese term of "Notes" is "票據". However, in the prospectuses and marketing materials (including the disclaimer therein) of the various series of Minibonds and Constellation Notes, "債券", instead of "票據", appeared as the Chinese rendition of the term "Notes". Has the use of these two terms by the issuer in the context of Minibonds and Constellation Notes given rise to any regulatory concerns? If yes, please explain; if no, the reasons.

11.1 It is noteworthy that "*An English-Chinese Glossary of Securities and Financial Terms*" ("Glossary") published by the SFC does not have legal force. As stated in the Foreword and Editor's Note to the Third and Fourth Editions respectively, the Glossary is only a collection of financial terms commonly used, and is meant to be a practical tool. Nevertheless, in addition to the translation of the terms "note" as "票據" and "bond" as "債券, 債權證明書" in the Glossary, the translation of other relevant terms may also shed light on the common usage of the terms "note" and "bond":-

(a) In the Third Edition of the Glossary published in 2004, which contains the translation commonly used in Hong Kong, Mainland China and Taiwan, the following translations are noted:-

- (i) "bill" as "票據",
- (ii) "treasury bill" as "短期國庫券, 國庫券, 短期國債",
- (iii) "treasury bond" as "國庫債券, 長期國庫券, 長期公債", and
- (iv) "treasury note" as "中期國庫券, 國庫票據, 中期國債, 國庫中期債券".

(b) In the Fourth Edition of the Glossary published in 2006, which contains translations commonly used in Hong Kong and/or Mainland China, the following translations are noted:-

- (i) "bill" as "票據",
- (ii) "treasury bill" as "短期國庫券, 國庫券, 短期國債",
- (iii) "treasury bond" as "國庫債券, 長期國庫券", and
- (iv) "treasury note" as "中期國庫券, 國庫票據, 中期國債".

The above illustrates that the terms "bill", "bond" and "note" all refer to debt instruments – in particular, the highlighted words show that these terms are interchangeably translated as "票據" or "債券". The key distinction is the duration of the debt instrument rather than the words "票據" or "債券". This also reflects the common usage in the market.

11.2 The term "debenture" is defined in section 2 of the CO to include "debenture stock, bonds and any other securities of a company whether constituting a charge on the assets of the company or not". There is no precise definition of what constitutes a "bond" or a "note". "Minibonds" or "Constellation Notes" could legitimately be described as debentures, bonds, structured bonds, notes, credit-linked notes or derivatives. The important features of the product are that they are not principal protected, they are credit-linked products and that the recourse of investors in the product is limited to the realisation of the underlying securities plus or minus the termination payment due to or payable by the issuer under the swap arrangement, and that at early termination due to the stated events investors may suffer substantial



or total loss, have been adequately disclosed. These salient features are reflected in both the prospectuses and the marketing leaflets.

- 11.3 Some commentators have suggested that “bonds” or “債券” indicates low-risk. However, this is not the case and it is important to note that the level of risk of a particular bond depends largely on the credit quality of the issuer, be it a corporation or even sovereign. Bonds issued by General Motors, for example, at the time when it was already in financial distress, would be very risky. There are different kinds of bonds in the market such as “high-yield bonds” which may comprise “junk-bonds” and are considered high-risk. This illustrates that the word “bond” in isolation does not confer any sense of safety.



- Q12. As stated in paragraph 28.2 of its Review Report (LC Paper No. CB(1)552/08-09(01)), CO only provided an inclusive definition of "debenture" and Minibonds were designed to fall within this definition. In view of the proliferation of structured financial products, such as Minibonds and Constellation Notes since 2003, has CFD conveyed any views/concerns to SFC proposing that a clearer delineation be introduced for the use of terms like "bonds" and "notes"? Has SFC ever considered the suggestion of introducing a more definitive scope for "debenture" under CO and discuss the suggestion with the Administration?**
- 12.1 As part of a comprehensive review of the CO prospectus regime designed to bring Hong Kong's laws in this area up to date, the SFC published a concept consultation paper in August 2005 entitled "Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance" ("Phase 3"). Paragraphs 9.3 and 9.11 of the Phase 3 consultation paper noted the inclusive nature of the definition of "debenture" in section 2 of the CO, particularly the reference to "any other securities" (rather than, for instance, "any other debt securities") in the definition may cause difficulty for market practitioners. The consultation paper also pointed out that case law offers limited assistance on the interpretation of "debenture" as a wide range of instruments creating or acknowledging a debt have been held to be debentures. The consultation paper proposed (among other things) to amend the definition of "debenture" by replacing the reference to "*other securities*" with "*other debt securities*". This minor clarification amendment received broad support. In addition to the minor clarification amendment, the "Consultation Conclusions on the Consultation Paper on Possible Reforms to the Prospectus Regime in the Companies Ordinance" published by the SFC in September 2006 proposed to carve-out structured products from the definition of "debenture". The Phase 3 consultation paper and consultation conclusions were circulated to, discussed and approved by the board of directors of the SFC prior to publication. These documents were published, uploaded on SFC's website and sent to the Administration.
- 12.2 Phase 3 involves a package of law reform proposals to modernize the public offering regime for shares and debentures in Hong Kong, many of which have market-wide implications but were not specifically designed to address the issues raised following the collapse of LBHI. The package of reform initiatives to be taken forward involve wide-ranging impact on the interests, practice and procedures of a cross-section of stakeholders involved in the public offering process (including IPOs) – these initiatives include: (i) moving from a document-based approach to a transaction-based approach; (ii) revamping the prescribed content requirements; and (iii) permitting incorporation by reference. After publication of the consultation conclusions in September 2006, the SFC undertook a substantial amount of work including soft-consulting various stakeholders on the detailed logistics and technical aspects of certain proposals to reduce any process risk associated with the implementation of these proposals. The SFC had completed an initial draft of the draft drafting instructions.
- 12.3 Another initiative to be taken forward is the proposal to transfer the regulation of public offers of structured notes to Part IV of the SFO. In view of the financial tsunami 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.



- 12.4 For the reasons set out in our report in December 2008 to the Financial Secretary, the proposed code would be premised on the two 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 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 an authorised product is failure-proof.



Q13. Under the existing regime, the marketing materials for Collective Investment Schemes (CISs) are subject to the "Advertising guidelines applicable to collective investment schemes authorized under the product codes" (Advertising Guidelines on CISs) (S18), while those for debentures are subject to the Guidelines on Materials for Debentures (S1-Appendix 1). Please provide a comparison of the key requirements set out in these two sets of guidelines, covering such aspects as general principles, language, graphics and warning statements to prospective investors.

- 13.1 The CO Marketing Guidelines were published by the SFC in 2003 pursuant to initiatives for the development of the retail debt market endorsed by the Government's Financial Market Development Task Force, with a view to striking the right balance between facilitating market development and protecting investors³. These Guidelines apply generally to publicity materials in cases of public offers of shares or debentures under the CO, including structured notes.
- 13.2 The *Advertising Guidelines Applicable to Collective Investment Schemes* ("**CIS Advertising Guidelines**") on the other hand are guidelines on the contents of advertisements in relation to collective investment schemes, mostly funds, authorised under the SFO.
- 13.3 Unlike structured notes, funds (which are by definition collective investment schemes) are actively managed – they are different in nature. Investors buying funds entrust their fund managers with discretionary powers to manage the portfolio on their behalf including to sell and purchase stocks or bonds according to the disclosed investment strategy.
- 13.4 As these two types of products are different by nature, the information that would be of concern to their respective potential investors would be different.
- 13.5 Information which concerns an investor of structured notes mainly includes the features, reference assets and scenario analyses of a particular product.
- 13.6 Investors of funds will be interested in information such as the historical performance, sector breakdown and country breakdown of the scheme. As such, the CIS Advertising Guidelines contain fairly detailed guidance on the presentation of historical performance information and other more specific practical guidance on marketing materials.
- 13.7 Despite these key operational differences, the two sets of guidelines share the same overarching principle that the marketing materials should not be false, biased, misleading or deceptive and should carry appropriate risk warning statements.
- 13.8 A comparison of the major items covered in the respective guidelines is as follows:-

³ Market development aside, some investor protection initiatives in the context of the review of the prospectus regime, e.g. those implemented through the Companies (Amendment) Ordinance 2004, i.e. the civil liability provision in the CO was amended to make clear that (a) persons who acquire shares or debentures in a public offering through an agent or intermediary would be accorded the same investor protection as investors who subscribe for shares or debentures; and (b) omission of material information in a prospectus would also give rise to liability.



	CO Marketing Guidelines	CIS Advertising Guidelines
Must be clear and not false, biased, misleading or deceptive	✓	✓
Consistent with the offering document	✓	✓
Warning statements	✓	✓
Disclose the name of issuer	✓	✓
Issuers being responsible for the advertisements	✓	✓
Read the offering documents for details	✓	✓
Guidelines re advertisements shown on radio / TV etc.	✓	✓
Guidelines on presentation of historical fund performance information	Not applicable	✓



Disclosure of risks of investment products to investors

Q14. With reference to Minibonds series 27, 34 and 35 and Constellation Notes series 44, 56 and 58, what types of risks, including the risks associated with each underlying component of each of the products, should be disclosed in the programme and issue prospectuses and marketing materials of these products?

14.1 Please see **Appendix J** for the respective risk disclosures made in the programme prospectuses, issue prospectuses and marketing leaflets of the relevant series of Minibond and Constellation Notes. A “✓” indicates that the relevant prospectus or marketing leaflet contains the specified disclosure item. For further information about these risk disclosures, please refer to the relevant prospectuses.



- Q15. Regarding the prospectuses of debentures (including structured notes) authorized under CO, SFC stated in its Review Report that "[a]lthough there is no continuing disclosure requirement under existing law, as a matter of practice, an issuer would, in response to inquiries raised by the SFC during the document vetting process, represent in the offering documents that it will make disclosure of information to avoid the establishment of a false market or disclosure of changes which may significantly affect the ability of the issuer to make payment on the structured notes" (paragraph 4.1.1 of Appendix 2 in LC Paper No. CB(1)552/08-09(01)). Please explain how the arrangement described above was applied in CFD's vetting of the draft prospectuses and marketing materials of LB-related structured financial products.**
- 15.1 There are no statutory requirements for ongoing disclosure of information to investors for prospectuses authorised under the CO. As stated in paragraph 11.48 of the Hay Davison Report, a prospectus for an unlisted issue provides a one-off snapshot intended to form the basis of a contract between issuers and individual investors. This approach is consistent with that adopted by comparable jurisdictions.
- 15.2 Unlike unlisted investment products (which are expected to be held until maturity) for which there is no assurance of a liquid secondary market, securities which are listed are intended to be traded on a continuous trading platform. Accordingly, issuers are subject to continuing disclosure obligations under the listing rules of the relevant stock exchange.
- 15.3 In light of the above and after discussions with issuers, issuers included a statement in prospectuses to the effect that it will make disclosure of information to avoid the establishment of a false market or disclosure of changes which may significantly affect the ability of the issuer to make payment on the structured notes.



Q16. Before the collapse of LB, did SFC receive any enquiries from, or engage in any discussion with, HKMA on matters relating to the disclosure of product information, notably risks, in the prospectuses and marketing materials of structured financial products? If yes, please provide the details.

16.1 According to our records, the SFC has not received any enquiries from, or engaged in any discussion with, HKMA on matters relating to the disclosure of product information, notably risks, in the prospectuses and marketing materials of structured financial products.



Q17. As SFC is responsible for authorizing the draft prospectuses and marketing materials of investment products, has SFC received any feedbacks from HKMA since April 2003 over the use of such documentations by Relevant Individuals at the point of sale? Have there been regular exchanges between SFC and HKMA on the key contents contained in such documentations?

- 17.1 The SFC has not received any feedbacks from HKMA since April 2003 over the use of prospectuses and marketing materials of investment products by Relevant Individuals at the point of sale.
- 17.2 There have not been any regular exchanges between the SFC and HKMA on the key contents contained in prospectuses and marketing materials of investment products.
- 17.3 Following the collapse of LBHI, the SFC and HKMA have had exchanges on the “health warning” statement⁴ which HKMA requested to be included in the marketing materials and offering documents of all structured investment products in its circular dated 25 March 2009.

⁴ The “health warning” statement as set out in HKMA circular dated 25 March 2009 reads as follows: “*This is a structured product involving derivatives. The investment decision is yours but you should not invest in the [product name/type] unless the intermediary who sells it to you has explained to you that the product is suitable for you having regard to your financial situation, investment experience and investment objectives.*”