

**For information  
on 11 June 2009**

**Legislative Council Panel on Financial Affairs**

**Issues Relating to the Regulation of Credit-linked Products  
Sold to Retail Investors**

**Purpose**

This note briefs members on the regulation of credit-linked products and actions taken to follow up on complaints in relation to Octave Notes.

**Background**

2. Against the backdrop of the filing by General Motors Corporation (GM) for bankruptcy protection on 1 June 2009, there has been concern amongst investors about the value of a couple of series of Octave Notes, which are secured on collateralised debt obligation (CDO) that has GM in the reference portfolio.

3. Octave Notes are credit-linked notes (CLNs) arranged by Morgan Stanley & Co. International Limited (MS). CLNs are a form of structured financial product. The principal or interest payment, or both, of a CLN are primarily affected by the occurrence of "credit events" of a single or a group of reference companies. Credit events may be triggered by -

- (a) the insolvency of a reference company;
- (b) the inability of a reference company to repay its debt on the maturity date; or
- (c) the need of a reference company to re-structure its debts of a minimum prescribed amount.

4. The occurrence of credit events or other early redemption events such as collateral default may trigger early redemption. In such a case, the CLNs would cease to bear interests starting from the interest payment date immediately preceding the date upon which notice is given of the occurrence of the credit event or the date upon which the early redemption event occurs. Investors are likely to suffer severe loss on the principal amounts of CLNs. The extent of loss might vary from series to series, depending on the nature of the early redemption event and the value of the underlying collateral at the time of early redemption. As of 8 June, the GM bankruptcy has not resulted in early redemption of any series of the Octave Notes.

### **Regulatory Framework of CLNs**

5. Issuers of CLNs are required to make sufficient disclosure of product features and associated risks in the offer documentation to enable investors to assess whether the product is suitable for them to invest in. The requirements are stipulated in the Companies Ordinance.

6. Intermediaries selling or recommending CLNs to investors are required to conduct a suitability assessment of the investment for each investor, taking into account his or her particular circumstances, such as financial situation, investment experience and investment objectives. Intermediaries are also required to undertake their own product due diligence and to ensure that adequate risk disclosure is made during the selling process. The details of the regulatory framework and guidelines governing the offer and sale of CLNs to retail investors through the banking network are at **Annex A** (paragraphs 1.1 to 1.7)

### **Size of Octave Notes**

7. According to the latest information provided by the Hong Kong Monetary Authority (HKMA) and the Securities and Futures Commission (SFC), the outstanding amount of Octave Notes arranged by MS involved 15 series, around 8 300 customer accounts, HK\$1.8 billion, and 16 distributing banks and three brokerages. Further details of the Octave Notes are at **Annex A** (paragraphs 3.1 to 3.2).

## **Related Complaints**

8. As at 5 June 2009, about 500 Octave Notes-related complaints concern registered institutions, while six concern an SFC licensed corporation. Around 70 of the complaints are related to the outstanding series of Octave Notes, and the majority of which was received in the past week. The remaining ones are about the early redemption of the three series owing to the bankruptcy of Lehman Brothers in September 2008 and they have been dealt with together with the Lehman Brothers Minibonds complaints. The two regulators have respectively started preliminary investigations into the relevant complaints, and will follow up with fair and due process. A detailed breakdown of the complaint figures received by the regulators and the actions taken are at **Annex A** (paragraphs 5.1 to 5.3).

## **Actions Taken**

9. The Administration has earlier expressed concern to HKMA and SFC about the implications of the crisis of the US car manufacturing companies on the relevant series of Octave Notes. We have urged regulators to monitor the situation closely with a view to ensuring more timely and transparent disclosures by CLN issuers. The two regulators have reminded the issuers and distributors of the Octave Notes to share the latest information on the Notes with their clients, and to handle any enquiries from the investors effectively. MS has posted the relevant information online, and met with distributors of Octave Notes to keep them updated. For actions taken by HKMA and SFC, please refer to **Annex B**.

10. The Administration together with HKMA and SFC will continue to closely monitor the situation.

Financial Services Branch  
Financial Services and the Treasury Bureau  
June 2009

**HKMA's and SFC's Response to Items (a) to (e)  
Raised by the LegCo Financial Affairs Panel in its Letter  
dated 1 June 2009**

Item (a)

**1. Regulatory framework and guidelines governing the offer and sale of credit-linked products to retail investors through the banking network**

- 1.1 Credit-linked Notes (CLNs) such as Octave Notes are structured as debentures. The relevant prospectuses have to comply with the registration and applicable disclosure requirements in the Companies Ordinance (CO). Essentially, this means that the prospectuses must contain the matters specified in the Third Schedule to the CO unless otherwise exempted.
- 1.2 Apart from the specific matters required under section 38(1) or section 342(1) of the CO to be set out in the relevant prospectuses by applicable paragraphs in the Third Schedule to the CO, 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”. Further in accordance with section 38(1A) or section 342(2A) of the CO, the relevant prospectuses must contain a statement in a prominent position advising the reader to take independent professional advice in case of doubt about any of its contents.
- 1.3 To avoid double regulation, there is an express provision in section 103(3)(a) of the Securities and Futures Ordinance (SFO) such that where the prospectus has complied with or is exempt from compliance with Part II (for companies incorporated in Hong Kong) or Part XII (for companies incorporated outside Hong Kong) of the

CO, it is exempt from the offers of investments regime in Part IV of the SFO<sup>1</sup>.

- 1.4 As for marketing materials relating to CLNs, publication of advertisements in relation to a prospectus must be authorised by the SFC<sup>2</sup>. The marketing materials are designed to raise investors' interest in an offer. They do not take the place of the prospectus. Investors are directed in the marketing materials to read and understand the prospectus before investing. By definition, marketing materials are not prospectuses and therefore will not contain all relevant information for investors to make an informed investment decision. In reviewing the marketing materials, the SFC refers to the "Guidelines on Use of Offer Awareness and Summary Disclosure Materials in Offerings of Shares and Debentures under the CO" published by the SFC. The Guidelines require, among other things, 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 deceptive.
- 1.5 With regard to regulatory requirements on the sale of investment products (including credit-linked products) to retail investors through the banking network, they are primarily set out in the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the Code):
- (a) The Code lays down the requirements to be observed by intermediaries and their marketing staff in carrying out regulated activities under the Securities and Futures Ordinance, including the promotion of investment products to customers. Generally, the Code requires licensed or registered persons to act honestly, fairly, with due skill, care and diligence in the best interests of their clients (General Principles GP1 and GP2).
  - (b) More specifically, paragraph 5.1 of the Code requires licensed or registered persons to establish their clients' financial situation, investment experience and investment objectives. Thereafter, paragraph 5.2 of the Code provides that having regard to information about the client of which the licensed or registered person is or should be aware through the exercise of due

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<sup>1</sup> It is noteworthy that the reverse does not apply – i.e. if the investment product falls within the definition of "debenture", compliance with Part IV of the SFO *per se* will not exempt the issuer from compliance with the prospectus regime in the CO.

<sup>2</sup> See section 38B of the CO.

diligence, the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for that client is reasonable in all the circumstances.

- (c) Paragraph 5.3 of the Code further provides that, a licensed or registered person providing services to a client in derivative products, including futures contracts or options, or any leveraged transaction should assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.
- (d) In May 2007, the SFC issued questions and answers to clarify the suitability requirement under the Code of Conduct to all licensed corporations and banks, listing out specific matters that an intermediary should have regard to when making a recommendation or solicitation (FAQs). Areas covered include:
- know their clients;
  - understand the investment products they recommend to clients (product due diligence);
  - provide reasonably suitable recommendations by matching the risk return profile of each investment product with the personal circumstances of each client to whom it is recommended;
  - provide all relevant material information to clients and help them make informed investment decisions;
  - employ competent staff and provide appropriate training; and
  - document and retain the reasons for each product recommendation made to each client.
- (e) The Code (paragraph 4.1) requires intermediaries to ensure that their staff are competent, fit and proper to undertake investment sales, and to provide appropriate training.

1.6 In addition to the Code, since January 2003, the HKMA has issued a guideline and 12 circulars to registered institutions (RIs) to provide

practical guidance on the expected standards and good practices in relation to sale of investment products (including credit-linked products). A list of the guideline and circulars is attached at **Appendix** for reference.

- 1.7 The HKMA's regulatory approach regarding the regulated activities of RIs comprises two pillars: day-to-day regulation and enforcement. In its day-to-day regulation of RIs, the HKMA adopts the standards set by the SFC, supplemented by additional guidance or requirements promulgated by the HKMA from time to time taking into account regulatory experience and market conditions. In terms of methodology, the HKMA conducts on-site examinations and off-site reviews of RIs' regulated activities. Where incidents involving possible misconduct or breach of the relevant statutory provisions or regulatory requirements are identified in the day-to-day regulatory work, such cases are referred to the HKMA's securities enforcement team for investigation: this may lead either to disciplinary proceedings by the HKMA or referral to the SFC for any action that it might consider appropriate. If sufficient evidence is found after investigation into those cases, the RI concerned and its staff are subject to the same range of disciplinary sanctions as would be the case of firms or individuals regulated directly by the SFC.

Item (b)

**2. Banks involved in selling retail credit-linked products, with information on banks which have sold Octave notes**

- 2.1 Based on information available in relevant offering documents authorized by the Securities & Futures Commission, a total of 20 authorised institutions (AIs) are involved in the distribution of retail CLNs which remained outstanding as of May 2009. Among these AIs, 16 of them have distributed Octave Notes.

Item (c)

**3. Information on each series of Octave Notes sold to retail investors through banks, including the collateralized debt obligations contained in the Octave Notes as underlying assets**

3.1 Octave Notes (Note) was issued by Victoria Peak International Finance Limited (Issuer), while Morgan Stanley & Co. International Limited (MS) is the arranger of the Note. The Note is a CLN. In brief, the Issuer uses funds received from Note holders to purchase an equal amount of underlying securities (mostly collateralized debt obligations, CDOs). The Issuer also enters into swap agreements, including credit default swaps, which enables the Issuer to pay an enhanced interest rate to Note holders. Octave investors are subject to, among other risk factors, credit risk, which comprises mainly of (i) counterparty risks; and (ii) the occurrence of (a) credit event of reference entities as specified in each series of the Note and (b) default event of the underlying CDOs. A typical CDO underlying the Note is referenced to over a hundred investment grade corporate names (reference pool) and has a credit rating which is one of the top three investment grades at the time of purchase. Since the start of the global credit crisis, some CDOs had been substantially downgraded to below investment grade.

3.2 As of end September 2008, there were in total 18 series of the Note outstanding, three of which had Lehman Brothers as one of the reference entities, thus were early redeemed after Lehman Brothers' filing of bankruptcy protection, resulting in substantial losses to the relevant Note holders. Regarding the remaining 15 series, MS has disclosed on its website comprehensive information for existing Note holders' reference ([www.morganstanley.com/octavenotes](http://www.morganstanley.com/octavenotes)).

#### Item (d)

#### **4. The total value of credit-linked products sold to investors, with breakdown on the value of Octave Notes**

4.1 Based on information provided to the SFC by the various issuers of unlisted retail credit-linked notes (CLNs), the total issue size of CLNs issued from June 2003 is approximately HK\$24,889 million. Of this amount HK\$2,557 million concerns the Octave Notes sold to retail investors, of which about HK\$1.8 billion remain outstanding.

Item (e)

**5. Number of complaints received on Octave Notes, progress of investigation of these complaints, and measures to follow up the complaints, such as whether the Government will consider putting forward some form of “buy-back proposal” for the banks concerned to buy back the Notes from the retail investors**

5.1 As at 5 June 2009, HKMA has received about 500 Octave Notes-related complaints, including those referred by SFC. Of which, 430 cases are Lehman Brothers-related and have been dealt with together with Lehman Brothers Minibonds complaints. The remaining 70 cases are non-Lehman Brothers-related and the majority of which were received in the past week. HKMA will deal with these complaints according to due and fair process.

5.2 As at 5 June, SFC had received 181 Octave Notes-related complaints since the collapse of Lehman Brothers in September 2008. Among these complaints, 143 were related to Lehman Brothers’ collapse. The SFC has referred 171 out of the 181 complaints to HKMA for follow-up.

5.3 The complaints on Octave Notes are basically subject to the same enforcement process as that for Lehman Brothers-related complaints. While observing the due process and the overriding principles for fairness, integrity and legal compliance, the HKMA will make every effort to deal with these complaints in the shortest possible time.

**Guideline and circulars issued by the HKMA since January 2003 in relation to sale of investment products**

<b>Guideline</b>	<b>Date</b>
Supervisory Policy Manual module SB-1 “Supervision of Regulated Activities of SFC-Registered Authorized Institutions”	28 March 2003
<b>Circulars</b>	<b>Date</b>
“Calls in Relation to Securities or Futures Products and Services”	13 January 2003
“SFC Guidelines for Addressing Analyst Conflicts of Interest”	8 November 2004
“The Securities and Futures Commission’s Report (the Report) on Selling Practices of Licensed Investment Advisers”	1 March 2005
“Retail Wealth Management (RWM) Business”	3 March 2006
“Thematic Examinations on Investment Advisory Activities”	1 March 2007
“Questions and Answers on Suitability Obligations Published by the Securities and Futures Commission (SFC)”	7 May 2007
“The Securities and Futures Commission’s Report on Findings of Second Round of Thematic Inspection of Licensed Investment Advisers (the Report)”	1 June 2007
“Selling of investment products to retail customers” ( <i>This circular was initially sent to selected retail banks on 23 October 2008 and then re-issued on 11 December 2008 to other RIs.</i> )	23 October 2008
“Circular Issued by the Securities and Futures Commission (SFC) on the Revised Advertising Guidelines Relating to SFC-authorized Collective Investment Schemes”	2 January 2009
“Report of the HKMA on Issues Concerning the Distribution of Structured Products Connected to Lehman Group Companies”	9 January 2009
“Circular Issued by the Securities and Futures Commission (SFC) Regarding Self-Examination of Controls and Procedures on Suitability Obligations”	26 February 2009
“Implementation of recommendations in the HKMA’s Report on Issues Concerning the Distribution of Structured Products Connected to Lehman Brothers (“the HKMA’s Report”) ”	25 March 2009

**Actions taken by HKMA**

- HKMA has already taken a number of steps, including the issuance of circulars and reminders, with a view to ensuring that banks implement adequate measures to manage the risks associated with retail investment products sold to customers. These measures include -
  - performing continuous review of the risk ratings assigned to investment products, taking into account latest market conditions and other relevant factors, and alert affected customers if there is a change to higher risk rating;
  - putting in place adequate procedures to ensure that their customers are made aware of all relevant information issued or made available by the issuers of these products in a timely manner; and
  - keeping their relationship managers well briefed on the information so that they can competently handle enquiries from their customers.
- HKMA has asked the distributing banks to proactively re-examine the selling process of the Octave Notes, in particular those sold to vulnerable customers. For cases which are identified by distributing banks as potentially involving mis-selling, the banks are required to report to HKMA and requested to explore ways to reach settlement with the affected customers.

**Actions taken by SFC**

- SFC has issued press releases to urge structured notes investors to seek updated information and warn them about indirect credit exposure. The Chief Executive Officer of SFC also conveyed similar message in public speeches on various occasions.

- The arranger of Octave Notes, i.e. MS, has published Octave Notes information online, and met with the distributors of the Notes to update them about the Octave Notes, and to address any concerns they may have. SFC has also been corresponding with MS to obtain updates on the Notes.
- SFC has issued letters to broker distributors of retail credit-linked notes (including Octave Notes) to remind them to take appropriate steps to bring material information regarding the notes to the attention of their clients in a timely manner, and alerting them to check the information on the relevant website of MS.
- SFC has liaised with HKMA on reminding distributors to pass any relevant information from the issuers onto the ultimate investors.