

Circular - Investment products related to Lehman Brothers

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23 September 2008

The Chief Executive
All registered institutions

Dear Sir / Madam,

Investment products related to Lehman Brothers

The HKMA notices that there are concerns among members of the public who had purchased from registered institutions (RIs) investment products related to Lehman Brothers (Lehman). These include structured notes issued by Lehman and credit linked notes put out by other issuers with Lehman as one of the reference entities.

Handling of enquiries and complaints

In view of the large number of investors in these Lehman products, I would urge all relevant institutions to be as transparent and forthcoming as possible in providing information to them. In particular I would like to draw your attention to the circular issued by the Securities and Futures Commission (SFC) on 19 September 2008, which is applicable to all RIs. The circular provides that, as institutions are expected to receive enquiries and complaints from their customers about investment products under current market situation, they should deal with these enquiries and complaints fairly and honestly with the level of skill, care and diligence expected under the SFC Code of Conduct and in the best interests of the client. The circular is attached as Annex and is also posted on the SFC's website (www.sfc.hk).

To further assist the relevant investors, the Hong Kong Monetary Authority (HKMA) requires all RIs which had sold Lehman products at the retail level to:

1. write directly to inform their relevant customers to explain clearly the latest situation with regard to these Lehman products, how the customers have been affected, and what options, if any, are available to them;
2. immediately establish a dedicated, manned (not machine-operated) telephone hotline to answer enquiries from their customers who had bought these products and notify the HKMA of the hotline number; and
3. arrange briefings / updates for your customers who had purchased these Lehman products.

Your institution is expected to put in place the above measures as soon as possible. I would appreciate if your institution could provide us in writing, through your usual supervisory contact, what measures are being taken (with dates of implementation) as soon as possible, but in any case, on or before the close of business this Wednesday (24 September).

Selling of investment products

I should remind all institutions that you are required to comply with the SFC Code of Conduct in selling securities and futures products. Among other things, the Code requires intermediaries to explain to the clients the products and the risks involved. Institutions are also required to assure themselves that customers understand the nature and risks of the products and which are consistent with the customers' investment objectives. Institutions should also assure that the customers have sufficient net worth to assume the risks and bear the potential losses of trading in the products. In addition, according to the HKMA Supervisory Policy Manual¹, before an institution launches a new product or service, the risk management function (which should be independent from the business units that generate risks and have a direct reporting line to the relevant risk management committee or senior management) should ensure that the risks are well understood and adequately assessed, and all relevant departments, e.g. risk control, accounting, operations, legal and compliance, should be consulted as appropriate.

In view of the current market situation, the risk level of many products may have risen. Your institution is expected to immediately review, if it has not done so already, the risk level of all investment products being sold to ensure that they are sold only to customers with comparable risk appetite.

Moreover, your institution should critically review the selling process for these Lehman products to determine if there are areas which fall short of the requirements under the SFC Code of Conduct and other relevant rules and regulations (such as the Q&As on suitability obligations published by the SFC on 8 May 2007), and implement enhancements where necessary.

Yours faithfully,

Nelson Man
Executive Director
Banking Supervision Department

c.c. SFC (Attn: Mr Martin Wheatley, Chief Executive Officer)

Encl. Annex - Circular by the SFC (PDF file, 276KB)

¹ See sections 4.3 and 5.1 of module IC-1 "General risk management controls" of the HKMA Supervisory Policy Manual.

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19 September 2008

Circular to All Licensed Corporations and Registered Institutions

This circular is directed to licensed and registered persons ("regulated persons") who have made investment recommendations or solicited clients in respect of investment products that may be affected by current market conditions.

Regulated persons are again reminded of their obligations under the Code of Conduct¹ to ensure suitability of their recommendation or solicitation for investors. The SFC posted on its website (www.sfc.hk) on 8 May 2007 a list of questions and answers ("FAQs") on the obligations of regulated persons to ensure that investment recommendations and solicitations to clients were suitable for each client. On the same day, the SFC issued a circular to all licensed corporations advising them of the FAQs on suitability obligations.

All regulated persons should take note that compliance with the rules and regulations including guidance in the FAQs will determine whether a regulated person is fit and proper to carry out regulated activities in Hong Kong.

Dealing with inquiries and complaints from clients or investors

Regulated persons are expected to receive a number of inquiries and complaints from concerned clients and investors about investment products under current market situation. SFC expects regulated persons to deal with all inquiries and complaints fairly and honestly with the level of skill, care and diligence expected under the Code of Conduct and in the best interests of the client.

Regulated persons should review their existing systems for complaints handling to ensure their systems are both in order and ready to deal with potential complaints from clients.

Under the Code of Conduct, regulated persons owe specific obligations to clients who have complaints. The Code of Conduct requires regulated persons to ensure that:

- complaints are handled in a timely and appropriate manner;
- steps are taken to investigate and respond promptly to complaints; and
- where a complaint is not remedied promptly, the client is given advice as to further steps that can be taken.

Regulated persons have a responsibility to :

- provide assistance to clients with inquiries and complaints;
- understand and be able to explain the nature and characteristics of the investment product that has been sold to the client especially in the current market environment; and

¹ Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission



- give clear and competent advice to clients about what options may be available to them.

The SFC will pay close attention to the number of complaints made about firms who do not comply with the requirements of the Code of Conduct. A large number of complaints against a single firm may indicate the firm is not adequately complying with its obligations under the Code of Conduct. The SFC will take action in these cases, including enforcement action where appropriate.

All regulated persons that have distributed either retail structured notes issued by the Lehman Brothers Group, or credit linked notes issued by other issuers with Lehman Brothers as one of the reference entities are expected to set up sufficient telephone hotlines to answer clients' inquiries and should ensure that the hotline telephone numbers are widely publicised.

Regulated persons with clients holding retail structured notes issued by the Lehman Brothers Group

We would like to remind regulated persons involved in the sale of retail structured notes issued by the Lehman Brothers Group about the SFC's press statement issued on 17th September 2008 clarifying certain issues on Lehman Minibonds (issued by Pacific International Finance Limited). The SFC reminds Minibonds investors that any early redemption amount investors may recover will depend upon a number of factors, including the nature and value of the collateral, the amount due under the swap arrangements and the costs, fees and expenses of selling the collateral in the market.

Furthermore regulated persons are generally responsible for holding such notes on behalf of investors, paying distribution amounts and passing on any notices from the issuer. When a credit event or other event of default is determined to have occurred resulting in early redemption, this information is made available through the clearing system as is the information on the early redemption amount and the date it will be paid. It is the regulated persons' duty to pass this information to investors.

The filing by Lehman Brothers Holdings Inc. of a petition under Chapter 11 of the U.S. Bankruptcy Code is likely to constitute an event of default under the swap arrangements Lehman Brothers entered into in respect of the Lehman Brothers retail structured notes. If so the affected notes will, subject to conditions and to a number other procedures, be subject to early redemption unless any or all the trustees for the notes direct otherwise.

Following termination of the swap arrangements, the collateral for the notes will be sold in the market. The proceeds from the sale of the collateral will be adjusted to take into account any payment which is due to Lehman Brothers on termination of the swap arrangements and for the costs, fees and expenses of making the sale. The proceeds would then be available for repayment to the affected investors. It is likely that the early redemption amounts will be less, and could be significantly less, than the original investment amounts. The determination of the early redemption amount for each series of the affected notes is likely to take some time.

The SFC has been in contact with the trustees for retail structured notes offered by Lehman-related entities; these trustees, which are all identified in the relevant prospectuses, are as follows:-



- for Minibonds offered by Pacific International Finance Limited: HSBC Bank USA, National Association, Issuer Services
- for notes offered by Atlantic International Finance Limited: The Hongkong and Shanghai Banking Corporation Limited
- for notes offered by Pyxis Finance Limited: HSBC Trustee (C.I.) Limited.

Each trustee is required to act in the best interests of retail investors and has engaged or may engage legal counsels to explore all options available to each series of the affected notes. It is likely that the trustees will take some time to determine any early redemption amount payable under these notes. In the meantime, investors are not required to submit any claims but await notification from the trustees, via their distributor.

Regulated person with clients holding credit linked notes issued by other issuers with Lehman Brothers as one of the reference entities

There are 3 issuers whose credit linked notes reference Lehman Brothers as one of the reference entities:-

- Constellation Investment Ltd. has 32 series of credit linked notes that reference Lehman Brothers
- Sparc Limited has 2 series of credit linked notes that reference Lehman Brothers
- Victoria Peak International Finance Limited has 3 series of credit linked notes that reference Lehman Brothers

The calculation agent of each series of notes will determine whether the filing by Lehman Brothers Holdings Inc. of a petition under Chapter 11 of the U.S. Bankruptcy Code constitutes a credit event under the terms and conditions of the notes. If this is determined, the issuers will issue a credit event notice to the regulated persons who acted as distributors and notify them of the occurrence of the credit event.

Upon determination of the occurrence of the credit event, the calculation agent of the notes will determine the credit redemption amount that is payable to investors. The credit redemption amount for a series of notes is normally calculated as follows:-

- aggregate nominal amount of a series of notes MINUS
- the amount of loss on the Lehman Brothers' reference obligation (this is determined by reference to prices quoted by market participants for the Lehman Brothers' note that was identified in offer documentation) MINUS
- the termination value of any swap, hedging and/or financial arrangements MINUS
- the difference between the face value and sale proceeds of the collateral (in the event that the sale proceeds is greater than the face value, the difference will be added rather than subtracted)

It is likely that credit redemption amounts will be less, and could be significantly less, than the original investment amounts.

If a credit event is determined to have occurred resulting in early redemption, this information is made available through the clearing system as is the information on the credit redemption



amount and the date it will be paid. It is the regulated persons' duty to pass this information to investors.

According to SFC understanding, the determination of whether the credit event has occurred will be made towards the end of next week but at the discretion of the calculation agents, this determination may be made at a later date.

Regulated persons are advised to take a more pro-active role in addressing investors' enquiries about their investments. For and on behalf of investors in order to ascertain the latest positions, regulated persons should approach:

- the trustees of retail structured notes offered by the three Lehman-related entities.
- the arrangers of the credit linked notes with Lehman Brothers as one of the reference entities.

Securities and Futures Commission

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SFO/IS/019/2008