



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

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29 December 2003

To all intermediaries dealing with clients who invest in structured products

Advice to Investors on Structured Notes

The SFC issued a press release today to give investors general advice on structured notes. We write to remind you that pursuant to the requirements under the Code of Conduct for Persons Licensed by or Registered with the Commission (“the Code”), you should assure yourselves that your clients understand the nature and risks of the products and have sufficient net worth to assume the risks and bear the potential losses of trading in the products. You should also ensure the suitability of your advice and recommendations for your clients in these products are reasonable in all the circumstances. For more details, you should refer to the Code which is available on the SFC’s website www.hksfc.org.hk.

The SFC has noted that a wide range of structured notes, such as equity-linked notes (ELNs) and credit-linked notes (CLNs), are now available in the retail market. Generally speaking, ELNs are a debt instrument where the coupon or repayment of principal whether in cash or physical delivery of the reference shares are conditional on the performance of a single stock or a basket of stocks. CLNs are notes under which payments of interest, principal or both are affected by the occurrence of “credit events” of a single company or a group of companies. A “credit event” may refer to situations where the reference company becomes insolvent or fails to repay its loans of a certain aggregate amount.

Among other things, the press release informs prospective investors in ELNs and CLNs that there are many different types of retail notes or bonds in the Hong Kong market place, many of which have unique and/or distinctive features, and not all retail notes or bonds will be capital protected.

In light of their sophisticated nature, investors are reminded to read carefully the contents of the offer documents or the term sheet to understand the pay-off mechanism and other terms and conditions of structured notes. This is to ensure that they are aware of each issue’s unique features and understand how it works before making an investment decision. They should also check the issuer’s creditworthiness, any secondary market arrangement, etc. to assess product suitability. Investors are also advised to seek professional financial advice if they are in any doubt.



SFC Website: <http://www.hksfc.org.hk>



Electronic Investor Resources Centre: <http://www.hkeirc.org>



To help investors learn more about structured notes, we have published two educational articles *Explaining Structured Notes* and *Evaluating Structured Notes*. To facilitate your explanation of the characteristics of structured notes to your clients, we attach below the two articles for your reference. We have also published other educational materials on bonds on the “Features” section of the SFC-operated Electronic Investor Resources Centre at www.hkeirc.org.

Investor Education and Communications Department



SFC Website: <http://www.hksfc.org.hk>



Electronic Investor Resources Centre: <http://www.hkeirc.org>

Investor Education

Explaining Structured Notes

As a result of market innovation in the prevailing low interest rate environment, you can now purchase through banks and brokers notes with their returns linked either to the price of a stock or a basket of stocks, or to the credit quality or performance of a single company or a group of companies by reference to certain defined events which adversely affect the creditworthiness of such company or companies. How are these notes different from traditional “plain vanilla” bonds?

First, what are equity-linked notes (ELNs)?

ELNs are a debt instrument where the return on investment is tied to the performance of a single stock or a basket of stocks. Movements in the value of the underlying stocks or basket of stocks may therefore adversely affect the return on your investment and may also adversely affect the market value of the ELNs prior to or upon maturity. Coupon rates on an ELN may be fixed for part of the life of the note, with subsequent coupons tied to the closing price of a stock or a basket of stocks (or a pre-determined stock within such basket, for example, the worst performing one) on a defined date or over a defined period by reference to a pre-determined formula.

Normally where an ELN is linked to a single stock, the closing price of such stock on a designated valuation date prior to maturity will, in the case of a bull ELN, determine whether investors will receive shares (by reference to a strike price determined prior to the issue of the notes) or repayment of the principal amount at maturity. You should note that where the notes are redeemed at maturity by physical delivery of the underlying shares, the value of your investment will equal the market value of the shares you receive, which could be substantially less than the value of your original investment. In the case of a bear ELN investors will, depending on the terms of such ELN, either sell such number of the underlying shares at the strike price or receive a cash payment from the issuer calculated at a predetermined formula (which could be substantially lower than the value of your original investment depending on the extent of the difference between the closing price and the strike price).

Where an ELN is linked to a basket of stocks, you may receive a cash payment or physical delivery of a particular stock in the basket identified on the designated valuation date.

The examples given below are for illustrative purposes only. You should note that an ELN may possess different features not covered by the illustrations. Make sure you study carefully the features of the notes (and, in particular, the formula used to determine the return on your investment) set out in the offer document and/or term sheet.

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Example 1: A ELN linked to a single stock

Suppose you have bought a 5-year ELN linked to Stock A with a strike price of \$80. Interest (or the “coupon”) is payable annually at a fixed rate of 7% in each of the first and second years. The coupon rate for subsequent years will be calculated based on the following formula:

The greater of 0% or 7% x factor, where

factor = [No. of trading days during the observation period when the closing price of Stock A \geq \$80] / Total no. of trading days of the observation period.

observation period = the whole coupon period shifted forward by 12 trading days.

coupon period = the period for which interest is payable in respect of the 3rd, 4th and 5th year.

Scenario 1:

During the 3rd year, there are 150 trading days out of the 248 trading days in the observation period that the price of Stock A remains at or above \$80. Therefore, the coupon rate for the 3rd year will be 4.2%(=7% \times 150/248).

Scenario 2:

Due to weak market sentiment, Stock A stays below \$80 over the whole observation period during the 4th year. Therefore, the factor will become zero and the coupon rate will be 0%.

Example 2: A ELN linked to a basket of stocks

Suppose you have bought a 4-year ELN which is linked to a basket of US stocks. Interest is payable annually at a fixed rate of 4% in the first year.

The coupon rate for subsequent years will be calculated according to the following formula:

The greater of 0% and 4% +(20% x reference rate), where

reference rate = rate of return of the worst performing constituent stock during the observation period.

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rate of return of a constituent stock = [(Closing price as at a coupon fixing date/Closing price as at the base date) – 1] x 100%

Scenario 1:

Suppose on the second coupon fixing date, the rate of return of the worst performing constituent stock is 2%. Therefore, the coupon rate for the 2nd year is 4.4% (=4%+(20% x 2%)).

Scenario 2:

Suppose on the third coupon date, the worst performing constituent stock reports a loss of 30% in its stock price relative to the base date. Then the coupon rate for the 3rd year becomes 0%. [As 4%+(20% x (-30%)) equals to -2%, 0% is taken as the coupon rate.]

Some notes may offer a “locked-in” return so that the coupon rate in a certain year will be at least equal to that of the immediately preceding year.

What about credit-linked notes (CLNs), how do they work?

CLNs are notes under which payments of interest, principal or both are affected by the occurrence of “credit events” of a single company or a group of companies. What constitutes a “credit event” depends on the technical definitions applicable to a particular issue and in general includes situations where the reference company (or companies in a reference portfolio) becomes insolvent, or fails to repay its loans of an aggregate amount of, say, at least US\$1 million, or faces an obligation to repay its loans before maturity, etc.

Depending on the structure, a CLN with principal protection may offer variable coupon rates conditional on the cumulative number of credit events which have occurred in respect of a reference company (or companies in a reference portfolio) since the issue date. For example, while a CLN linked to a portfolio of companies may have a fixed coupon rate of 4% for the first year, subsequent coupon rates may be determined by the cumulative number of credit events - the more the number of credit events, the lower the coupon rate. Thus, the coupon rate may go down to 3% with the occurrence of one credit event, dropping further to 2% with the occurrence of two credit events. The terms of the CLN may provide that no further payments of interest will be made once four or more credit events occur.

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A CLN may also be structured in such a way that gives you a fixed coupon rate over its life, subject however to the occurrence of a credit event in respect of the underlying company or any of the reference companies in a reference portfolio. Once a credit event occurs, you will no longer be entitled to receive any further interest payment, including what has been accrued since the last interest payment date before the occurrence of such credit event. Your note will also be redeemed on or before the maturity date, possibly at an amount substantially less than the principal amount you invested. Such redemption amount will be calculated in accordance with the terms set out in the offer document or term sheet but will often depend on the net sale proceeds after expenses when particular debt instruments of the reference company in question are sold following the credit event.

A “first-to-default” CLN means the relevant credit event that triggers the credit linked redemption of the notes is the first default of any of the reference companies. In the event that a credit event occurs in respect of any one of the reference companies, the redemption value of the notes is reduced by the fall in the value of particular debt instruments of the relevant reference company. The credit risk that you bear under the notes is not allocated to any particular reference company in any proportion. After the declaration of a credit event in relation to any such company, interest ceases to be payable (including interest accrued since the last interest payment date before the occurrence of the credit event) and the note will be redeemed on or before the maturity date in accordance with the terms of such note. The value of such CLN is likely to drop substantially.

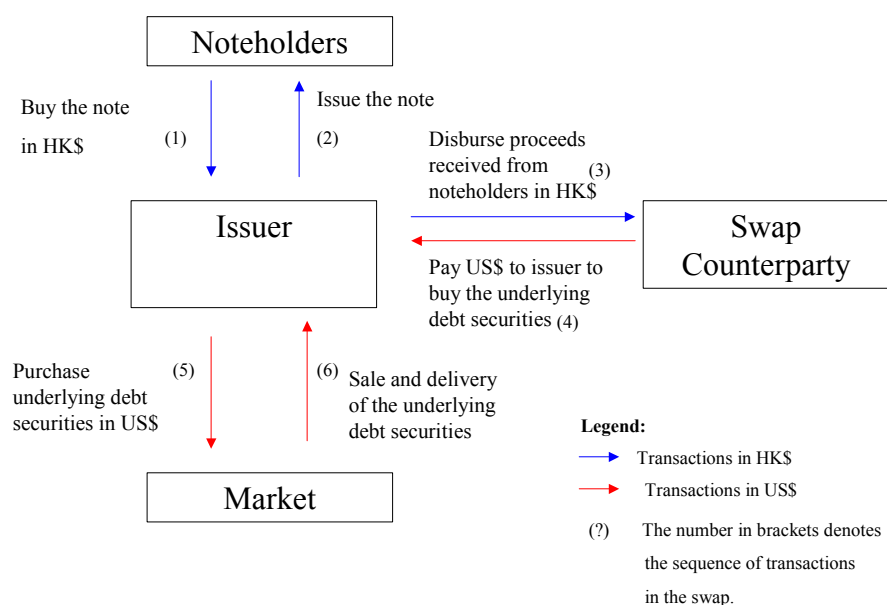
Are there any special arrangements behind the ELNs or CLNs?

There may be complex swap arrangements behind some ELNs or CLNs. In certain cases, issuers may use the funds raised from the offering of the notes to buy underlying debt securities with matching cashflows to the relevant notes which are specially issued by the associated companies of the arranger of the notes. Repayment of interest and/or principal of the notes is backed by cashflows from the underlying debt securities. If the notes and the underlying debt securities are denominated in a different currency, issuers will need to enter into a cross-currency interest rate swap agreement. The diagrams below illustrate the cashflows behind a note which is issued in HK\$ but the underlying debt securities on which the note is secured are denominated in US\$. Such an arrangement introduces another risk factor in that the default of the counterparty in the swap arrangement may affect the issuer’s ability to repay the interest and/or principal under the notes to the noteholders. Also, upon any default it is likely that expenses will be incurred in unwinding the swap arrangements and these costs will reduce the proceeds available for repayment to noteholders.

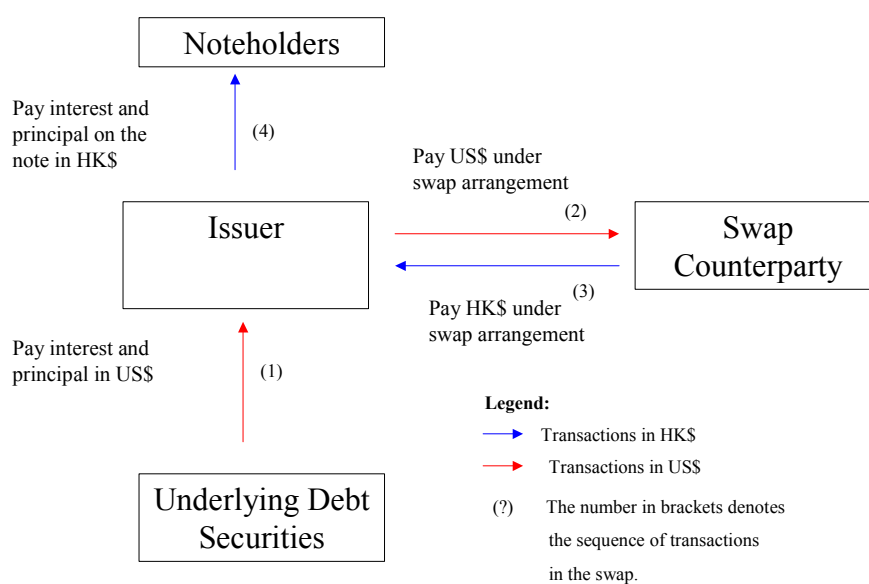
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Explaining Structured Notes

Movement of Initial funds



Payment Cashflows



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Evaluating Structured Notes

Since structured notes are sophisticated instruments, you should consider carefully whether they are suitable for you in light of your experience, financial position, investment objectives and other relevant circumstances. The following questions may help you:

- ***Who is the issuer?***

CLNs or ELNs are usually linked to well known companies. However, don't confuse these companies with the issuers of the notes. The notes do not constitute obligations of the reference companies underlying the notes. It is the issuer, rather than the company or companies to which the return on the notes is linked, which owes money to the noteholder and is obligated to pay the interest and repay principal under the notes.

CLNs or ELNs may be issued either by large international financial institutions or their affiliates or by thinly-capitalised special purpose vehicles not affiliated with such financial institutions. The performance of obligations by a thinly capitalised issuer will not necessarily be guaranteed by another company.

- ***How creditworthy is the issuer?***

The issuer's creditworthiness reflects its ability to repay noteholders the principal and interest. As previously mentioned, some issuers are thinly-capitalised special purpose vehicles not affiliated with the large international financial institutions acting as arrangers for the offering of the notes. CLNs or ELNs issued by such special purpose vehicles are sometimes structured so that proceeds from the offering are used by the issuer to acquire, for example, certain underlying debt securities with matching cashflows guaranteed by, say, the holding company of the arranger, on which the notes are secured. You should note that the "guarantee" given in relation to the underlying debt securities does not extend to the notes themselves. It only means that the issuer is guaranteed repayment of principal and interest in respect of the underlying debt securities held by it. Such notes will also usually contain a "limited recourse" provision. Whether the issuer can meet its obligation under the notes depends on the receipt by the issuer of monies due to it under such underlying debt securities. The "limited recourse" provision has the effect of restricting the noteholder's claim against the issuer for non-payment of principal or interest to the underlying debt securities or any money derived from it, which means that you cannot make any further claim against the issuer.

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Evaluating Structured Notes

- ***What is my exposure to the subject matter underlying the ELN or CLN?***

An investment in ELNs or CLNs is not an investment in the securities or assets underlying such notes and you have no rights (e.g. voting rights) in respect of such underlying securities or assets. However, movements in the value of the underlying securities or assets or changes in the perception of the credit quality of the underlying reference companies (e.g. a downgrading of their credit ratings) may adversely affect the market value of the notes you hold.

- ***Is the note backed by a guarantor?***

The presence of a guarantor guaranteeing the obligations of the issuer under the notes can provide an additional layer of protection to the noteholder. A guarantor is a third party (usually the holding company of the issuer) which agrees to repay you the interest and/or principal in case the issuer defaults. The presence of a guarantor should not be confused with “capital protection” or “principal protection” i.e. the return on maturity of the amount invested in the notes. It is quite possible for the obligations of the issuer to be guaranteed, and at the same time for the terms of the notes to result in a repayment on maturity or early redemption of an amount which is less or substantially less than the amount invested.

- ***Can the maturity date of the note be changed at the option of the issuer?***

The terms of the note may allow the issuer to extend its term if it wishes. This means you should be prepared that the principal owed to you may be repaid at the option of the issuer on a specified date which may be three years later than the original maturity date. In case you need cash urgently, selling the note in the secondary market is the only way to encash your investment.

Alternatively, the issuer may have a call option which allows it to redeem all or part of the notes before their scheduled maturity date. This option exists solely for the benefit of the issuer and will be exercised when it is in the issuer’s interests to do so. Generally where a call option is exercised, investors will receive a predetermined redemption amount but this may depend on the performance of the underlying asset and this amount may be less than the initial investment made.

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Evaluating Structured Notes

- ***Will there be a secondary market for the notes?***

Unless the CLNs or ELNs are listed on the Stock Exchange, there will not be an established trading market for the notes upon completion of the offer. Although there may be market making arrangements in respect of the notes, the market maker is usually under no obligation to make a market in the notes and you may not have access to a firm bid or offer price for the notes, or such price may not be one at which you wish to purchase or sell.

The prices at which the CLNs or ELNs may be traded in the secondary market, if one develops, may be different from the price at which you acquired the notes depending on many factors including prevailing interest rates, interest rate expectations, perceptions of an issuer's credit quality, the price of the reference stock, time remaining to maturity and the market for any similar products. Such prices, together with the terms of these structured notes, will determine the return on your investment in such instruments. With a structured note, you are exposed to much more than just the credit risk of the issuer.

You should also be aware that your total return on the notes will be affected by fees charged by your broker or dealer in respect of the operation of your investment account, transfers of notes, custody services and collection of interest and principal payments.

- ***What are my rights as a noteholder?***

In most cases, CLNs or ELNs are represented by a global note deposited with a nominee on behalf of the relevant clearing systems through which the notes are held and traded. Definitive certificates will only be issued in respect of the notes in very limited circumstances (for example, closure of the relevant clearing systems for a continuous period of 14 days). You should be aware that for the purposes of the terms and conditions of the notes (including provisions governing payments, notices and meetings of noteholders etc), the term "noteholder" will, where the note is represented by a global note held through a clearing system, mean the nominee of the clearing system or the dealers through whom the notes are acquired and held and who are shown in the records of the clearing system as a holder of a principal amount of the notes. You will therefore have to rely on your broker to credit your account with payments credited to your broker through the clearing system and to distribute to you notices which your broker receives through the clearing system from the issuer of the notes. If the notes incorporate a redemption feature, which allows either

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the issuer or you to early redeem the notes or to select between cash or physical settlement at maturity, any notice required to be given by you to the issuer must be given through the clearing system by your broker.

If the ELNs or CLNs are not listed on the Stock Exchange, any dealings in them will be off-exchange transactions. Investors will not be covered by any investor compensation fund established to provide compensation in respect of listed securities in the event of broker default.

Look up the feature details

There are different types of retail notes or bonds in the market, many of which have unique and distinctive features. Not all retail notes or bonds, including ELNs and CLNs, are capital protected. As the market for such structured notes develops, novel features that are not present in previous note offerings may evolve. This article does not seek to cover all risks relating to an investment in such notes and, in practice, no such article would be able to do so. You should carefully read the contents of the offer document or the term sheet, which can help you understand the features of a note or a bond. When in doubt, consult your financial adviser as to the suitability of the note or bond as an investment.