

31 March 2016

Circular to Licensed Corporations

Distribution of bonds listed under Chapter 37 of the Main Board Listing Rules¹ and local unlisted private placement bonds

The Commission has observed an increasing number of licensed corporations (“LCs”) distributing corporate bonds to retail investors² and high net worth investors³ in recent years. The bonds sold by LCs included bonds offered for subscription and listed under Chapter 37 of the Main Board Listing Rules (“Chapter 37 Bonds”)⁴ and unlisted bonds issued by Hong Kong listed companies (or their non-operating subsidiaries) and offered for subscription via private placement (“Local Unlisted Private Placement Bonds”) (together referred to as “Bonds”). Many of the Bonds contain complex features and/or inherent risks including lack of a secondary market which results in them being highly illiquid.

From our recent inspections, LCs distributing the Bonds appear to be running the following compliance risks in relation to their selling practices:

- 1) LCs providing potentially misleading or inaccurate information⁵ to clients about the nature and/or risk of the Bonds, which appeared to be inconsistent with the requirements of the Code of Conduct⁶ on selling practices. This might constitute an offence under section 107 of the Securities and Futures Ordinance⁷;
- 2) LCs seemingly doing insufficient due diligence⁸ to appropriately understand the risk-return profile of the Bonds before recommending them to clients. We found cases where LCs recommended the Bonds to clients outside of the appropriate risk categories due to inadequate understanding of the Bonds. This appeared to be inconsistent with the suitability requirements⁹ of the Code of Conduct;

¹ The Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited.

² The term “retail investor” refers to any person other than a professional investor as defined in Part 1 of Schedule 1 to the Securities and Futures Ordinance.

³ The term “high net worth investor” refers to a professional investor falling under paragraph (j) of the definition of “professional investor” in Part 1 of Schedule 1 to the Securities and Futures Ordinance who has a portfolio or total assets of not less than the applicable monetary threshold specified in the Securities and Futures (Professional Investor) Rules (i.e., the \$8 million minimum portfolio threshold for individuals; and the \$8 million minimum portfolio threshold or the \$40 million minimum total assets threshold for corporations).

⁴ Some main features of Chapter 37 Bonds are: i) they are not issued to the public and are targeted at professional investors only which includes high net worth investors because of waivers granted since 2011 under Rule 2.04 of the Main Board Listing Rules (for details, please refer to the [circular](#) issued by the HKEx on 30 March 2012); and ii) issuers of Chapter 37 Bonds include listed companies or their non-operating subsidiaries.

⁵ We observed that the issuers of the Bonds were not always correctly stated in the product documentation provided to clients. We also noted an example where the product documentation of a Chapter 37 Bond provided to clients contained inaccurate information regarding the internal risk rating assigned by the LC to the bond. Also, the product documentation did not appear to give a balanced view of the potential upside versus the downside investment and credit risks of the bond.

⁶ Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code of Conduct”).

⁷ Section 107(1)(a)(i) of the Securities and Futures Ordinance provides that “a person commits an offence if he makes any fraudulent misrepresentation or reckless misrepresentation for the purpose of inducing another person to enter into or offer to enter into an agreement to acquire, dispose of, subscribe for or underwrite securities”.

⁸ Paragraph 3.4 of the Code of Conduct and paragraph VII.3 of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission.

⁹ Paragraph 5.2 of the Code of Conduct.



- 3) LCs asking clients to whom the LCs had solicited or recommended the Bonds to sign declarations or acknowledgements that the LCs had not recommended the Bonds or solicited clients and/or the clients had not relied on any recommendation from the LCs. Client agreements should not contain terms which misdescribe the actual services to be provided to the client. Such terms and statements might not comply with the Code of Conduct obligation to act in the best interests of clients¹⁰ and would be in breach of the new client agreement requirements¹¹; and
- 4) LCs failing to draw their clients' attention to the liquidity risks of the Bonds when making a recommendation or solicitation to them, which may prejudice clients' ability to make an informed investment decision. LCs may be in breach of their suitability obligations if the liquidity risk of the Bonds is not taken into account when LCs solicit or recommend them to their clients.

Chapter 37 Bonds

The Commission noted instances where Chapter 37 Bonds had been sold to retail investors and would like to highlight that Chapter 37 Bonds are unsuitable for sale to retail investors. Chapter 37 Bonds are meant to be targeted only at professional investors (including high net worth investors)¹².

LCs need to bear in mind that, under the listing regime, the listing documents of Chapter 37 Bonds have not been vetted by the HKEx since amendment of the Chapter 37 of the Main Board Listing Rules in 2011. Listing documents of Chapter 37 Bonds are no longer subject to detailed disclosure requirements, and the HKEx adopts a "light touch" approach in listing Chapter 37 Bonds compared to other instruments. The HKEx only vets applicants for compliance with listing eligibility¹³, and checks listing documents only for compliance with the obligations to include disclaimer and responsibility statements¹⁴ in prescribed forms and a statement limiting distribution of the document to professional investors only. Accordingly, the listing status of Chapter 37 Bonds should not be taken as an endorsement of the commercial merit, credit quality or quality of disclosure in the listing documents of Chapter 37 Bonds.

Therefore, in the course of distributing Chapter 37 Bonds, LCs:

- 1) should not take the listing status to denote any commercial merit, a low product risk rating or high credit quality in the due diligence review;
- 2) should not represent the listing status as an endorsement of the offer or the Chapter 37 Bond during the selling process; and

¹⁰ General Principles 1 and 2 of the Code of Conduct.

¹¹ New client agreements requirements will be effective on 9 June 2017. Please see the [Consultation Conclusions on the Client Agreement Requirements](#) dated 8 December 2015 for details.

¹² For details, please see answers to questions 1 and 7 of [Frequently Asked Questions – Debt Securities For Professional Investors Only](#) issued by the HKEx.

¹³ Rule 37.03 to 37.08 of the Main Board Listing Rules set out the applicants' qualifications for listing, for example, an applicant whose shares are listed on the HKEx or another stock exchange would be eligible.

¹⁴ It is stated in the statements that, amongst others, the HKEx takes no responsibility for the contents of the listing document, and the directors of the issuer collectively and individually accept full responsibility for the accuracy of the information contained in the listing document.



- 3) should, in addition to the points mentioned above, draw clients' attention to the prescribed disclaimer statement in the listing document in order to assist clients make an informed decision.

Some Key Controls and Procedures in the Distribution of the Bonds

The Commission reminds LCs distributing the Bonds to put in place adequate policies and procedures under which they:

- 1) conduct proper product due diligence to ensure that they understand the important aspects including the complex features and risks of the Bonds, and properly communicate them to their sales staff;
- 2) appropriately identify the target investor group taking into account any selling restrictions and ensure that the risk return profile of recommended Bonds matches with the financial situation, investment objectives, investment experience, risk tolerance and other relevant circumstances specific to the client. The Commission also reminds LCs that Chapter 37 Bonds should only be offered to professional investors;
- 3) provide sufficient and accurate information about the Bonds to clients and always present balanced views and not solely focus on advantageous terms such as high coupon rates or yields when making the solicitation or recommendation to, and assessing suitability for clients;
- 4) fully disclose to clients the risks specific to the Bonds such as illiquidity and the lack of availability of secondary market, and explain any key complex features to help clients make informed investment decisions; and
- 5) stop asking clients to sign declarations or acknowledgements which are inconsistent with the Code of Conduct obligations and/or which misdescribe the actual services provided / to be provided to clients. LC should commence revising and re-executing (if necessary) client agreements in light of the recent [Consultation Conclusions on the Client Agreement Requirements](#)¹⁵.

LCs are reminded that under the New Professional Investor Regime (in the form of a new paragraph 15 of the Code of Conduct), LCs are now bound by the suitability requirement⁹ in relation to high net worth individual clients effective from 25 March 2016¹⁶ and client agreement and risk disclosure statement requirements are required by the latest 9 June 2017¹⁷.

As some of the Bonds are high-yield bonds¹⁸ and/or have special or complex features which carry additional risks, LCs should also have regard to the two circulars previously issued by the Commission¹⁹ respectively on [Selling of Fixed Income Products](#) and [Selling of Complex Bonds and High-Yield Bonds](#).

The Commission will take appropriate regulatory action against LCs found to have breached the Securities and Futures Ordinance, the Code of Conduct's provisions on selling practices,

¹⁵ [Consultation Conclusions](#) issued by the Commission on 8 December 2015.

¹⁶ [Consultation Conclusions](#) issued by the Commission on 25 September 2014.

¹⁷ [Circular](#) issued by the Commission on 21 March 2016.

¹⁸ High-yield bonds refer to bonds which are generally below investment grade or are unrated.

¹⁹ Circulars issued by the Commission respectively on [19 November 2012](#) and [25 March 2014](#).



and/or the requirement to act in the best interests of their clients, and will continue to use a range of supervisory tools, including inspections and mystery shopping programs, to monitor compliance.

Should you have any queries regarding this circular, please contact Ms Seine Luk at 2231 1696.

Intermediaries Supervision Department
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