

19 November 2012

Circular to Licensed Corporations and Registered Institutions

Selling of Fixed Income Products

In the current low interest rate environment, investors strive to achieve higher yield. Within this context, it is noted that fixed income products being marketed and sold to clients include high-yield corporate bonds (which are generally below investment grade or are unrated), bonds with special features and funds investing in high-yield bonds. Such products carry additional risks of which investors should be aware.

Key risks of investing in bonds

Intermediaries are reminded that they should not market or treat all bonds as risk free products that are suitable for all investors. Holders of bonds, including plain-vanilla bonds, are subject to various risks, including but not limited to:

- Credit risk - bonds are subject to the risk of the issuer defaulting on its obligations. It should also be noted that credit ratings assigned by credit rating agencies do not guarantee the creditworthiness of the issuer;
- Liquidity risk - some bonds may not have active secondary markets and it would be difficult or impossible for investors to sell the bond before its maturity; and
- Interest rate risk – bonds are more susceptible to fluctuations in interest rates and generally prices of bonds will fall when interest rates rise.

Key risks of investing in high-yield bonds

In addition to the generic risks listed above, investments in high-yield bonds are subject to risks such as:

- Higher credit risk - since they are typically rated below investment grade or are unrated and as such are often subject to a higher risk of issuer default;
- Vulnerability to economic cycles - during economic downturns such bonds typically fall more in value than investment grade bonds as (i) investors become more risk averse and (ii) default risk rises.

Bonds with special features

Furthermore, some bonds may contain special features and risks that warrant special attention. These include bonds:

- That are perpetual in nature and interest pay-out depends on the viability of the issuer in the very long term;
- That have subordinated ranking and in case of liquidation of the issuer, investors can only get back the principal after other senior creditors are paid;
- That are callable and investors face reinvestment risk when the issuer exercises its right to redeem the bond before it matures;
- That have variable and/or deferral of interest payment terms and investors would face uncertainty over the amount and time of the interest payments to be received;



- That have extendable maturity dates and investors would not have a definite schedule of principal repayment;
- That are convertible or exchangeable in nature and investors are subject to both equity and bond investment risk; and/or
- That have contingent write down or loss absorption feature and the bond may be written-off fully or partially or converted to common stock on the occurrence of a trigger event.

Funds investing in high-yield bonds

Intermediaries should also pay particular attention to those funds that invest primarily in high-yield bonds as (i) they will be subject to the risks associated with investments in bonds as described above; and (ii) the net asset value of a fund that invests in high-yield bonds may decline or be negatively affected if there is a default of any of the high yield bonds that it invests in or if interest rates change. The special features and risks of high-yield bond funds may also include the following:

- Capital growth risk - some high-yield bond funds may have fees and/ or dividends paid out of capital. As a result, the capital that the fund has available for investment in the future and capital growth may be reduced;
- Dividend distributions - some high-yield bond funds may not distribute dividends, but instead reinvest the dividends into the fund or alternatively, the investment manager may have discretion on whether or not to make any distribution out of income and/ or capital of the fund. Also, a high distribution yield does not imply a positive or high return on the total investment; and
- Other key risks that may relate to the relevant fund including concentration of investments in particular types of specialized debt or a specific geographical region or sovereign securities.

Distributors' obligations

Intermediaries should observe the selling practice requirements, including the suitability obligations, set out in the Code of Conduct¹, Internal Control Guidelines², Suitability FAQ³ and other circulars.

The potential risks highlighted in this circular are non-exhaustive. Given the potential wide scope of features and risks of fixed income products, intermediaries should put in place appropriate measures, systems and controls to ensure that their staff (i) have a thorough understanding of such products, (ii) are able to explain to the client prior to or at the point of sale the key features and risks of the products and the implications thereof, and (iii) are familiar with the selling practice requirements.

Intermediaries are also reminded of their obligations to:

- perform due diligence on the fixed income products they recommend to their clients while taking into account of the features and risks of the products and the implications to their clients. Importantly, intermediaries should not simply treat all fixed income products as having a similar level of risk;
- perform the know your client process by collecting client information such as investment objectives and risk tolerance levels and ensure suitability of the recommendation by matching the risk return profile of the recommended fixed income products with the client's personal circumstances;

¹ Code of Conduct for Persons Licensed by or Registered with the SFC

² Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC

³ Questions and Answers on Suitability Obligations issued by the SFC on 8 May 2007



- always present balanced views and not solely focus on advantageous terms such as high coupon rates or yields when recommending fixed income products to clients. Intermediaries should also explain to the client the key features, disadvantages and downside risks; and
- where intermediaries receive benefits, such as rebates, for selling the products, they should disclose such benefits to the client prior to or at the point of sale.

Finally, senior management of intermediaries are reminded to diligently supervise the selling practices of sales staff and put in place proper systems and controls to ensure full compliance with the relevant regulatory requirements.

Should you have any queries regarding the contents of this circular, please contact Ms Lorraine Chan on 2842-7751.

Intermediaries Supervision Department
Securities and Futures Commission

End

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