The Resolution of the Structured Notes Fiasco in Hong Kong, Singapore, and Taiwan

Christopher Chao-hung Chen, Singapore Management University

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Christopher CHEN Chao-hung
Assistant Professor of Law, Singapore Management University

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Abstract

This article argues that alternative dispute resolution is not a panacea for settling massive investor complaints. Regulators must create clear and effective conduct of business rules and strengthen the contractual composition of structured products to give investors a better chance of recovering their investments in an event such as Lehman’s collapse.
I. Introduction

This article explores the legal and policy implications of how the structured notes saga ended in Hong Kong, Singapore, and Taiwan. Among the victims of the Lehman Brothers (Lehman) collapse were many East Asian retail investors, many of whom had placed their life’s savings into seemingly secured and profitable structured notes within an environment of high savings and low market interest rates since the turn of the millennium.\(^1\) On paper, retail structure notes created a win-win-win situation. Investors could receive decent income, local distributors and relevant parties (eg, trustee and calculation agents) could earn fees, and arranging banks could tap into cash savings in the Far East.\(^2\) Unfortunately, when Lehman collapsed, retail structured notes became a huge bubble.

In Hong Kong, there was ‘a nominal value of HK$12.6 billion in the hands of approximately 34,000 investors’\(^3\) for Lehman minibonds and over HK$ 2.9 billion in other credit-linked notes referred to Lehman as a reference entity.\(^4\) The Hong Kong Securities and Futures Commission (HKSFC) and the Hong Kong Monetary Authority received over 27,000 complaints.\(^5\) In Singapore, the Monetary Authority of Singapore (MAS) estimated that about 7,800 investors with a total investment of S$ 508 million suffered as a result of the Lehman minibonds while about 2,000 investors with a total investment of about S$ 157 million sustained losses as the result of other credit-linked notes.\(^6\) There was no official investigation report in Taiwan. The

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\(^1\) For example, the gross national savings in proportion to the gross domestic product was 31.58% in Hong Kong in 2000 (44.04% in Singapore and 28.42% in Taiwan), according to the World Economic Outlook <http://www.imf.org/external/ns/cs.aspx?id=28> accessed 8 March 2012. However, the one-year time deposit rate has dropped below 1% since 2002 in Hong Kong, 2003 in Taiwan, and 2004 in Singapore. Historical data can be found at the websites of the Hong Kong Monetary Authority <http://www.info.gov.hk/hkma/eng/statistics/msb/index.htm>, the Monetary Authority of Singapore <https://secure.mas.gov.sg/msb/InterestRatesOfBanksAndFinanceCompanies.aspx>, and the Central Bank of the Republic of China <http://www.cbc.gov.tw/np.asp?ctNode=369&mp=1> assessed 8 March 2012.

\(^2\) The monetary flow behind an issue of structured notes is not always clear. Taking the Morgan Stanley Pinnacle Notes in Singapore as an example, all issues of the Pinnacle Notes were secured by structured notes issued by another entity under the Morgan Stanley group. Thus, in a way, money was transferred from investors to the issuer, then to the issuer of the collateral.


\(^4\) HKSFC report (n 3) 29.

\(^5\) HKSFC report (n 3) 2.

\(^6\) MAS, Investigation Report on the Sale and Marketing of Structured Notes linked to Lehman Brothers 4 (7 July 2009)(“MAS report”). This report can be retrieved at
Trust Association of Taiwan reported that outstanding investments in structured products via banks’ trust departments had amounted to over NT$90.9 billion by the end of 2007.\textsuperscript{7} According to the Bankers Association of Taiwan (TBA), a total of 25,214 complaints were submitted to the TBA for adjudication at the end of 2011 with another 40,954 cases settled before entering the adjudication stage.\textsuperscript{8} Unlike in Hong Kong and Singapore, the structured notes market in Taiwan was dominated by equity-linked and interest rate-linked products rather than credit-linked notes. Obviously, it is a daunting challenge to settle such a massive number of disputes of such magnitude. Mounting political pressure and public opinions in such situations mean that regulators cannot afford to do nothing, and while they cannot simply force banks to absorb all of the losses, the next best thing is to help investors recover as much as possible via legal means.

The fundamental question is how far regulators should go in their efforts to help investors recover more money. The nature of financial transactions implies that higher returns must be accompanied by higher risk. Thus, it is inappropriate to assume that regulators must help investors fight banks for their losses in all circumstances. This is an illustration of \textit{caveat emptor}. Thus, a significant part of regulatory reforms after the structured notes saga has been to ensure that investors know what they are buying before investment. This fits into the ‘consumerist narrative’ of financial law.\textsuperscript{9}

However, the Asian structured notes saga was different. First, the sheer amount of misselling found by regulators in Hong Kong and Singapore was appalling. Although it is not fair to say that all sales of structured notes involve misselling, it is certainly not uncommon. Second, the heart of the saga was notes that had been arranged or issued by Lehman entities, whose collapse was probably not envisaged by investors or domestic banks. Even regulators might have been fooled by the high credit ratings given to these notes and reference entities.

Based on the assumptions that the misselling of structured notes is widespread and that regulators must do something to help investors, this article analyses how the structured notes saga ended in Hong Kong, Singapore, and Taiwan. This article does not comment on the details

\textsuperscript{8} The data can be found at the TBA website <http://www.ba.org.tw/all.aspx?sn=564> accessed 9 Jan 2012.
of regulatory reforms in the three aforementioned jurisdictions. Instead, it approaches from another angle, asking how to effectively settle a large number of complaints and what the law can do to improve the recovery of losses for retail investors. The settlement of structured notes disputes produces different results in different countries, to the extent that one might wonder whether the law can play its hand to reach better settlement outcomes.

The following sections briefly introduce the background of retail structured notes in all three jurisdictions. Part III explores how Hong Kong, Singapore, and Taiwan dealt with structured notes disputes. Part IV addresses the legal and policy implications, including its treatment in courts, the need for an alternative dispute resolution body, the effectiveness of voluntary settlement, and the final settlement of Lehman minibonds. Part V concludes the article.

II. Retail Structured Notes

A structured financial product is a financial instrument that combines a conventional financial product (eg, a deposit or debenture) with features of financial derivatives (eg, a credit default swap). The underlying variables of a financial derivative can refer to a wide range of variables, from securities and commodities to all sorts of market rates or indices. Essentially, derivatives ‘allow trading in the return or price fluctuations of other assets without the necessity of trading in the assets themselves’. Thus, investors can enjoy the benefits of the underlying conventional instrument (eg, fixed income offered by bonds) and the embedded derivative (eg, speculating on the price movement of another asset). For example, the Pinnacle Notes Series 11 in Singapore referred to a basket of shares, including the Hong Kong Stock Exchange, three Chinese entities, and two other Singaporean companies. Investing in this note allowed investors to benefit (in part) from the rise and fall of stock prices for Chinese companies without having to open a trading account in China.

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Therefore, ‘[structured notes] arguably generate investment opportunities that otherwise would not be available. In this sense, they “complete” the markets for fixed income securities’.\textsuperscript{12} This includes investment in unconventional assets. For example, the Lehman minibonds sold in Hong Kong and Singapore are credit-linked notes by nature, so that:

[i]nvestors gain exposure to the credit risk of the Reference Entities without directly holding the debt obligations of the Reference Entities and without directly involving any Reference Entity in the transaction. This is achieved by linking payment of the principal and interest on the Notes to a Reference Entity’s default (defined as a Credit Event).\textsuperscript{13}

The filing of Chapter 11 protection by Lehman affected Asian structured noteholders in various ways. First, subject to documentation, holders of notes issued by Lehman entities took a direct hit because the collapse of Lehman would normally constitute a default.\textsuperscript{14} Second, if Lehman was a reference entity in a credit-linked note, then a credit event had taken place and losses were transferred from the swap counterparty to the issuer and then to investors.\textsuperscript{15} Third, the collapse of Lehman triggered the default of the collateral that secured the notes in some cases, which led to investors suffering losses.\textsuperscript{16} Last, the sudden deterioration of global financial markets created a volatile environment that caused losses for some structured noteholders, notably some equity-linked note investors in Taiwan.\textsuperscript{17}

Nonetheless, not all structured notes caused heavy losses to investors after Lehman’s bankruptcy. For example, a holder of interest rate-linked notes might have gained from the ultra-low interest rate environment if he had been in the position of a floating rate payer. It all depends on the position taken by the investor and the movement of the market.

\textsuperscript{12} Frank Partnoy and David A Skeel, Jr., \textit{The Promise and Perils of Credit Derivatives} (2007) 75 U Cin L Rev 1019, 1027-1028.

\textsuperscript{13} Singapore Minibond Base Prospectus for Series 9 & 10 (dated 26 June 2008) 27.

\textsuperscript{14} For example, Lehman minibonds in Singapore or Hong Kong.

\textsuperscript{15} For example, the DBS High Notes 5 and Merrill Lynch Jubilee Notes in Singapore. In both cases, DBS and Merrill Lynch decided that the value of the notes post-Lehman would be zero so that investors could recover nothing on paper. MAS report (n 6) 4.

\textsuperscript{16} For example, the Pinnacle Notes in Singapore. Morgan Stanley also determined the redemption value to be zero, meaning that investors could recover nothing in any event. See MAS report (n 6) 4.

\textsuperscript{17} For example, in Taiwan, one type of equity-linked notes involved a design in which heavy losses would be triggered only when the prices of the reference portfolio dropped below a significant level (eg, 40\% of the original price).
III. Settlement of the Structured Notes Saga

A. Hong Kong

In general, Hong Kong dealt with the structured notes saga in two main ways. First, banks were encouraged to conduct internal investigations and settle with customers directly if appropriate. In addition, the HKSFC could facilitate a bank’s willingness to settle voluntarily with implicit discipline action against the bank after conducting an investigation. Normally a bank would repurchase the notes back from a customer that had accepted its settlement offer.

Second, regarding Lehman minibonds, the HKSFC entered into a collective agreement with sixteen banks in July 2009, under which the banks agreed to repurchase the notes from investors at 60% of the notes’ original value (or 70% if an investor was over 70 years old). Investors could receive more in return if the receiver could recover more than 60% from the collateral. However, this agreement was entered into without any admission of legal liability and the banks also agreed to ‘immediately implement special enhanced complaints handling procedures to resolve, in a fair and reasonable manner, all complaints in relation to the sale and distribution of other structured products’. However, those who had settled with banks beforehand were excluded from this collective bargain. The final settlement regarding minibonds came in March 2011. Minibond investors could recover at least 71.43% (and in some series over 95%) of their original investment after the sale of the collateral and over 65% of investors could recover more than 80%.

B. Singapore

In general, Singapore took a two-prong approach. On the one hand, the MAS began its investigations and encouraged banks to deal with customers by not taking an overly legalistic

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20 ibid.
21 ibid.
22 ibid.
approach when resolving client complaints. The MAS also agreed that any settlement could be offered on a voluntary basis without any admission of liability.

On the other hand, Singapore relied on the Financial Industry Disputes Resolution Centre Ltd. (FIDReC), an institution similar to the Financial Ombudsman Services in the UK, to deal with disputes outside the judicial system. According to the FIDReC, there were a total of 2,634 complaints filed to the FIDReC by the end of August 2011, of which 1,364 cases were related to Lehman minibonds. As subsequently mentioned, most complaints were resolved within three years. Unfortunately, the outcome of these cases was confidential. Nonetheless, the FIDReC made it clear that it would consider the residual value of Lehman minibonds when making a decision.

Regarding Lehman minibonds, the final liquidation came in February 2010 when the receiver, the trustee, and the swap counterparty reached an agreement about the liquidation of collateral. The final recovery rate varied depending on the minibond series, ranging from as high as 70.8% to as low as 21.5%. The amount received by each investor depended on ‘the recovery value of the series of notes bought, as well as the outcome of the dispute resolution process’. Overall, the MAS announced, ‘the recovery values of the notes and the settlement offers that have been accepted, 80% of retail investors will receive 50% or more of their investment back’. In total, investors clawed back 64.5% of the total amount invested in minibonds.

C. Taiwan

Retail structured notes also led to a large number of disputes in Taiwan. However, Taiwan’s financial regulator did not play a hard with banks from the start. One practical explanation for this approach is that the overall exposure was simply too massive for banks to swallow. Instead of filing lawsuits (see below), Taiwanese investors could choose to file complaints with the TBA.

24 MAS report (n 6) 20-21.
25 MAS report (n 6) 21.
30 ibid.
31 ibid.
32 ibid.
Although over 65,000 complaints have been filed with the TBA since 2008, only the results of the 100 cases have been published. To use the results as a benchmark, 77% of investors were awarded compensation, but the average rate of recovery was a mere 20.31% for each investor among 77 cases. For notes arranged by Lehman, banks in Taiwan are still waiting for the final liquidation of Lehman’s estate.

IV. Lessons from the Resolution of the Structured Notes Fiasco

Even though the structured notes fiasco may have come to a gradual close, there are lessons to be learned and applied in the future.

A. Structured Notes Disputes in Court

How did the courts fare with structured notes disputes? Interestingly, there were few lawsuits heading into the judicial system except in Taiwan. Many investors were probably put off by legal costs. In Hong Kong, there were a few cases involving some elements of criminal conduct. Some chose to bring a class action in the US against Lehman, but the case was referred to arbitration. One claimant even applied judicial review to challenge the decision to suspend investigation after the collective agreement. However, no reported judgment regarding civil remedies has appeared.

In Singapore, some investors argued that their investment in DBS High Notes 5 should be void *ab initio* due to mistake or uncertainty because there were four different versions of the critical term ‘credit event redemption amount’ within the notes’ documentation. Unfortunately, their action was rejected by the High Court and then the Court of Appeal based on the decision that the term could be ascertained by construction. In another reported judgment, the claimant’s case

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34 HKSAR v Chu Lai Sze [2010] HKEC 1820 (Court of First Instance, Hong Kong); Cheung Kwai Kwai, Re [2011] HKEC 1084 (District court, Hong Kong); HKSAR v Tai Ching [2011] HKEC 1085 (District Court, Hong Kong).
35 In re Lehman Brothers Holdings Inc., 2011 WL 5103346 (SDNY); Ka Kin Wong v. HSBC USA, Inc. 2010 WL 3154976 (S.D.N.Y.).
36 Shek Lai San v Securities and Futures Commission [2010] HKEC 640 (Court of First Instance, Hong Kong). The application was rejected.
37 Soon Kok Tiang v DBS Bank Ltd [2011] 2 SLR 716 (High Court, Singapore).
38 Soon Kok Tiang v DBS Bank Ltd [2012] 1 SLR 397 (Court of Appeal, Singapore).
was dismissed for procedural reasons.\textsuperscript{39} Some Pinnacle Notes investors filed actions in New York against Morgan Stanley, the arranging bank. So far the proceedings have focused on procedural issues.\textsuperscript{40} However, these investors did convince the US courts to issue an anti-suit injunction against the defendant.\textsuperscript{41}

Taiwan has offered a greater number of judicial decisions regarding structured notes. Research has suggested that among 103 lawsuits between 2009 and 2010, only 17 cases were eventually decided in favour of investors.\textsuperscript{42} Although the overall recovery rate was roughly 16.89\% of the original investment amount for all disputes, those who actually won their cases recovered an average of 96.62\% of the total amount of claim.\textsuperscript{43} Thus, bringing litigation to Taiwanese courts might offer little chance of success, but the reward was certainly significant upon winning the case.

Even with a greater number of lawsuits heading into trials in Hong Kong or Singapore (both were former British colonies), the prospect of an investor receiving favourable judgments is probably not high if we use English case law as reference. A series of misselling claims in England since 2008 regarding structured notes have shown that investors’ actions were usually dismissed.\textsuperscript{44} If an action is based on misrepresentation, one might face difficulty overcoming his own signature on contractual documents.\textsuperscript{45} In addition, the collapse of Lehman could be seen as an unfortunate intervening event that broke the causation chain between losses and any misselling conduct.\textsuperscript{46} Recent Taiwan Supreme Court judgments also took a similar view regarding contractual signature and causation.\textsuperscript{47}

\textsuperscript{39} Lee Chang-Rung v Standard Chartered Bank [2011] 1 SLR 377 (High Court, Singapore).
\textsuperscript{40} Dandong v Pinnacle Performance Ltd 2011 WL 5170293 (SDNY).
\textsuperscript{41} Dandong v Pinnacle Performance Ltd 2011 WL 6156743 (SDNY).
\textsuperscript{43} Chen (n 42) 213.
\textsuperscript{46} Rubenstein v HSBC Bank plc [2011] EWHC 2304 (QB) at 116-117.
\textsuperscript{47} Eg Taiwan Supreme Court judgment 100 tai shan 933, Supreme Court judgment 100 tai shan 1060, and Supreme Court judgment 100 tai shan 2178.
Against this backdrop, the judicial system does not seem to be the best place for investors to resolve misselling disputes. This makes the case for alternative dispute resolution and paves the way for voluntary settlement.

**B. Alternative Dispute Resolution**

One response to the structured notes fiasco was the creation of alternative dispute resolution institutions (ADR body) for consumer financial transactions in Hong Kong (which did not have one) and Taiwan (which offered one that is not quite independent under the Bankers Association). This article does not challenge the purpose of having an ADR body for consumer financial transactions. However, we do question whether an ADR body is capable of handling a large number of disputes in an efficient manner. Given very limited public data, this can be measured in two ways: the time required to resolve complaints and the recovery rate offered by an ADR body.

The FIDReC in Singapore did not publish the results of mediation or adjudication, so we have no data with which to compare. The number of complaints filed and resolved indicates that about 72% of complaints lodged have been resolved or will have hearings completed by 31 August 2009. This figure had risen to 94.66% by 2010 and to 99.3% by 2011. Thus, the FIDReC resolved the majority of the complaints within three years. By the end of August 2011, 2,240 of 2,364 complaints had been resolved. This represents a rate of 747 cases per year and roughly 2 complaints per day during a three-year span. Given the number of complaints filed, this appears to be an efficient result.

In contrast, the TBA in Taiwan provided no data for our analysis of how quickly the TBA has handled complaints over time. However, because there were only 9 members under the TBA to consider over 65,000 complaints (as opposed to the 15 adjudicators assigned by the FIDReC for structured products), it adopted a strategy of classifying complaints into 8 categories and

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48 HKSFC, *Consultation paper on proposals to amend the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission in relation to the establishment of the Financial Dispute Resolution Centre Ltd and the enhancement of the regulatory frame work* (Nov 2011) <https://www.sfc.hk/sfcConsultation/EN/sfcConsultMainServlet?name=FDRCCoC> accessed 6 March 2012.
49 Taiwan Consumer Protection Act articles 13-30 (June 2011).
107 key issues (eg, whether the know-your-customer process was properly executed) based on investors’ allegations. The TBA would then assign points to a complaint depending on how badly a bank was alleged to have breached relevant rules to determine how serious the misselling was and to award compensation on this basis. This helps to achieve a mass resolution without comprehensively considering the evidence of each case. It probably explains why most complainants were awarded compensation, but most did not recover much in the end. It is arguable whether this serves the purpose of an ADR body providing just and equitable results for investors outside courts.

It is difficult to analyse the success of ADR bodies in different countries without complete data. The FIDReC may have provided a comforting model for Hong Kong and Taiwan. However, we should note that the number of disputes in Singapore is considerably less than in Hong Kong and Taiwan. Clearly, having an ADR body is not a panacea. It is one thing to have an institution that deals with occasional cases, but it is another thing entirely to effectively manage an overwhelming number of complaints. Taiwan’s experiences show that if an institution is not fully capable of handling a huge number of complaints within a short period of time, the result might not necessarily be beneficial for investors in terms of recovering more of their investments.

C. Voluntary Settlement

Another intuitive response from regulators was to give banks a chance to tidy up the mess first. For courts, promoting voluntary settlements might have saved them from being flooded with excessive litigations. For an investor, a voluntary settlement might mean quicker recovery of some losses. Moreover, settling with customers does not necessarily mean losses in banks’ financial statements. If banks acquire notes from investors after settlement, they can recover a significant amount of the money paid to investors or even make a profit if the payout to investors is less than the recovery value of the notes in the end. The same might not apply to other structured products in different forms. However, it was hard to imagine that a bank would voluntarily offer high settlement rates without some pressure.

With all the benefits of voluntary settlement in mind, the real question is whether investors are really better off accepting a settlement offer from their banks. While there was no public

55 See above III.C.
information in Taiwan, we may consider the results of voluntary settlement in Hong Kong and Singapore with some public data. In Singapore, it was reported that investors recovered a total of S$ 107.34 million (out of a total of S$ 373.7 million in investments) by settling with banks,\(^{56}\) indicating an average recovery rate of about 28.72%. We do not have the exact numbers needed to make a weighted calculation, though some investors did recover over 50% or even 100% of their investment via voluntary settlement.\(^{57}\) On average, the recovery rate by voluntary settlement is far less than what a minibond holder could have recovered if he had held the notes for two more years.

In Hong Kong, voluntary settlement was actually somewhat involuntary. For example, Sun Hung Kai Investment Services Ltd agreed with the HKSFC to repurchase minibonds from its clients at their original value after HKSFC’s investigation raised serious concerns about misselling.\(^{58}\) At least six other firms settled with customers in a similar fashion.\(^{59}\) Offering voluntary settlement at a favourable price allowed some banks to avoid further regulatory penalties without admitting any legal liability.

In hindsight, Singapore’s experiences show that voluntary settlements do not necessarily serve the customers’ best interests. A comparison of the results in Hong Kong and Singapore reveal that voluntary settlement is more beneficial for investors if it is achieved with full regulatory backing. The question then becomes how to create a better environment in which more favourable voluntary settlements can happen. We propose that the clear and enforceable conduct of business rules (and not just abstract and conceptual guidelines) must be put in place, not only for banks to comply with, but also to make it easier for regulators to identify faults in a bank’s sale process. For investors, having clear conduct of business rules might also gain them the upper hand when bargaining for settlement. This article does not suggest that it is wrong to encourage banks to settle with customers. Nonetheless, regulators should also consider the surrounding conditions facing the issuance of each note (eg, quality of collateral and liquidity) if the ultimate goal is to return as much money as possible to the investor.

\(^{56}\) MAS report (n 6) xvi and xvii.
\(^{57}\) ibid.
\(^{59}\) See <http://www.sfc.hk/sfc/html/EN/general/general/lehman/lehman_structure_products.html> accessed 20 February 2012. Among the six banks, the lowest offer was 80% of the principal investment amount, with several returning over 95%. 
D. Lessons from Lehman Minibond Settlements

For Lehman minibonds, Hong Kong investors, on average, achieved better recovery than those in Singapore despite the fact that the same accountancy firm acted as a receiver facing the same swap counterparty and arranging bank. While it might come down to the quality of collateral for each issue, one critical difference is that the collective agreement in Hong Kong guarantees a minimum 60% of recovery, whereas there was no such guarantee in Singapore. Assuming that the collateral for minibonds in Hong Kong was not significantly more valuable than it was for those in Singapore, the collective agreement might be the biggest variable rendering different results.

The Hong Kong scheme has some benefits. On the one hand, banks can avoid penalties because the HKSFC agreed to suspend further investigation on the condition that the banks agree to participate in the collective scheme. From the government’s point of view, it can divert resources from an investigation to help investors achieve more recovery while it is still possible. On the other hand, instead of posting 60% of book losses, banks have more incentive to press the receiver to cut a better deal because they become the nominal holders of minibonds after the collective agreement. Setting the minimum recover at 60% can also avoid a bank settling with a customer at a low price and earn a windfall if the bank can settle with Lehman or sell the notes to a third party at a higher rate.

The situation in Taiwan offers a lesson on what not to do. In Taiwan, banks were already the nominal holders of notes as trustees of non-discretionary trust accounts. Combined with the low compensation rate awarded by the Bankers Association or courts and little pressure from regulators, Taiwanese banks could happily do nothing while taking their chances in proceedings and waiting for Lehman’s liquidators to make a decision.

The above discussion does not suggest that the law must force banks to enter into a collective agreement in any event. Nonetheless, having such a scheme does seem to make a huge difference for investors for Lehman minibonds in Hong Kong and Singapore. In short, the structured notes fiasco proves that there is no such thing as a free meal. Regulators must create incentives to achieve a favourable outcome.

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E. The Quality of Collateral and Contractual Protection

An additional point raised in the settlement of Lehman minibonds is that the quality of collateral and contractual protection is instrumental in helping investors to recover their investments. Because structured notes are debt securities, it is essential that they are not only secured by collateral, but also secured by collateral of a certain genre and quality. The collateral of minibonds in Hong Kong was fortunate to be of a quality that could be sold at a decent price in 2011. However, holders of some Pinnacle Notes in Singapore were not so lucky because the collateral was in default and became valueless.

Moreover, it is of the utmost importance to determine which party receives money first in the event of default, because the collateral is normally charged to secure monetary payments, not only to noteholders, but also to the swap counterparty and trustee or relevant agents. It is most favourable for investors if noteholder priority is chosen from the beginning. The second best and probably more acceptable arrangement is a flip provision, depending on which party is in default. If this is the case, the governing law should be carefully chosen to avoid the wrath of the anti-deprivation rule.61

A stronger argument is that structured notes designed for retail investors are suitable only if they are secured by quality collateral with a choice of payment priority not totally in favour of the counterparty.62 In this light, regulatory reforms after the Lehman collapse have failed to catch up with this point in Singapore and Taiwan. In Singapore, new rules focus on the process of dispensing financial advice.63 The MAS does require that a bank consider the risk-reward characteristics before selling a product.64 However, the law does not specify the danger of an inappropriate contractual structure. Taiwan’s new regulation shares a similar problem.65

In contrast, Hong Kong has moved in this direction. The Code on Unlisted Structured Investment Products published in October 2010 requires the collateral of structured products to meet certain

61 Belmont Park Investments PTY Ltd v BNY Corporate Trustee Services Ltd [2011] UKSC 38.
65 Taiwan Regulations Governing Offshore Structured Products (2010), art 23.
criteria. For example, the collateral must be ‘in cash or … liquid and tradable’ and should not include ‘structured products whose payouts primarily rely on embedded derivatives or synthetic instruments’. This may prevent situations in which structured notes are secured by other high-risk, collateralised debt obligations.

Pursuing this line of argument might lead to a suggestion that a certain form of product intervention might be necessary to not only make a complex financial product more suitable, but also to equip investors with better weapons to recover their investments. It is beyond the scope of this article to discuss the theoretical underpinnings of investor protection rules. However, because local regulators in Asia might have little power to directly regulate arranging banks in New York or London, it is even more important to ensure that the documentation (often provided by the arranging bank) does not tilt towards banks to achieve a better possibility of recovery for investors without excessive regulatory intrusion.

V. Conclusion

The settlement of the structured notes fiasco in Hong Kong, Singapore, and Taiwan provides a number of lessons. First, there must be clear conduct of business rules to increase banks’ compliance and help regulators apply pressure to banks for voluntary settlements with favourable terms. Second, it is important that a complex financial product has the contractual structure required for investors to recover maximum value from their investments. Third, even with a decent contractual structure, regulators can still create incentives to encourage banks to claim from counterparties. The collective agreement for Lehman minibonds in Hong Kong is a good example. Fourth, an ADR body is not a panacea to deal with a massive number of complaints surfacing almost at the same time.

Even after the global financial crisis, there has been no shortage of appetite for structured financial products in Asia because it remains an environment of high savings and low interest rates. For example, plenty of unlisted structured products have been issued in Hong Kong since 2009. Another bubble may be just around the corner. If history is to be any guide, how the

66 Hong Kong Code on Unlisted Structured Investment Products, rule 5.13.
67 Dandong v Pinnacle Performance Ltd 2011 WL 5170293, 2 (SDNY).
structured notes saga ends should help promote better investor protection and provide the tools to handle a massive number of investment disputes triggered by a single event.