

Shareholder Rights Directive II



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Foreword

The Shareholders Rights Directive II (SRD II) comes into full effect on 3 September 2020. It is designed to strengthen the position of shareholders and improve corporate governance standards at companies whose securities are traded on the EU's regulated markets. SRD II builds on and updates the requirements of the 2007 Shareholder Rights Directive.

Since June 2019, first phase elements of SRD II have come into force across Member States, principally addressing matters of transparency, policy and process by and between shareholders, institutional investors and asset managers when investing in listed equities. From 3 September 2020 requirements such as the identification of shareholders, the transmission of information between issuers, investors and intermediaries and the greater engagement of shareholders within Corporate Voting will come into effect.

Identification of shareholders has been a fraught topic in Europe for decades. From time to time, publicly traded issuing companies need to know who their major shareholders are. This may be needed for the purpose of corporate control, or for developing shared views on the aims and activities of the issuing company. While some European countries have historically enabled the identification of shareholders to varying degrees, others have focused on preserving privacy of ownership. SRD II strikes a balance by applying a uniform right to the identification of shareholders above a specified level.

SRD II also updates the requirements for the communication process between issuers and investors via intermediaries. There is now an expectation of electronic communication amongst intermediaries, and the same-day passage of information.

The detailed implications for shareholder communication processes are wide-ranging. SRD II will require significant changes to systems, affecting activities such as corporate communication, corporate events and voting. This guide explains what is happening and outlines some important implications for the various participants.

Owing to the current COVID-19 public health situation, it is possible that market developments might impact the timetable to practically implement SRD II. HSBC will continue to monitor and communicate any developments to clients.



1 > What is SRD II?

The Basics

First due to be transposed into EU law in June 2019, SRD II will come into full effect from 3 September 2020.

The Directive aims to strengthen the position of shareholders and ensure that decisions are made for the long-term stability of companies. The rules, which will amend the original SRD, are designed to materially enhance corporate governance standards at companies which are registered within the European Economic Area (EEA), and whose securities are traded on EEA regulated markets.

The regulation envisages extra-territorial application.

Non-EEA intermediaries, for example, could be instructed to provide details about their client's holdings to an EEA issuer. Consequently, any intermediary – irrespective of whether or not it is located inside the EEA – is expected to support the new processes. Penalties for non-compliance with SRD II vary on a Member State by Member State basis, and a number of jurisdictions have confirmed they will levy fines for non compliance with requirements.

Who's impacted?



- ◆ SRD II applies to all intermediaries, asset managers, asset owners, and proxy advisors holding or providing services to EEA securities.
- ◆ SRD II applies to EEA registered issuers whose securities are traded on EEA regulated markets.
- ◆ SRD II sets out to strengthen the position of shareholders and ensure that decisions are made for the long-term stability of companies.

What are the operational impacts?



- ◆ Intermediaries need to facilitate further investor engagement within corporate Europe, support a new shareholder identification process, transmit corporate actions in a shorter timeframe, and provide transparency on costs to shareholders.
- ◆ Asset managers and institutional investors are required to provide greater transparency around their investment strategies, engagement policies with shareholders and use of proxy advisors.
- ◆ Proxy advisors will need to provide transparency around their methodologies, models and procedures to shareholders.

Which securities are in scope?



- ◆ SRD II applies to equities with voting rights attached that are admitted for trading on an EEA regulated market and whose issuer has a registered office within the EEA.*

Where will the impacts be felt?



- ◆ SRD II is an EU directive, but has extra-territorial application in that the directive expects any non-EEA intermediary holding EEA registered shares to support compliance with the requirements. Shareholders of these EEA securities, regardless of where they are located, are also in the scope of the Directive update.

*Some markets have included additional security types as in scope for SRD2

1 > What is SRD II?

Objectives of SRD II

The legislation was introduced for several reasons. Firstly, regulators felt a number of institutions were not long-termist in their investment approach, with many appearing to lack proper visibility over companies' transactions with their directors and senior management. In addition, there were concerns about substandard cross-border shareholder communication by companies and opacity when voting on executive / directors' compensation packages. And finally, SRD I was open to interpretation. These deficiencies are believed to have contributed to some of the corporate failures which have taken place over the last decade.

In response to these perceived weaknesses, SRD II seeks to achieve the following:



- ◆ Ensure that all impacted institutions are incentivised to promote the long-term health of the companies in which they are invested. Regulators argue that such engagement will help facilitate sustainability in the broader EU economy.



- ◆ Make it easier for issuers to identify shareholders by obliging intermediaries to communicate investor information (e.g. name, contact, registration number, number of shares) upon issuer request.

- ◆ Promote transparency of the shareholder engagement processes deployed within the investment strategies of institutional investors and asset managers.



- ◆ Improved governance, transparency and oversight of directors' remuneration. Shareholders to vote on the company's remuneration policy and remuneration report.



- ◆ Improve the involvement of shareholders in corporate governance. This will be achieved by calling on issuers to provide shareholders with the information they need to vote on key issues during general meetings.



1 > What is SRD II?

Key Milestones

SRD II was due to be transposed into each Member State's national law by June 2019. The transposition has taken longer than that in some Member State's, but nonetheless involves a two stage implementation. Phase 1 targeted to apply from June 2019, impacted mainly asset managers, asset owners and proxy advisors. This phase requires more transparency on how asset owners, asset managers and proxy advisors operate.

Phase 2 is due to apply from September this year and focuses on Intermediaries. These phase 2 provisions include the identification of shareholders, transmission of information to support the exercise of shareholder rights, and transparency of costs.

Regulatory Timeline



There are two key implementation dates to note for SRD II:



2 > Phase 1 – What's the Scope?

Asset Owners and Asset Managers

As asset owners and asset managers have an integral role to play in promoting sustainability and long-termism at European corporates, they are subject to tightened transparency and reporting rules.

Engagement (Article 3G)

Institutional investors and asset managers shall comply with the engagement requirements, or publicly disclose a clear and reasoned explanation outlining why they have chosen not to comply. The requirements include the production of documentation outlining how they integrate their shareholder engagement policies into their investment strategies.

Asset managers and asset owners must also publicly disclose, on an annual basis, details of how their engagement policies have been implemented. This should include:

- ◆ A general description of their voting behaviour.
- ◆ Explanations covering the most significant votes.
- ◆ Information pertaining to their relationships with proxy advisers.

Investment Strategy of Institutional Investors and their Arrangements with Asset Managers (Article 3H)

Institutional investors shall publicly disclose how their investment strategies are consistent with the profile and duration of their liabilities. For example, where long-term liabilities are concerned, institutional investors will need to disclose how these contribute to the medium-to-long-term performance of their assets.

For circumstances in which an asset manager invests on behalf of an institutional investor, that investor must disclose the following information:

- ◆ How the asset manager is incentivised to align its investment strategy with the institutional investor, especially around long-term liabilities.
- ◆ How that arrangement incentivises the asset manager to make investment decisions, based on assessments about the medium-to-long-term financial and non-financial performance of the investee company.
- ◆ How the methods and evaluation of the manager's performance and remuneration are in line with long-term liabilities in particular, and how they take long-term performance into account.
- ◆ How the institutional investor monitors portfolio turnover costs incurred by the asset manager.
- ◆ The duration of the relationship with the asset manager.



2 > Phase 1 – What's the Scope?

Transparency of Asset Managers (Article 3I)

Asset managers are required, on an annual basis, to report specific information to their institutional investor clients. They should report information about how their investment strategy and its implementation contributes to the medium to long term performance of institutional investors' assets or of the fund. The report should include:

- i. Key material outlining the medium to long-term risks associated with the investments
 - ii. Portfolio composition
 - iii. Portfolio turnover
 - iv. Portfolio turnover costs
 - v. The use of proxy advisors for the purpose of engagement activities
 - vi. The firm's policy on securities lending and how it is applied to fulfil its engagement activities, if applicable
 - vii. Any conflicts and how they have been managed.
- ◆ Asset managers must also notify investors if any conflicts of interest have arisen in connection with their engagement policies, and if so, how these have been addressed.

Transparency of Proxy Advisors (Article 3J)

Proxy advisers need to have – and publicly disclose – a code of conduct. Proxy advisers must also provide the following information in relation to the preparation of their research, advice and voting recommendations:

- ◆ The methodologies and models applied.
- ◆ The main information sources used.
- ◆ The procedures put in place to ensure quality of the research, advice and voting.
- ◆ How national market, legal, regulatory and company-specific conditions are taken into account.
- ◆ The voting policies applied for each market.
- ◆ Dialogues with companies that are the subject of research, advice or voting recommendations.
- ◆ The policy regarding the prevention and management of potential conflicts.



3 > Phase 2 – What's the Scope?

Intermediaries

An “intermediary” is defined as an investment firm, credit institution or central securities depository (CSD) that offers any of the following services in respect of in-scope securities:



The intermediary holds securities on behalf of its clients. As a result, the intermediary is not the beneficial owner of the securities, and only has a contractual relationship with its clients to provide custody services.

- ◆ **First intermediary:** Under SRD II, the term ‘first intermediary’ applies to the issuer CSD. It also applies to other market participants nominated by the issuer to maintain their share records by book entry, and participants that hold shares on behalf of the beneficial owners.
- ◆ **Last intermediary:** The first intermediary can also be the last intermediary in some instances. The term ‘last intermediary’ applies to any market participant that looks after the securities accounts in the chain of intermediaries on behalf of the shareholder.

It is critical under SRD II to distinguish between the intermediary and the shareholder. SRD II imposes a number of new requirements on intermediaries in the chain, so it is essential they fully understand their role in the process.

For example, for shareholder disclosure requests, all intermediaries before the last intermediary will be required to respond to the issuer and forward any new disclosure requests to the next intermediary in the chain. Once this is complete, the last intermediary will need to identify the shareholders on behalf of the issuer.

Shareholders

As part of SRD II, intermediaries will provide impacted corporate event advices to end shareholders, who will see a more rapid delivery of notices. These rules will impose very few added operational requirements on shareholders.



4 > Operational Challenges for Intermediaries

SRD II introduces a number of operational changes for intermediaries. Existing process flows to support corporate action processing now essentially need to be completed faster or within specific deadlines.

There is also a requirement for intermediaries to communicate in a machine-readable format, which will lead to the introduction of new and updated SWIFT messaging formats. In addition, intermediaries must be able to facilitate wider shareholder engagement in voting events. This will result in the wider adoption of proxy voting services at both a shareholder and intermediary level.

We explore these points in more detail ahead.



4 > Operational Challenges for Intermediaries

Focus 1 – Shareholder Identification/ Disclosure Processing

The regulation introduces significant changes to shareholder identification rules initiated by issuers. The general process for the exchange of information has been defined. This includes deadlines to be complied with, general guidance on standardisation and processing rules, and the content of messages.

In particular, the following new ISO 20022 messages have been defined:

- ◆ The request to disclose information regarding shareholder identity.
- ◆ The response to a request to disclose information regarding shareholder identity.

Market standards have been developed and state best practice is for the requesting message to cascade from the issuer through the chain of intermediaries, with each intermediary forwarding the request on to the next intermediary in the chain.

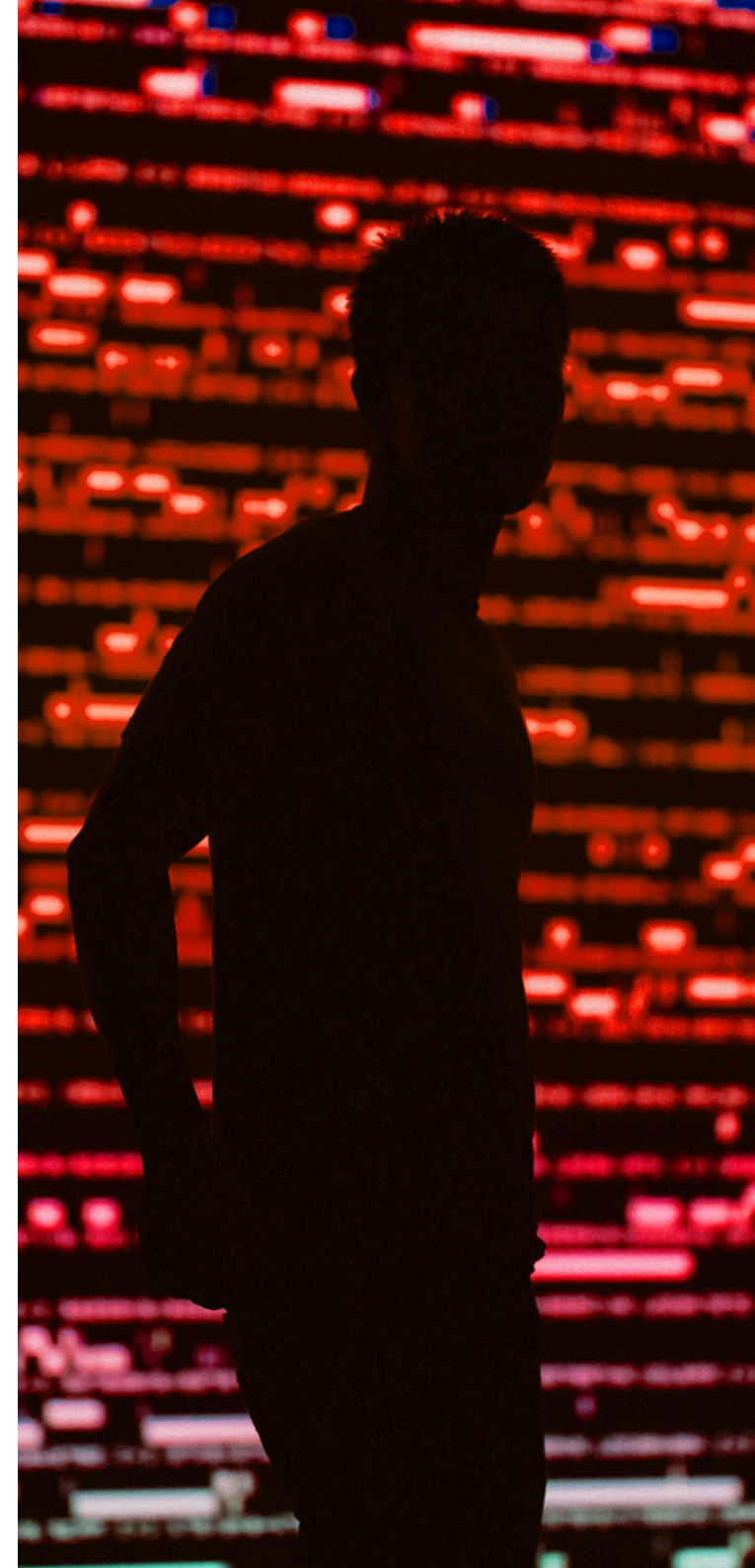
The response will include the total number of shares held by the responding intermediary, as well as a breakdown by client, whether or not the client is an intermediary or the final shareholder. Intermediaries will need to aggregate holdings from multiple client accounts as necessary to reflect holding.

Intermediaries are also required to disclose specific information relating to their clients and the positions held on their behalf. This includes shareholder name and address, as well as client identification data (e.g. Legal Entity Identifier (LEI) for legal entities).

New Threshold Levels

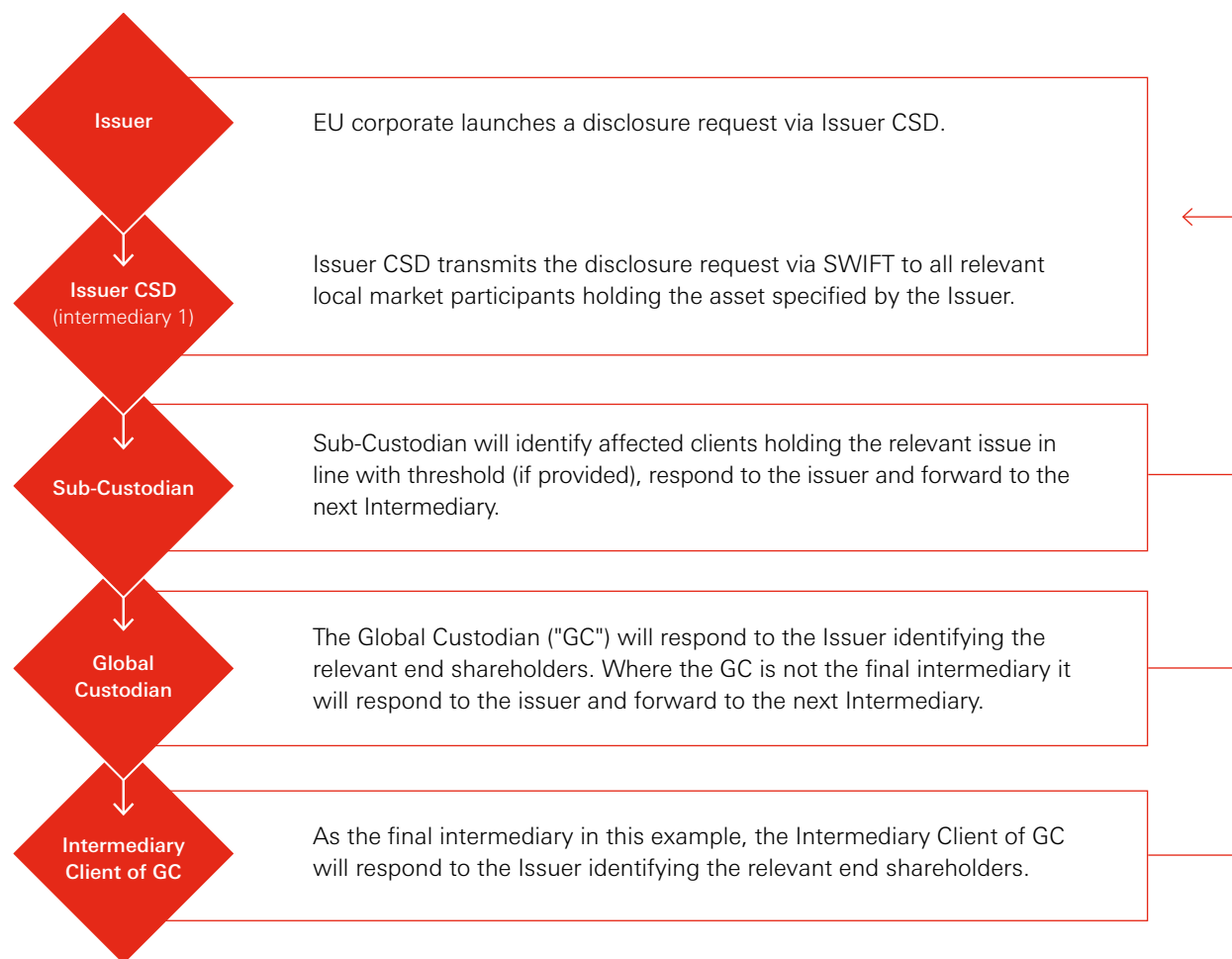
The Directive sets a de minimis 0.5% threshold for the identification of an individual shareholder. However, a Member State might propose a specific threshold not greater than 0.5%. At the time of writing, full transposition to all EEA countries has not yet completed. It could be that intermediaries will be faced with managing varying threshold levels within the disclosure process. This could present considerable operational challenges for intermediaries and shareholders.

The Directive requires that Member States send their chosen thresholds to the European Securities Markets Authorities (ESMA). The selected thresholds will be available on the ESMA website. As part of the new disclosure process, each intermediary must be able to identify and correctly report all clients affected by the relevant threshold level.



4 > Operational Challenges for Intermediaries

How the Shareholder Identification Process Will Typically Work



Disclosure Process Timings

Corporate action event	Timings	Participant responsible
Shareholder disclosure request	Same business day if received by 4pm, otherwise by 10am the next morning	All intermediaries
Shareholder disclosure response	Record date+1 if in the future Receipt date+1 if record date is less than 7 days ago Issuer deadline if record date >7days	Last intermediary

4 > Operational Challenges for Intermediaries

Focus 2 – Corporate Actions

All notices of income or entitlement must now be transmitted through the intermediary chain, according to the timelines set out by SRD II. This will increase operational complexity for intermediaries, in that the new timelines compress operational windows for processing these notices, which must be standardised and processed “without delay”.

New Processing Timeframes

SRD II introduces very specific processing timeframes that intermediaries must adhere to going forward. The key takeaways are that any corporate action notices received from issuers/agents/CSDs before 4pm in the intermediary’s location need to be processed and transmitted to the next intermediary by the end of the same day. Any Corporate Action notices received after 4pm need to be processed by 10am the next day.

Corporate action event	Timings	Participant responsible
Corporate event notice	Same business day if received by 4pm, otherwise by 10am the next morning	All intermediaries
Corporate event deadline	A maximum of 3 days between the issuer deadline and the final intermediary response deadline	All intermediaries
Confirmation of processing to shareholder or Intermediary	Immediately following receipt of instruction	All intermediaries

The deadline referred to in the second subparagraph shall not apply to responses to requests or those parts of requests, as applicable, which cannot be processed as machine-readable and straight-through processing. It shall also not apply to responses to requests that are received by the intermediary more than seven business days after the record date. In such cases, the response shall be provided and transmitted by the intermediary without delay and in any event by the issuer deadline



4 > Operational Challenges for Intermediaries

Focus 3 – Facilitation of Voting Rights/Proxy Services

As we have outlined, the core aim of SRD II is to encourage greater shareholder participation with European listed companies, thereby helping to drive long-term sustainability. Currently shareholders can choose to participate in corporate events directly or through a nominated third party. Going forward, intermediaries will need to facilitate this optionally via their proxy services. These services will be available to both shareholder and other intermediary clients of the intermediary. Examples of such services include the exchange of notices of participation and proof of entitlements.

As an intermediary, HSBC is required to offer our clients services enabling them to participate in the exercise of rights associated with voting events and general meetings. HSBC intends to offer this via our proxy agent ISS.

HSBC will offer our clients the ability to opt out of proxy services, should this be permitted. This approach will be finalised in line with industry standards and best practice.

Timings for Voting Events

Corporate action event	Timings	Participant responsible
Corporate event notice	Same business day if received by 4pm, otherwise by 10am the next morning	All intermediaries
Confirmation of vote cast electronically	Immediately following confirmation of vote	Issuer via proxy
Confirmation of recording and counting of votes	No later than 15 days after the request or general meeting, whichever occurs later	Issuer via proxy

Confirmation of votes cast electronically must be provided immediately after the vote has been cast, while the confirmation of counting and recording is expected within 15 days of the meeting itself.

The implementing regulation has also set out the minimum standard fields of information that must be catered for in the communication and response of this rights exercise. Existing SWIFT 20022 messages are being adapted to support this requirement. We will explore this later.

4 > Operational Challenges for Intermediaries

Focus 4 – SRD II Extra-territoriality

SRD II has extra-territorial implications, in that it anticipates that any non EEA intermediaries or shareholders should implement the relevant requirements defined therein. Essentially, any global shareholder or intermediary holding EEA-issued securities can be called on by the EEA issuer to disclose their holding via the chain of both EU and global intermediaries. Processing deadlines should apply to the time zone of the intermediary receiving the disclosure request, corporate event notice and so on.

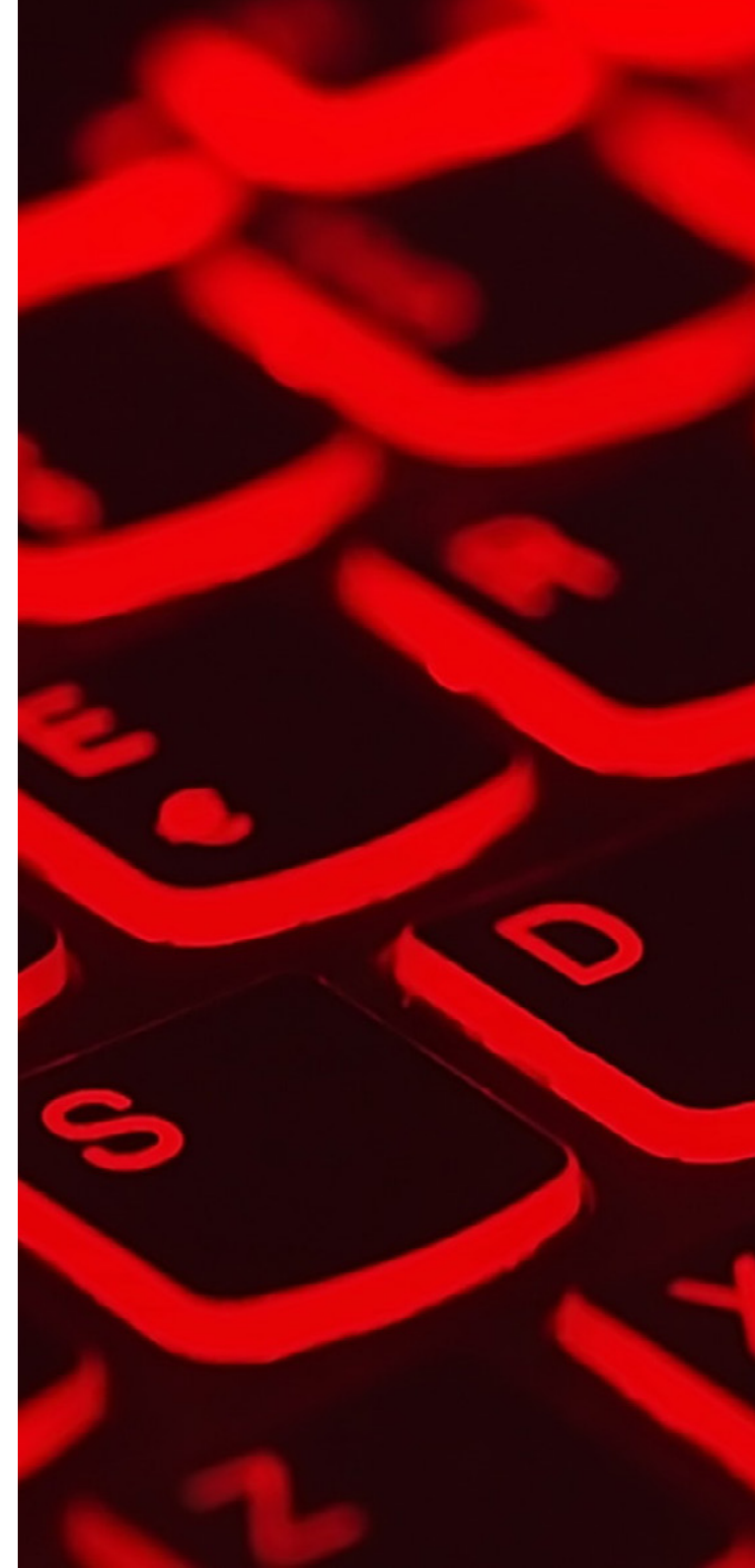
Focus 5 – SWIFT Message Changes

The implementing regulations do not include specific requirements to support the “machine-readable format” mandate. However, the industry has been focusing on SWIFT as the predominant messaging media, and is working to update existing message formats and introduce new messages to support the roll-out of SRD II. This includes the addition of two new messages to support the shareholder identification process, as well as the adoption of the new Swift 20022 messages to support the meeting, entitlement and voting process.

HSBC will continue to support ISO 15022 and relevant ISO 20022 messaging in line with agreed industry best market practice for other corporate events outside the new disclosure process. As previously mentioned, this will include the roll-out of new SWIFT ISO 20022 formats.

Focus 6 – Brexit

Since the UK left the EU on 31 January 2020, we are monitoring the situation to understand how SRD II adoption may be affected. For now, HSBC is including the UK in its preparations as per the UK’s adoption of SRD II last year.



5 > Summary of the Key Points

When?

Phase 2 is scheduled to apply from 3rd September 2020.

What?

From this date, intermediaries will be required to:

- ◆ Identify shareholders upon request by issuers or nominated issuer agents.
- ◆ Facilitate greater shareholder engagement through the provision of proxy services.
- ◆ Transmit corporate notices and events within specific new timelines.

Where?

SRD II is an EU directive with extra-territorial implications, meaning that the Directive expects that any non-EEA intermediary holding an EEA registered security should be capable of satisfying the requirements. By extension, any non-EEA shareholders of such securities will also be impacted.

HSBC Clients: Phase 2 – What to expect?

Corporate actions

- 01 Shareholders and intermediaries currently receiving SWIFT messaging on COACS can change to SWIFT messages itself including buyer protection and market deadline dates.
- 02 The quantity of messages may also increase as we meet SRD II requirements on timings to notify clients.
- 03 This may also lead to follow-up messaging when further clarifications are available.

Shareholder disclosures

- 01 Intermediaries will receive disclosure messages that HSBC has received from sub-custodians, issuer CSDs or issuer agents where intermediaries hold impacted securities.
- 02 HSBC plans to send these requests via ISO 20022 formatted messages, in line with industry guidance.

Proxy voting

Proxy voting services are provided by ISS. ISS will make available its online platform, Proxy Exchange, and plans to provide an ISO 20022 option to intermediary clients of HSBC.



6 > How Can HSBC Assist You?

HSBC is actively engaged in industry preparations for SRD II. We are leveraging our experience working with all parts of the SRD II value chain – issuers, intermediaries and shareholders.

We are also actively supporting clients address other concurrent regulatory changes, for example, the Securities Financing Transactions Regulation (SFTR) and Central Securities Depositories Regulation (CSDR).

In the coming months, HSBC will keep our clients updated with a series of FAQ bulletins and updates as items become clearer in the roll-out of the Directive. In the meantime, please do keep in contact with your Client Service Manager or Relationship Manager should you have any questions regarding progress towards regulatory compliance.

As noted, where proxy services are concerned, HSBC will contact clients in due course to confirm the requirements around voting participation or whether an “opt-out” is permitted. Please discuss with your Client Service Manager if you have not yet been approached on this topic.



Conclusion

The phase 2 requirements of the EU Shareholder Rights Directive II are due to apply from the 3 September 2020. There are significant impacts for issuers, intermediaries, asset managers and asset owners in terms of disclosures, transparency of share ownership and the faster passage of information from issuers to shareholders via custodian banks and other intermediaries. There can also be effects for parties outside the EU. HSBC will continue to help our clients navigate the journey to SRD II compliance.

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Appendix

Key Articles of the New Directive

Article #	Name	Details	Target
Article 3a	Identification of shareholders	Member States shall ensure that companies have the right to identify their shareholders. Member States may provide for companies having a registered office on their territory to be only allowed to request the identification of shareholders holding more than a certain percentage of shares or voting rights. Such a percentage shall not exceed 0,5 %	Intermediaries
Article 3b	Transmission of information	Member States shall ensure that the intermediaries are required to transmit information, without delay, from the company to the shareholder or to a third party nominated by the shareholder	Intermediaries
Article 3c	Facilitation of the exercise of shareholder rights	Member States shall ensure that the intermediaries facilitate the exercise of the rights by the shareholder, including the right to participate and vote in general meetings	Intermediaries
Article 3d	Non-discrimination, proportionality and transparency of costs	Member States shall require intermediaries to disclose publicly any applicable charges for services provided for under this Chapter separately for each service	Intermediaries
Article 3g	Engagement policy	Member States shall ensure that institutional investors and asset managers either comply with the requirements set out in points (a) and (b) or publicly disclose a clear and reasoned explanation why they have chosen not to comply with one or more of those requirements. (a) Institutional investors and asset managers shall develop and publicly disclose an engagement policy that describes how they integrate shareholder engagement in their investment strategy. The policy shall describe how they monitor investee companies on relevant matters, including strategy, financial and non-financial performance and risk, capital structure, social and environmental impact and corporate governance, conduct dialogues with investee companies, exercise voting rights and other rights attached to shares, cooperate with other shareholders, communicate with relevant stakeholders of the investee companies and manage actual and potential conflicts of interests in relation to their engagement. (b) Institutional investors and asset managers shall, on an annual basis, publicly disclose how their engagement policy has been implemented, including a general description of voting behaviour, an explanation of the most significant votes and the use of the services of proxy advisors. They shall publicly disclose how they have cast votes in the general meetings of companies in which they hold shares. Such disclosure may exclude votes that are insignificant due to the subject matter of the vote or the size of the holding in the company	Asset Managers & Asset Owners
Article 3h	Investment strategy of institutional investors and arrangements with asset managers	1. Member States shall ensure that institutional investors publicly disclose how the main elements of their equity investment strategy are consistent with the profile and duration of their liabilities, in particular long-term liabilities, and how they contribute to the medium to long-term performance of their assets. 2. Member States shall ensure that where an asset manager invests on behalf of an institutional investor, whether on a discretionary client-by-client basis or through a collective investment undertaking, the institutional investor publicly discloses the following information regarding its arrangement with the asset manager (a) how the arrangement with the asset manager incentivises the asset manager to align its investment strategy and decisions with the profile and duration of the liabilities of the institutional investor, in particular long-term liabilities; (b) how that arrangement incentivises the asset manager to make investment decisions based on assessments about medium to long-term financial and non-financial performance of the investee company and to engage with investee companies in order to improve their performance in the medium to long-term; (c) how the method and time horizon of the evaluation of the asset manager's performance and the remuneration for asset management services are in line with the profile and duration of the liabilities of the institutional investor, in particular long-term liabilities, and take absolute long-term performance into account; (d) how the institutional investor monitors portfolio turnover costs incurred by the asset manager and how it defines and monitors a targeted portfolio turnover or turnover range; (e) the duration of the arrangement with the asset manager.	Asset Managers & Asset Owners
Article 3i	Transparency of asset managers	Member States shall ensure that asset managers disclose, on an annual basis, to the institutional investor with which they have entered into the arrangements referred to in Article 3h how their investment strategy and implementation thereof complies with that arrangement and contributes to the medium to long-term performance of the assets of the institutional investor or of the fund. Such disclosure shall include reporting on the key material medium to long-term risks associated with the investments, on portfolio composition, turnover and turnover costs, on the use of proxy advisors for the purpose of engagement activities and their policy on securities lending and how it is applied to fulfil its engagement activities if applicable, particularly at the time of the general meeting of the investee companies. Such disclosure shall also include information on whether and, if so, how, they make investment decisions based on evaluation of medium to long-term performance of the investee company, including non-financial performance, and on whether and, if so, which conflicts of interests have arisen in connection with engagements activities and how the asset managers have dealt with them	Asset Managers
Article 3j	Transparency of proxy advisors	Member States shall ensure that proxy advisors publicly disclose reference to a code of conduct which they apply and report on the application of that code of conduct. Where proxy advisors do not apply a code of conduct, they shall provide a clear and reasoned explanation why this is the case. Where proxy advisors apply a code of conduct but depart from any of its recommendations, they shall declare from which parts they depart, provide explanations for doing so and indicate, where appropriate, any alternative measures adopted. Information referred to in this paragraph shall be made publicly available, free of charge, on the websites of proxy advisors and shall be updated on an annual basis	Proxy Advisors

Note: Regarding Article 3d – transparency of costs, HSBC will publish relevant costs on its website from 3 September 2020 as required under this directive.

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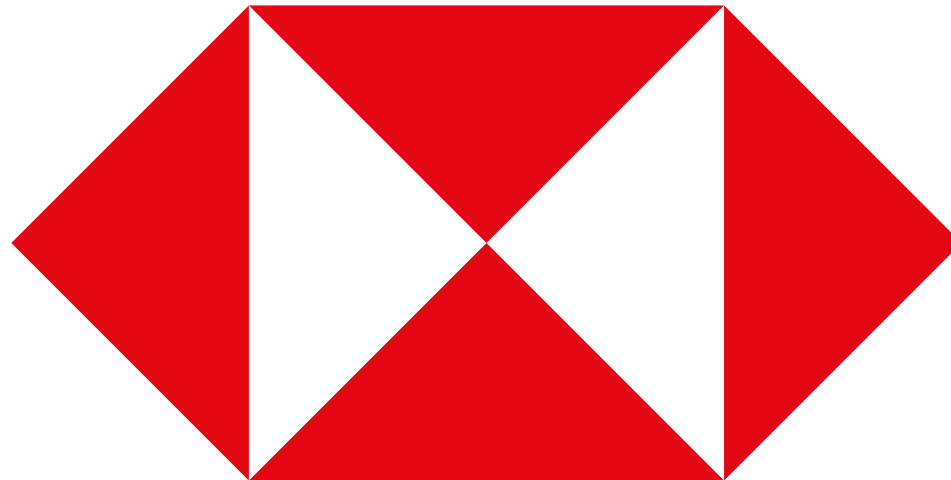
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