**Opening Statement by Peter Au-Yang**
**Acting Chairman of the Securities and Futures Commission**

**LegCo Financial Affairs Panel Meeting**

**5 January 2006**

Honourable Chairman Bernard Chan

Honourable Members of the Financial Affairs Panel

1. First of all, thank you for inviting us to brief you on the SFC's report on Hong Kong's derivative warrants market, which was issued on 25 November 2005. As you may be aware, the report is entitled *A Healthy Market for Informed Investors – A Report on the Derivative Warrants Market in Hong Kong*.

2. This report was triggered by concerns – both within the SFC as well as the market – about the increased activity in our derivative warrants market. The concerns raised relate to a range of matters including the possible impact on the overall stability of our stock market; possible market manipulation; the appropriateness of our existing regulatory framework; and the level of investor knowledge and understanding.

3. In what follows, I would like to take you through the key findings and proposals set out in our report. First however, allow me to mention very briefly how we approached this review and what we focused on.

4. We started our review by going back to basics – by asking ourselves what purpose derivative warrants and a derivative warrants market served. We

concluded that these products serve a useful purpose in our market. Specifically –

i) If used properly, derivative warrants can play a useful role in the portfolio of our investors. They allow investors to use their capital more efficiently, to hedge their risk exposures from other investments and to diversify and strengthen their portfolio.

ii) Secondly, many international markets, and certainly the major markets in Europe, have a derivative warrants market, while in Asia, many markets are trying to develop their derivative warrants market. The existence of a derivative warrants market in many markets suggests that such products have an important role to play and is important in maintaining Hong Kong's status as an international financial centre.

iii) Thirdly, although the trading activities in our derivative warrants market is voluminous (i.e. accounting for about 19% of the total market turnover), they do not currently threaten the overall stability of our stock market given its current market value of about HK$4.5 billion and dynamics of our stock market as a whole.

5. Having concluded that there is a need for the existence of a derivative warrants market, we then considered the particular features and practices in our derivative warrants market. We made a number of observations –

i) First, derivative warrants are complex products and many investors, particularly retail investors, do not fully understand how they work.

ii) Secondly, there are currently a number of undesirable or inappropriate practices in the market. On the enforcement side, we have commenced a number of formal investigations relating to activities in the derivative warrants market including possible false trading, fixing of the settlement price during the expiry process, non-compliance with the liquidity providing obligations and illegal short-selling of derivative warrants. Our investigations continue in this area.

iii) Thirdly, we see issuers adopting high penetration marketing techniques to promote their derivative warrants. The result is that derivative warrants are now regarded as a mainstream financial product rather than being recognized as the complex products that they are.

iv) There is a tendency for unsophisticated investors to rely heavily on turnover when deciding whether to invest in a particular derivative warrant or not, rather than understanding its particular features and value.

6. Our findings lead us to believe that there are basically two areas that we need to focus on – first improving the regulatory regime for derivative warrants and, secondly, enhancing investor understanding about derivative warrants and how they work. To that end, we have proposed a six-point plan.

i) First, we propose amending the liquidity provider provisions to tighten the minimum service levels, to ban external liquidity providers and to provide more information relating to liquidity provision activities to the market.

ii) Secondly, we propose facilitating both further issues and identical issues. This will help alleviate price anomalies and enhance market competition.

We propose facilitating further issues by reducing the processing time and increasing the maximum number of units that an issuer may hold when making a further issue. Both these will help shorten the current time lag that has the potential to create supply shortage. For identical issues, our proposals are to relax the current minimum life of 6 months and minimum price requirements of HK$0.25 as these may inhibit the creation of identical issues.

iii) Thirdly, we propose banning commission rebate and other incentive schemes altogether as the current market practices encourage over-exuberance in derivative warrants trading and other market abuses.

iv) Fourthly, we propose issuing new principle based guidelines for the marketing of derivative warrants to cover the whole spectrum of the marketing and promotion campaign via all forms of media. However, we acknowledge that our own rules may not be sufficient to catch all marketing activity. We are therefore also currently discussing this issue with the Broadcasting Authority and the Television and Entertainment Licensing Authority with a view to identifying measures to strengthen the regulation of financial programmes on the radio and television.

v) Fifthly, we propose requiring the use of plain language and summaries in listing documents and to allow investors to readily compare the terms of apparently similar derivative warrants.

vi) Lastly, we propose enhancing our already extensive investor education programme and working with the market to see how they can help to improve investor understanding of derivative warrants.

In the Report, we have provided a detailed coverage of the extensive investor education efforts which we have put in during the years. Going forward, we have a number of new investor education initiatives in the pipeline. In particular –

- We will be launching a new TV and radio announcement campaign which will be supported by advertorials in popular newspapers, to alert investors that derivative warrants are complicated products and that it is essential to understand their terms before investing in them.

- We have recently launched an open Investor Story Competition where participants are invited to recount true stories of their experiences in investing in derivative warrants, and to comment on how investor education helped them.

- We will be encouraging intermediaries to enhance their clients' understanding of the risks associated with trading in derivative warrants and to use the SFC's education materials for this purpose.

- We shall also explain in plain language the impact of any rule changes in the derivative warrants market so that retail investors are better able to understand how the market works and the steps they need to take to protect their own interests.

HKEx has indicated that it too will be contributing to investor education by looking into ways to enhance its website to improve information dissemination.

7. I would like to emphasise here that in devising our proposals, we have focused on achieving the right balance between – on the one hand – securing an appropriate degree of protection for members of the investing public and – on the other hand – not over-regulating the market so as to stifle continuous innovation and development. We also believe our proposals will make it easier for both the regulator and market participants to identify improper practices and behaviour, and respond accordingly.

8. We have invited the public to comment on our proposals before the end of January 2006. As of today, we have received 3 responses. The first was a technical comment on the format of the report file on our website which we have subsequently addressed. The other two responses, one from an individual and another one from an issuer, gave comments on some of the proposals put forward in the Report. As one may expect, they hold opposite views over some of the issues such as whether to tighten the obligations of liquidity providers or to ban the appointment of external liquidity providers.

9. We expect to receive more comments from the market, probably towards the end of the consultation period. Our next step will be to consider the comments received and discuss these with HKEx. Specific proposals for amendments to the SFC's Codes and Guidelines and the Listing Rule will thereafter be developed and consulted on in due course, as appropriate.

10. I would be happy to answer any questions members may have. Thank you.