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Legislative Council

LC Paper No. CB(1)615/05-06(04)

Ref : CB1/PL/FA

Panel on Financial Affairs
Meeting on 5 January 2006

Background Brief
on the review of derivative warrants market

Purpose

This paper sets out the background of the review of derivative warrants market conducted by the Securities and Futures Commission (SFC), and summarizes the concerns expressed by Members on related issues.

Background

2. Since their introduction in Hong Kong in 1989 and as revised in 2002, derivative warrants have become a popular product among a broad cross-section of investors, particularly retail investors. Prior to 2002, the Stock Exchange of Hong Kong (SEHK) operated a quota system which limited the issue of derivative warrants over a company's shares to the lower of 20% of its issued share capital or 30% of its public float. To help eliminate pricing anomalies when there is a supply and demand imbalance, the Hong Kong Exchanges and Clearing Limited (HKEx) adopted a number of measures in 2002 after market-wide consultation, including abolishing the quota system, requiring issuers to provide liquidity in their warrants, and relaxing rules to facilitate further issues.

3. During the first ten months of 2005, the turnover in the derivative warrants market averaged HK$3.3 billion a day, representing 18% of the average daily total stock market turnover. In comparison, the average daily turnover for 2004 was HK$2.1 billion, or 13% of the total. The significant growth in trading activities in the derivative warrants market has caused various concerns, including that the growing size of the market would threaten the stability of the stock market, and that the regulatory framework needs to be reviewed to address the undesirable and inappropriate market practices. The fall of the Hang Seng Index by 301.49 points on 18 August 2005 has given rise to more concerns about the increased activities in the derivative warrants market. Members also expressed their concerns on the subject at the meeting of the Panel on Financial Affairs (FA Panel) on 13 October 2005 and through raising written questions for the Council meeting on 19 October 2005.

4. Against this background, the SFC conducted a comprehensive review of the derivative warrants market. Upon completion of the review, the SFC issued a report on 25 November 2005 for consultation up to 31 January 2006.

Derivative warrants

Benefits and risks

5. Derivative warrants are complex financial instruments. They give buyers the right, but not the obligation, to buy or sell an underlying asset at a pre-determined price (commonly referred to as the strike price or exercise price) on or before a specified date (commonly referred to as the expiry date or maturity date). The underlying asset may be any asset including a single stock, a basket of stocks, an index, a currency, a commodity or a futures contract.

6. Derivative warrants are listed on the SEHK and traded like stocks, i.e. they may be bought and sold in the market at anytime before they expire[Note]. They can be attractive to investors for several reasons. First, as they cost only a fraction of the price of their underlying asset, they provide a much cheaper alternative to investing in the underlying asset. Second, they have a leveraging effect, i.e. a small change in the price of the underlying asset can result in a much larger change in the price of the derivative warrant, and thus potentially greater gains (or losses, as the case may be). Third, as a warrant holder is not obliged to exercise his rights when the exercise price of a call warrant is higher than (or for a put warrant lower than) the price of the underlying asset, the potential loss is capped in that, at worst, the warrant holder loses the entire amount invested but does not have to pay up a further sum on maturity.

7. Derivative warrants have a limited life span. Once the exercise period lapses, the warrant will have no value.

Regulatory framework

8. The existing regulatory regime for derivative warrants in Hong Kong is basically set out in Chapter 15A of the Listing Rules. In addition, the SFC has issued guidelines regarding the use of marketing material in relation to derivative warrants. The regulatory regime covers the following items:

[Note] Derivative warrants may be divided into 2 types – Call warrants and Put warrants. Call warrants give the holder the right to buy a given amount of the underlying asset at a predetermined exercise price while Put warrants give the holder the right to sell a given amount of the underlying asset at a predetermined exercise price. Moreover, the right to buy or sell (as the case may be) may either be exercised on the expiry date (in which case they are called European style warrants), or at anytime on or before the expiry date (in which case they are called American style warrants). Furthermore, settlement on expiry may be in cash or by physical delivery. In Hong Kong, derivative warrants listed on the SEHK are generally European style warrants, cash settled, and automatically exercised.

(a) Scope of the underlying asset of a derivative warrant;

(b) Basic terms and conditions: a minimum issue price of HK$0.25; minimum lifespan of six months and maximum of five years; how the settlement price is to be calculated; and mode of settlement;

(c) Issuer requirements: not being a private company; must have a net asset value of more than HK$2 billion; must have attained the required credit rating and relevant experience;

(d) Requirements relating to the contents of listing documents;

(e) Other requirements, including the requirement of issuers to appoint a liquidity provider to provide liquidity in their derivative warrants; and

(f) Requirements that marketing material must be accurate and neither misleading nor biased; must refer to the full terms and conditions in the listing documents, and include appropriate risk warnings.

Members' concerns about trading of derivative warrants

9. In view of recent public concerns about the risks associated with trading of derivative warrants in Hong Kong and the regulation of such trading activities, members agreed at the FA Panel meeting on 13 October 2005 that the Administration, the SFC and the HKEx should be invited to discuss the subject with the Panel. Members are concerned about the need for strengthening the measures for regulation of warrants trading (including regulation of media programmes on warrants trading), and measures for guarding against market manipulation and addressing potential conflict of interest in the giving of investment advice by media commentators.

10. Hon Albert CHENG raised two written questions on the subject at the Council meeting on 19 October 2005. Mr CHENG's written questions and the Administration's replies are in **Appendices I and II**.

SFC's review report

11. After completing a review on the subject, the SFC issued a "A Healthy Market for Informed Investors – A Report on the Derivative Warrants Market in Hong Kong" (the Report) on 25 November 2005, inviting market participants and interested parties to give their written comments on or before 31 January 2006. On the same day, the HKEx issued a press release indicating that it generally supported the direction of the proposals made in the report and would work

closely with the SFC and the industry to further develop specific market enhancement proposals.

12. The Report contains the SFC's "Six-Point Plan" for improving the derivative warrants market, as follows:

(a) Tightening the requirements on liquidity providers generally and making their operations more transparent;

(b) Facilitating issuers to issue additional units in popular warrants, and allowing other issuers to issue identical warrants to enhance market competition;

(c) Banning commission rebates and other incentive schemes;

(d) Publishing new guidelines on marketing of derivative warrants and working with the Broadcasting Authority in relation to commentators who are not regulated by the SFC;

(e) Requiring issuers to use "plain language" in listing documents and to publish a two-page summary of key product features, risks and benefits of each warrant; and

(f) Launching new investor education initiatives to further improve investor understanding on derivative warrants.

13. The SFC's press release on the Report with a summary of the "Six-Point Plan" is in **Appendix III**. The Report was issued to members of the FA Panel and members of the Panel on Information Technology and Broadcasting on 3 January 2006 (LC Paper No. CB(1)630/05-06(01)).

Recent developments

14. The SFC will brief the FA Panel on the findings of the review on derivative warrants at the meeting to be held on 5 January 2006.

Council Business Division 1
Legislative Council Secretariat
3 January 2006

Appendix I

LEGCO QUESTION NO. 11
(Written Reply)

Asked by : The Hon Albert CHENG Date of meeting: 19 October 2005

Replied by: Secretary for Financial Services and the Treasury

Question :

It has been reported that the Hong Kong stock market saw abnormal and sharp movements on 18 August this year, with the index once dropping over 300 points during the day. The incident had aroused suspicion of market manipulation involving false prices. In the wake of the incident, some small investors published an open letter in newspapers to appeal for regulation of covered warrants (commonly known as "warrants") by the Government, and the Securities and Futures Commission and the Independent Commission Against Corruption also intervened by investigating the incident. In this connection, will the Government inform this Council whether:

(a) it knows the reasons for the Stock Exchange of Hong Kong ("SEHK") relaxing the restrictions on the issuance of warrants in 2001 so that issuers may issue unlimited number of warrants; whether SEHK will review the merits and demerits of the relaxation and whether the market-making system will be abolished;

(b) it knows how SEHK will prevent market manipulation by issuers, including their participation in transactions on a substantial scale, and their suppression of the prices of underlying shares before the warrants are due to expire, resulting in small investors being unable to deliver such shares upon exercise of the warrants; and

(c) it has assessed if the practice of allowing SEHK, as the regulating body, to gain profits from charging listing fees has given rise to a conflict of interest; if assessment has been made, of the results?

Reply :

Madam President,

In response to the questions raised by the Honourable Albert Cheng, the Administration has sought information from the Securities and Futures Commission (SFC) and the Hong Kong Exchanges and Clearing Limited (HKEx). Our reply to the three-part question is set out below.

(a) Prior to 2002, the Stock Exchange of Hong Kong (SEHK) operated a quota system which limited the issuance of derivative warrants over a company's shares to the lower of 20% of its issued share capital or 30% of its public float. In May 2001, the HKEx carried out a public consultation on the listing and trading rules of SEHK on derivative warrants and noted that other exchanges internationally did not adopt a quota system to limit the issuance of derivative warrants. The HKEx also noted that if a quota system was to be imposed to limit the issuance of derivative warrants over the shares of a particular company, the quota system would in certain instances restrict the ability of issuers to launch warrants to meet demands. As a result, pricing anomalies (i.e. when the price of a derivative warrant reaches unreasonably high level when compared with its theoretical value which is determined by factors such as the price of the underlying stock, time to maturity, implied volatility, etc.) might occur in the derivative warrants. To help eliminate pricing anomalies when there is a supply and demand imbalance, the HKEx adopted a number of measures in 2002 after the market-wide consultation, including abolishing the quota system, requiring issuers to provide liquidity in their warrants, and relaxing rules to facilitate further issues.

In view of recent public as well as market concerns over a number of issues related to the derivative warrants market in Hong Kong, the Administration has requested the SFC and HKEx to look into the concerns raised. The review being conducted by the SFC is expected to complete by the end of November this year. On the other hand, the HKEx has issued a public consultation document on the issuance and trading of derivative warrants on 10 October 2005. A copy of the consultation document is attached at Annex.

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(b) Since 1998, all derivative warrants listed on SEHK have been settled in cash and not the underlying shares. To guard against possible market manipulation at expiry, the Listing Rules stipulate that cash settlement at expiry should be calculated using the average closing price of the five days preceding the expiry date. This measure helps to minimize potential manipulative action by issuers or anyone to influence the price of the underlying stock of a derivative warrant and reduce market volatility. Moreover, only liquid stocks with large market capitalisation (i.e. a public float capitalisation of $4 billion or above) can be qualified as underlying stocks for single stock derivative warrants. This also makes it difficult for anyone trying to manipulate the market.

It should be noted that active or bulk trading by issuers may not necessarily be related to market manipulation as issuers are required to provide liquidity. Both the SFC and HKEx have a surveillance team to monitor any suspicious or manipulative activities. Where appropriate, HKEx will refer suspicious cases to the SFC for follow up. The SFC will take necessary enforcement action against market misconduct. The SFC is currently investigating a number of suspected market manipulation derivatives warrants trading activities.

(c) To address potential conflict of interest and ensure that HKEx's interests coincide with those of the public, adequate statutory safeguards have been put in place in the Securities and Futures Ordinance, which include –

(i) A requirement for HKEx to act in the interest of the public, having particular regard to the interest of the investing public, and to ensure that the interest of the public prevails over any other interests;

(ii) Authority of the Government to appoint independent directors to the Board of Directors of HKEx in the interest of the investing public or in the public interest;

(iii) Authority for SFC to approve all fees and charges related to HKEx's regulated activities including listing fees;

(iv) Power for SFC to give direction to HKEx if it considers that a conflict of interest has arisen; and

(v) Authority for the SFC to approve any amendments by HKEx to the listing and trading rules of SEHK.

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NEWS RELEASE 10 October 2005

HKEx Discusses Derivative Warrants and Invites Feedback

Introduction

1. Since their introduction in Hong Kong in 1989 and as revised and re-launched in 2002, derivative warrants (DW) have proven to be a very popular product among a broad cross-section of investors, particularly retail investors. Despite this popularity and the significant growth in the DW market, this investment instrument has at times also generated its share of discussion and debate. In Part I of this article the requirements governing DW contained in the Stock Exchange's Listing and Trading Rules are discussed. Part II provides a summary of the recent discussion and debate and HKEx management's response. Finally, HKEx invites interested parties to provide their views on the DW market and the matters discussed in this article.

   HKEx has worked closely with the Securities and Futures Commission (SFC) concerning the DW market since its inception. Recent discussions with the SFC include the issues raised in this article. HKEx will continue to assist the SFC in its consideration of the DW market and the feedback received on this article will be shared with the SFC. HKEx understands that the SFC will be publishing its views on the DW market by approximately the end of November 2005.

<u>Part I - Listing and Trading Rules for DW</u>

Issuer Eligibility

2. DW holders are unsecured creditors of an issuer. They have no preferential claim to any securities an issuer may hold to hedge the exposure arising from a DW issue. As such, investors are exposed to the credit risk of the issuer; HKEx has sought to reduce that risk by imposing stringent entry criteria for issuers. There is, however, no guarantee against an issuer's default and as discussed below such default represents only one of the various risks to which investors are exposed when trading DW.

3. An issuer is required to have net assets of $2 billion or more. This level is seen as a measure of the issuer's commitment to the business of issuing derivative warrants. Issuers are also required to have either a credit rating (which must be at least an "A" grade) or to be regulated by the Hong Kong Monetary Authority (HKMA) or the SFC. The minimum credit rating is currently equivalent to the sovereign rating ceiling assigned to the Hong Kong SAR Government. Requiring issuers who do not meet the minimum rating requirement to be regulated by either the HKMA or the SFC helps to ensure that the issuer will be subject to an appropriate regulatory regime which will protect the interests of parties dealing with an issuer.

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電話 Tel: (852) 2522 1122 傳真 Fax: (852) 2295 3106 網址 Website: www.hkex.com.hk 電郵 E-mail: info@hkex.com.hk

4. The issuer eligibility requirements are intended to provide a high degree of assurance, but not a guarantee, that issuers will be able to fulfil their obligations arising from DW issuance. Since 1989, there has been only one case of an issuer default on its obligations as a DW issuer. DW are complex leveraged products and pose numerous risks that investors should be aware of. For this reason DW may not be suitable for many retail investors and investors should make sure they understand warrants and the related risks before trading in them.

DW Liquidity

5. Issuers are required to provide liquidity for DW issues. To comply with this requirement issuers are required to appoint a Liquidity Provider (LP), who must be a Stock Exchange Participant and who may be either a member of the issuer's group or an independent party who acts as the issuer's agent. Liquidity may be provided by means of market-making in which either two-sided quotes are made on a continuous basis or are made in response to a quote request. Issuers should specify the applicable spread interval between their bid and ask prices in the listing document. Liquidity should be provided commencing no later than five minutes after the market opens and should be for a minimum of 10 board lots. There are exemptions for fast markets and for when an issuer has no DW available to sell. All dealings by an issuer in one of its DW must be conducted through the applicable LP. The LP for each DW has a broker number starting with "95" or "96" thus providing transparency of the LP's trading activity.

6. The requirement to provide liquidity was introduced in 2002 after the market-wide consultation conducted in 2001[1]. The requirements are intended to help ensure that investors are able to purchase and sell DW throughout an issue's life in what are considered to be retail-sized amounts. These requirements were set at a light level to enable market forces and competition to drive issuers to provide service levels beyond those noted above. Other exchanges also address the issue of post-listing liquidity in DW by likewise requiring issuers to provide a market-making capability for their DW. Market-making is also a normal feature of the exchange-traded options markets internationally.

Further Issues of DW

7. As noted above issuers are required to ensure a certain level of liquidity for their DW. One of the exceptions to this requirement is where the issuer has sold the entire approved supply of the relevant DW in which case it is no longer required to quote offer prices for that issue. When over 80 per cent of a DW issue has been sold an issuer may, but is not required to, create an additional supply of that issue by way of a Further Issue.

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[1] *Consultation Paper: The Listing Rules of the Stock Exchange of Hong Kong Relating to Derivative Warrants* published May 2001 by HKEx

8. Further Issues are permitted on the basis that they help to eliminate pricing anomalies when DW issues have been fully sold. Creating a timely additional supply of a DW helps ensure that the price of the DW is determined by fundamental market factors (eg strike price relative to underlying asset price, expected volatility of the underlying asset(s), time to maturity and interest rate) rather than by supply and demand for the DW. Further Issues are discussed again below.

Eligible Stocks

9. To be eligible for DW issuance a stock must be either a constituent of the Hang Seng Index or be on a list published by HKEx approximately every quarter. To be included on the list a stock must have maintained a public float capitalisation of $4 billion or more for approximately three months. Newly listed stocks may be exempted from the three-month requirement if their public float capitalisation is at least $10 billion. Currently, about 90 listed stocks are eligible for DW issuance.

10. These requirements are intended to limit issuance to liquid stocks in order to minimise the potential impact of DW on the price of the underlying shares. To guard against any such impact at DW expiry, cash settlement at expiry is calculated using the average closing price for the five days preceding the expiry date. In practice, DW expiry has not proven to be a problem as the number of DW outstanding usually shrinks substantially prior to expiry. HKEx also notes that the vast majority of DW are issued on the Hang Seng Index and on 10 to 15 stocks which are among the highest in terms of liquidity and market capitalisation.

11. The Exchange previously operated a quota system which limited DW issuance over a company's shares to the lower of 20 per cent of its issued share capital or 30 per cent of its public float. In reviewing the Listing Rules in 2001 HKEx noted that other exchanges did not adopt a quota as a means of limiting DW issuance. The interests of issuers, HKEx and market participants are aligned in this area. Although each issuer will have a different risk appetite, in general issuers limit issuance or use alternative hedging mechanisms to minimise any impact their DW issuance and hedging activity may have on the prices of an underlying shares. If a quota system were to be imposed it would in certain instances restrict the ability of issuers to launch Further Issues, potentially resulting in pricing anomalies in the DW. In light of these factors the quota system was repealed in 2002 after market-wide consultation.

Transparency

12. All DW launches and upcoming expirations are published on the HKEx website. Issuers' listing documents including the particulars of each DW are also published on that website. Each day issuers publish a daily trading report showing their aggregate sales and purchases of each DW and related average prices, and the total amount of that issue in the market. As mentioned, trading by the DW's LP can be seen by the market due to the LP's unique broker number which is displayed on AMS/3. As discussed below, extensive technical details about each DW are available from most DW issuers' websites, newspapers and other financial publications, as well as various information vendors.

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Trading Rules

13. The LP for each DW is allowed to short sell the DW and receives an exemption from the "tick rule" in this regard; other market participants are not allowed to short sell DW.[2] There is also a provision for DW Hedging Participants (DWHP) who are appointed by the issuer to conduct hedging activities and who receive an exemption from the tick rule for hedging in the underlying stock. However, only two out of approximately 20 DW issuers have appointed a DWHP. HKEx provides an AMS/3 terminal or a standard "throttle" to each LP for every five DW for which they provide liquidity. (Throttle refers to the standard order input capacity within which orders can be submitted to the trading host system through the Open Gateway within a specific period of time.)

Part II - Some Concerns regarding the DW Market and HKEx Management's Response

14. ***Some market participants argue that the DW market unduly influences the prices of the underlying stocks and increases market volatility.***

Response

The DW market adds liquidity to trading in the underlying stocks via DW issuers' hedging transactions and as such provides benefits to all market participants. It must be noted, however, that this liquidity is just one of many forces that interact in a free price discovery market to establish a market price. Moreover, many DW are hedged with options and other instruments rather than the underlying stock.

DW are leveraged and have lower transaction costs (eg no stamp duty for cash-settled DW) than the underlying stocks. For these reasons, market forces may first appear in the DW market or other derivative markets rather than the market in the underlying shares; this is similar to and also observable in futures and options markets in Hong Kong and overseas.

Overall, market volatility in Hong Kong has been low whilst DW activities have been growing as reflected in Appendix 1. Some academic studies indicate that the presence of derivatives trading does not affect or may decrease market volatility, whilst other studies provide a contrary view. On these points there is no consensus among academics.

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[2] The "tick rule" stipulates that a short sale of a Designated Security shall not be made on the Exchange below the best current ask price except where the Designated Security is an Exchange Traded Fund traded under the Pilot Programme or is an Exchange Traded Fund approved by the SFC to be excluded from the application of this Regulation.

In any event, if derivatives such as DW are not traded on the Exchange or the Exchange environment is not conducive to their trading then these instruments are very likely to trade in the over-the-counter markets or in overseas markets. Derivatives on Hong Kong stocks are already traded in Singapore, Germany, and the United States, among other markets. In the past, trading in Japanese NIKKEI index futures moved from Japan to Singapore and German Bund futures moved from Germany to London when local conditions were not conducive or competitive in relation to the derivatives. Further, given that the most actively traded DW in Hong Kong relate to "blue chip" stocks that are also available for trading in other major international markets, it is possible that various DW hedging activity using the underlying stock may also migrate to these other markets.

15. ***Other market participants say DW prices and trading activity may be manipulated by issuers, liquidity providers or others.***

Response

As derivatives, the prices of DW can be compared to similar derivatives on the underlying stock such as other DW and Exchange-traded stock options. One such comparative measure is known as "implied volatility". In its educational programmes for DW, HKEx encourages investors to learn more about the various factors that affect DW prices and to compare products against one another to assess the price and whether one product may be out of line with the others. Various DW issuers' websites also include much information in this regard. HKEx is considering ways to improve the disclosure and dissemination of technical information about DW and will discuss these ideas with DW issuers and the SFC.

Sometimes a popular and active DW may trade at a premium to similar DW and Exchange-traded stock options. Market feedback indicates that this may occur due to buying demand that results when a DW has sold out or before a Further Issue can be completed. In these situations, arbitrage activity may not operate freely, for example because supply is fixed and the DW is not eligible for short selling, except by the issuer's LP. Although the issuer may launch a Further Issue (in effect increasing the available supply of the issue) after 80 per cent of an issue has been sold out, some issuers report that there may be insufficient time to complete the Further Issue to keep up with the demand thus potentially leading to a higher price (and higher implied volatility) than similar products. However, when the issuer does launch the Further Issue, the additional supply may satisfy the demand and lead to a correction of the DW price. This may be seen by some as manipulation. Issuers comment that the rules should be changed to enable Further Issues to be completed more quickly which would help to prevent these potential overvaluations. In other derivatives markets such as those for futures and options, supply is not fixed and new short positions are allowed thus making pricing anomalies less likely. In other words, natural market forces serve to ensure that price discovery is allowed to operate freely.

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Recently there have been suggestions that issuers create "wash sales" in DW to create the appearance of trading activity to attract additional investor interest in the DW. Some observers say that issuers may pay incentives to those who generate such trading activity (discussed further below). In this regard, issuers' trading in their DW may be conducted only through the designated LP whose trading is transparent to the market. The HKEx surveillance team monitors for wash sales and other suspicious activity and refers cases where appropriate to the SFC. See also paragraph 18 below concerning rebates and other incentives.

16. ***One concern is that DW issuers are permitted to reissue additional DW which can have the effect of driving down DW prices.***

Response

This is most likely because of the factors mentioned in the second paragraph above. HKEx believes a less restricted issuance system would be more efficient and less likely to produce pricing anomalies, for example no specific limit on each issue or by enabling faster completion of Further Issues.

17. ***Some people complain that DW do not always reflect movements in the underlying share price.***

Response

This phenomenon may be explained by a failure to understand the various factors that affect a DW price. The HKEx educational programme for DW covers a variety of factors including implied volatility, premium, gearing, time to expiry, and the "delta" (or hedge ratio) of DW. Information on these factors is often also provided on issuers' websites.

Some examples of how market forces may affect DW include –

- DW prices may fall even though the underlying asset price has not changed. This can result from a decrease in the implied volatility determined by market forces. Similarly, DW prices may fall over time as they approach expiry, which is why options are often referred to as a "decaying asset."

- The delta of a DW will determine how sensitive the DW is to changes in the underlying asset price. DW with strike prices far "out of the money" may not respond at all to some changes in the underlying asset price whereas those far "in the money" may move nearly one-to-one with the underlying asset.

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18. ***Another concern is that DW issuers pay incentives or rebates to selected brokers or other investors who trade in their warrants. Observers argue these practices are not fair or are designed to create an appearance of active trading in the DW.***

Response

Discounted commissions and other sales incentives may be part of normal competition and consistent with market rules. However, market feedback indicates that some trading in DW may be generated solely to receive sales incentives. HKEx management questions whether it is appropriate for DW issuer incentives or commission rebates to be the only reason DW trades are conducted and intends to discuss this further with the SFC.

19. ***Some people suggest that insufficient effort is made in providing education about DW.***

Response

HKEx agrees that education is very important. HKEx has a continuing educational effort to explain to market participants including the investing public the features and risks of DW. A main message is that DW carry a high degree of risk and may not be suitable for all investors, particularly small retail investors whose market knowledge or financial resources may be inadequate to enable them to understand the risks and bear losses. The HKEx educational programme also covers the technical aspects of DW.

HKEx market education activities with EPs on DW include the following.

- Distribution of DW education materials among other materials relating to a general overview of trading securities and other listed products.

- Publication and distribution of flyers on DW through the following channels:
  - HKEx's sales counter
  - Investor seminars organised by HKEx
  - Expositions with HKEx's participation in public exhibitions
  - Visits to EPs
  - Requests from EPs
  - Visitors to HKEx; etc.

- HKEx's Product webpage on DW publishes information relating to DW under the following headings:
  - DW Leaflet.
  - Listing Documents.
  - Daily Trading Summary.
  - Pre-Listing Trading Summary.
  - Trading Arrangement Announcements (Including New Listing, Last Day of Dealings and Others).
  - Derivative Warrants Manual Transactions for the Day.
  - Derivative Warrants with Liquidity Provider Information.
  - Basket Warrants Information.
  - Obligations of Liquidity Providers for Derivative Warrants.

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- Newspaper articles relating to DW
  HKEx publishes articles relating to products in the newspapers, including articles about DW.
- Continuous Professional Training (CPT) course relating to DW
  From July 2004 to date, HKEx organised 10 CPT courses for EP staff on various topics relating to DW, such as on DW in theory and in practice, relationships with other listed derivative products, trading strategies and market analysis. Leading issuers were invited as speakers.

HKEx also organises periodic investor education events. So far in 2005, HKEx has organised three public seminars specifically on DW and another for the Institute of Financial Planners of Hong Kong.

Conclusion

20. HKEx has striven to create an evolving framework for the issuance and trading of DW and other structured products that is transparent and tailored to meet market needs, consistent with international standards, and which recognises that there is substantial retail interest in dealing in DW. HKEx management believes this helps to maintain Hong Kong's position as a leading international financial centre.

21. Some concerns about the DW market appear to result from misunderstandings of the technical aspects of DW. In this regard, HKEx has an educational programme for DW and will increase its efforts in this area whilst also encouraging issuers and EPs to participate and it will coordinate with the SFC. Other concerns about the DW market suggest changes should be made to improve the market and HKEx has in this article indicated that it will consider a number of possible changes. These will be discussed further with market participants and the SFC. Finally, there are concerns that there is misconduct in the DW market. In this regard, HKEx will continue its surveillance programme in cooperation with the SFC to detect and punish any misconduct.

22. DW are geared instruments and investing in them carries many risks. In certain cases investors may sustain a total loss of their investment. Investors should ensure that they fully understand all the risks involved before they invest in DW.

23. HKEx invites all interested persons to provide comments on this article and the DW market. Comments received will be shared with the SFC.

    Comments should be sent to the address below:

    Hong Kong Exchanges and Clearing Limited
    11th Floor, One International Finance Centre
    1 Harbour View Street
    Central
    Hong Kong

Re: Understanding Derivative Warrants / Request for Comments

Comments may also be sent by fax to (852)2868-5223 or by email to feedback@hkex.com.hk.

The names of persons who submit comments on this paper together with the whole or part of their submissions may be disclosed to members of the public.

Appendix

Appendix 1 – Volatility Chart

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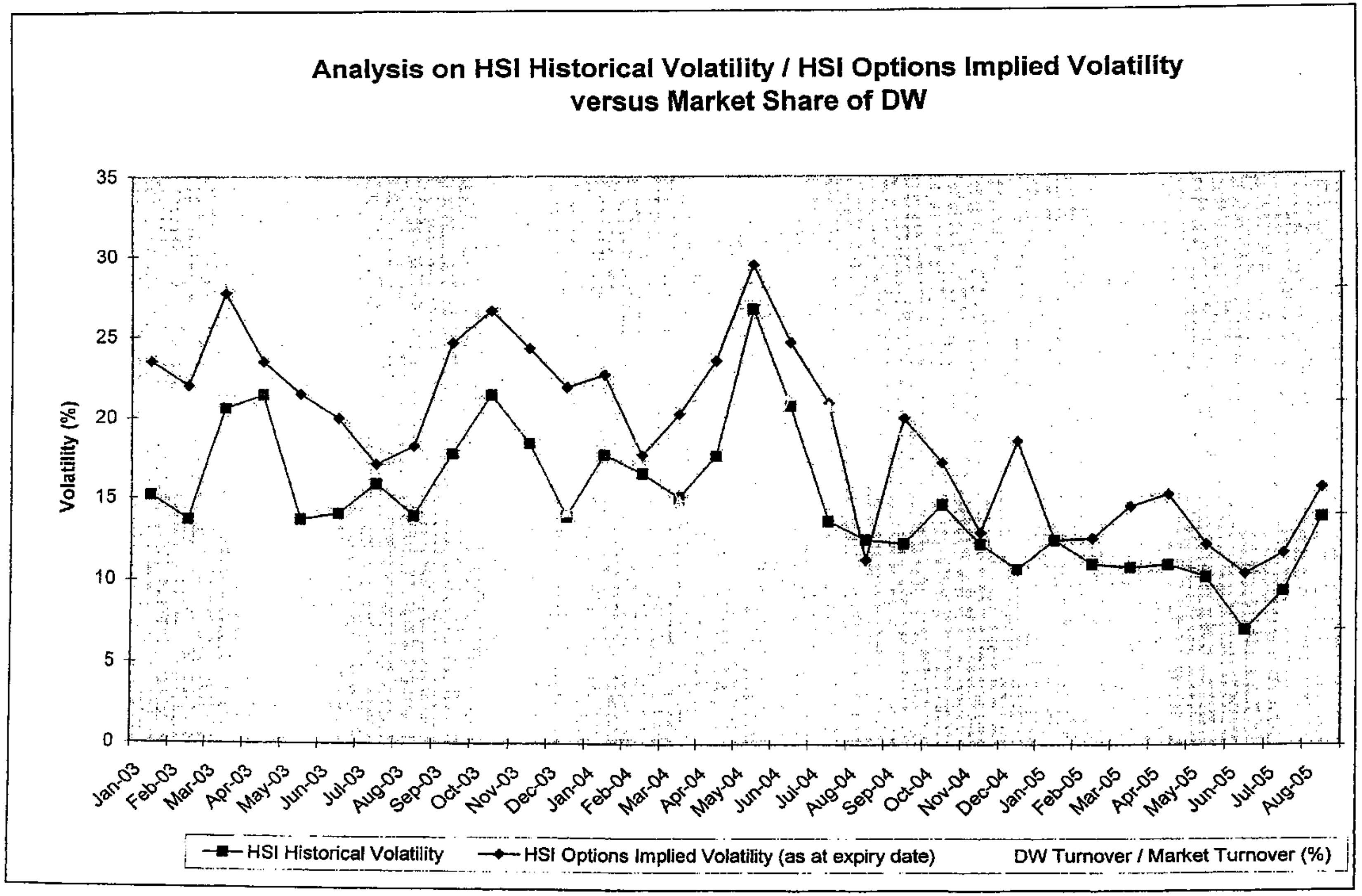
Appendix 1 - Price Volatility of the Hang Seng Index



Legislative Council Question No. 19
(Written Reply)

Asked by : Hon Albert Jinghan CHENG **Date of Meeting :** 19 October 2005

Replied by : Secretary for Commerce, Industry and Technology

Question:

It has been reported that, in introducing and recommending individual covered warrants (commonly known as "warrants") on their programmes, hosts of business/financial programmes in the local media might have shown favouritism towards individual issuers and misled small investors. Moreover, as the market-making system is adopted in the local warrant market, market manipulation is prone to arise. In this connection, will the Government inform this Council:

(a) how it prevents hosts of such business/financial programmes from showing favouritism towards individual warrant issuers and misleading small investors on their programmes;

(b) whether it knows if the Broadcasting Authority ("BA") has investigated if hosts of such programmes have assisted issuers in manipulating the market; and

(c) whether it knows if BA, the Independent Commission Against Corruption and Securities and Futures Commission have issued any guidelines concerning the contents of such business/financial programmes, and whether a system of declaration of interests has been established for hosts of such programmes?

Reply:

Madam President,

(a) Licensed television and sound broadcasters (licensees) have to comply with the codes of practice (the codes) issued by the Broadcasting Authority (BA). Radio Television Hong Kong has also agreed to comply with the codes on a voluntary basis.

To prevent programmes from misleading the public, paragraph 3 of Chapter 9 of the Generic Code of Practice on Television Programme Standards and paragraph 22 of the Radio Code of Practice on Programme Standards require the licensees to ensure that due impartiality is preserved in respect of factual programmes (including financial programmes). Licensees must make every reasonable effort to ensure that the factual content of programmes is accurate. The programmes should not be slanted by the concealment of facts or by misleading emphasis.

On safeguards against conflict of interest, paragraph 8 of Chapter 9 of the Generic Code of Practice on Television Programme Standards and paragraph 27 of the Radio Code of Practice on Programme Standards stipulate that the licensee shall devise and institutionalise a mechanism whereby its presenters of factual programmes are required to disclose the existence of any commercial agreement or arrangement that may call into question the fairness or impartiality of the programmes. The licensee must also exercise its editorial judgement and decide whether the relevant programme presenter(s) should refrain from taking part in discussion of issues over which he/she may have conflict of interest; or a disclosure announcement of the existence of a relevant commercial agreement should be made at the time of broadcast of the programme material.

The licensee shall receive and consider any complaint from any member of the public with respect to the potential conflict of interest of its programmes. The licensee shall inform the complainant and the BA of the findings of its investigation and make the findings available for public inspection free of charge by, for example, posting them on its website. The purpose is to enhance the transparency of programmes, so as to let members of the public participate in scrutinising if a presenter's comments constitute a conflict of interest.

The BA requires the licensees to comply with the provisions as stipulated in the codes in spirit as well as in letter and that the codes should be read in conjunction with relevant legislation and licence conditions currently in force, including the Securities and Futures Ordinance that regulates the securities and futures markets.

On the other hand, the Securities and Futures Commission (SFC) requires all firms and individuals licensed by the SFC for conducting regulated activities to comply with the following requirements set out in the Code of Conduct issued by the SFC when they prepare and publish investment research on securities (including stocks and derivatives) or otherwise disseminate all or part of their investment research in the mass media (printed materials and broadcasting):

(i) When the abovementioned person provides analyses or comments on securities in respect of a listed corporation in the mass media in his/her personal capacity, including appearing in person, he/she should disclose the following at the time the analyses or comments are provided -
   (I) his/her name:
   (II) his/her licence status; and
   (III) where he/she and/or his/her associate has a financial interest in the listed corporation, the fact of having such an interest.

(ii) When the abovementioned person is asked by members of an audience, or otherwise by a journalist, for analyses or comments on specific securities, he/she may offer such analyses or comments, provided that he/she makes the disclosures as mentioned above.

(b) In such cases, the BA will refer the matter to relevant authorities for investigation. The SFC will also investigate any person (whether programme hosts or otherwise) suspected of engaging in market misconduct activities.

(c) The Independent Commission Against Corruption has not issued any relevant guidelines. The codes issued by the BA and SFC are cited in the reply to part (a) above.

SFC Launches Six-Point Plan for the Derivative Warrants Market

The SFC today releases a Report on the Derivative Warrants Market in Hong Kong. The report reveals the SFC's Six-Point Plan for improving the market.

The Six-Point Plan addresses the SFC concerns about market conduct and the quality of information provided to investors, and contains proposals to make the market more efficient, fair and competitive.

In releasing the report, SFC Chairman, Mr Martin Wheatley, said: "Our report provides a comprehensive review of the derivative warrants market and highlights a number of areas where we believe reform is needed. Our objective is to facilitate the development of a healthy warrants market for investors to make informed investment decisions."

"We look forward to receiving comments on the proposals contained in our Six-Point Plan," he said.

The report focuses on the following areas:

- it reviews market characteristics and practices;
- it assesses the impact of derivative warrant activities on stock market stability;
- it identifies areas of regulation that need strengthening; and
- it assesses investor education needs

The report notes that the Hong Kong derivative warrants market is the most active in the world, with high turnover. However, having looked at the overall size of the market and other issues, the report concludes that the operation of the derivative warrants market does not currently have an untoward systemic impact on the overall market. The SFC believes that the derivative warrants market serves a useful purpose for investment and hedging, and should be allowed to prosper so that investors may have more product choice.

However, the report notes a number of practices that give rise to concern and proposes regulatory responses in six areas. The Six-Point Plan is summarised below.

1. Liquidity providers

The first area relates to the obligations and practices of liquidity providers who, on behalf of issuers are required to stand in the market to provide the opportunity for investors to trade their warrants.

The report notes that the levels of service and prices offered by liquidity providers can vary significantly from what is outlined in the listing documents. The report proposes tightening the requirements on liquidity providers generally and making their operations more transparent.

The report also expresses concern about issuers appointing liquidity providers who are outside parties.

"We believe there is more likelihood of an issuer properly supervising the liquidity provider if they are part of the same group," Mr Wheatley said. "Accordingly we propose requiring issuers to appoint in-house liquidity providers."

2. Further issues and identical issues

Another concern noted in the report is how prices of derivative warrants are often influenced by demand. The report proposes changing some Listing Rules to make it easier for issuers to issue additional units in popular warrants, and also to allow other issuers to issue "identical" warrants creating more competition.

"We are aware that some commentators have proposed banning further issuance. However, we believe some of the price distortions in the market are caused by limited supply," Mr Wheatley said. "Our proposals to allow further and new issues to be made quickly, will reduce price distortion and encourage competition in the market, and so benefit investors."

3. Commission rebates

The report concludes that commission rebates and other incentive schemes are not operating to the benefit of the market or the retail investors, and are open to abuse.

There are trades created apparently with the aim only of benefiting from a commission rebate. The report notes the risk of retail investors getting a false picture of the level of trading in a warrant when in fact the turnover mainly comes from trades that are carried out to generate commission.

The SFC proposes banning these schemes. "Our study of these schemes indicates that rather than generating legitimate activity benefiting retail investors, the major benefits are going to a limited number of people," Mr Wheatley said.

4. Marketing guidelines

The report makes certain proposals about the information that is available to investors and the level of understanding of many retail investors.

The SFC urges investors to be cautious about how they source information about derivative warrants. "We are concerned that investors sometimes respond to the latest 'tips' from television or radio commentators, or press articles. While these commentaries may provide useful information, we want to ensure that if anyone has any financial interest or benefit gained from making such comments, that is disclosed," Mr Wheatley said.

The SFC will publish new guidelines covering marketing of derivative warrants and that it will work with the Broadcasting Authority in relation to commentators who are not regulated by the SFC.

5. Plain language

The other concern expressed about information is whether investors have difficulty in understanding listing documents. The report notes that such documents are lengthy and couched in technical language. The SFC proposes requiring issuers to use "plain language" in their documents and to publish a two-page summary of the key product features, risks and benefits of each warrant. The SFC will work with the industry to agree on common definitions and standard terms.

6. Investor education

The report also announces new investor education initiatives by the SFC to further improve investor understanding. These include new investor competitions, changes to its website and a public interest television commercial. The SFC notes that the stock exchange will improve the information that it makes available to investors, particularly through its website.

Mr Wheatley said: "We want to remind retail investors that derivative warrants are not for everyone. They do have significant risks and you should know what you are investing in. I'll repeat the title of one of our recent Dr Wise articles: *If in doubt, stay out.*"

The report also notes that the SFC has started investigations into certain derivative warrants activities, 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 warrants. Investigations are continuing.

The SFC's proposals are open for comment until the end of

January 2006. Following that and taking any comments into account, formal consultation will take place on any changes to the Listing Rules.

A Healthy Market for Informed Investors – A Report on the Derivatives Warrants Market in Hong Kong is available at the SFC office and on the SFC website.

Ends