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Panel on Financial Affairs

Meeting on 23 May 2011

Background brief on regulation of derivative warrants market

Purpose

This paper provides background information on regulation of the derivative warrants (DWs) market in Hong Kong and summarizes the major concerns and views expressed by members when the subject was discussed by the Panel on Financial Affairs (the Panel).

Background

Derivative warrants

2. DWs are a form of structured products. 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.[1]

[1] DWs 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, DWs listed on the SEHK are generally European style warrants, cash settled, and automatically exercised.

3. DWs were first listed in Hong Kong in 1989. They are listed on the Stock Exchange of Hong Kong (SEHK) and traded like stocks, i.e. they may be bought and sold in the market at any time before they expire. They can be attractive to investors mainly because they allow a leveraged play on the underlying asset and thus provide a much cheaper alternative to investing in the underlying asset. Besides, as DWs only confer a right but not an obligation to buy or sell the underlying asset, there is no need for the investor to pay up a further sum on maturity and his loss is thus capped at the amount paid for the DWs.

Regulatory framework

4. SEHK is the frontline regulator responsible for reviewing and approving listing documents for listed structured products such as DWs and callable bull/bear contracts. Under the current regulatory framework, listed structured product issuers generally issue marketing materials via relevant intermediaries licensed by the Securities and Futures Commission (SFC) without having to seek the SFC's prior authorization. These SFC licencees must, however, abide by the Guidelines on Marketing Materials for Listed Structured Products published by SFC in September 2006.

5. The requirements for listing structured products, including eligibility of issuers, are set out in Chapter 15A of the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (Listing Rules), which are administered by SEHK, under the oversight of SFC. Chapter 15A of the Listing Rules covers the following items:

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

(b) basic terms and conditions;

(c) issuer requirements;

(d) requirements relating to the listing documents;

(e) requirements relating to the marketing materials; and

(f) other requirements, including the requirement of issuers to appoint a liquidity provider to provide liquidity in their DWs.

Review of the derivative warrants market in 2005

6. Since their introduction in Hong Kong in 1989, DWs have become a popular product among a broad cross-section of investors, particularly retail investors. To help eliminate pricing anomalies when there is a supply and demand imbalance, SEHK adopted a number of measures in 2002 after market-wide consultation, including abolishing the quota system[2], requiring issuers to provide liquidity in their warrants, and relaxing rules to facilitate further issues.

7. The trading activities in the DW market grew significantly in 2005[3] and had caused various concerns including the possible impact on the overall stability of the stock market, possible market manipulation, appropriateness of the existing regulatory framework, and the level of investor knowledge and understanding. Against this background, SFC conducted a comprehensive review of the DW market, and issued on 25 November 2005 a report entitled "A Healthy Market for Informed Investors – A Report on the Derivative Warrant Market in Hong Kong" (the Report) for public consultation. The major review findings as set out in the Report were as follows –

(a) DWs, if used properly, could play a useful role in the portfolio of investors. Many international markets had a DW market and many markets in Asia were trying to develop their DW markets.

(b) Although trading activities in the DW market in Hong Kong were voluminous accounting for about 19% of the total market turnover, they did not currently threaten the overall stability of the stock.

(c) DWs were complex products and many investors, particularly retail investors, did not fully understand how they worked.

(d) Certain practices in the market might be inappropriate and not in the best interests of investors. Practices that SFC was particularly concerned included the following –

  (i) There had been a significant growth in issuers' trading activities in the market, and such increased trading

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2 Prior to 2002, SEHK operated a quota system which limited the issue of DWs over a company's shares to the lower of 20% of its issued share capital or 30% of its public float.

3 During the first ten months of 2005, the turnover in the DWs 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.

activities of issuers might be attracting unsophisticated investors who tended to rely heavily on the turnover in a DW when making their investment decisions and assessing liquidity;

(ii) Certain DW issuers employ high penetration marketing techniques to promote their DW through the mass media, and as a result, the DW market was considered by many to be a mainstream financial product; and

(iii) Retail investors commonly used DWs as a short-term speculative instrument, sometimes without fully understanding their nature and complex price mechanism.

8. The Report contained a Six-Point Plan focusing on improving the regulatory regime for DWs in Hong Kong and enhancing investor understanding about DWs and their operation. In gist, the proposals were –

(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 DWs and working with the Broadcasting Authority (BA) in relation to commentators who were 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 DWs.

9. SFC issued a press release on 31 March 2006 setting out how it would take forward the proposed "Six-Point Plan". The press release is in the **Appendix.**

Review on regulation of structured products in 2009

10. Triggered by the Lehman Brothers Minibonds Incident, SFC conducted a review of the legislative framework for regulation of public offers of structured products in 2009. Following a two-month public consultation commenced in October 2009 and upon consulting the Panel on the relevant legislative proposals on 3 May 2010, the Administration introduced the Securities and Futures and Companies Legislation (Structured Products Amendment) Bill 2010 (the Bill) into the Legislative Council on 14 July 2010. The Bill sought to transfer the regulation of public offers of structured products in the form of shares or debentures from the Companies Ordinance (Cap. 32) to the Securities and Futures Ordinance (Cap. 571) (SFO) so that structured products (regardless of their legal form) would be regulated under one regime, i.e. the offers of investments regime under the SFO. For listed structured products including DWs, it was proposed that SEHK should remain as the frontline regulator after the proposed transfer. Accordingly, the issue by SFC licencees of offering documents and marketing materials of listed structured products and the products themselves would continue to be exempted from SFC's authorization. The Bill was passed at the Council meeting on 4 May 2011.

Deliberations of the Panel

11. On 5 January 2006, the Panel discussed the findings of SFC's review of the DW market in Hong Kong. The major concerns/views expressed by members and the responses of the Administration, SFC and the Hong Kong Exchanges and Clearing Limited (HKEx) are summarized below.

Reasons for and impacts of the growth of the derivative warrants market

12. Panel members were concerned about the significant growth of the DWs market in Hong Kong, and the impacts of the DW market activities on the stability of the stock market. SFC advised that the total market value of DWs represented only a small percentage of the total market capitalization of the stock market. The trading activities in DW market, though voluminous, did not currently pose a threat to the overall stability of the stock market. Moreover, SFC had developed a market risk monitoring system to assist in monitoring the various markets. The system served to enhance the understanding of market dynamics and identify risks that might pose a threat to market stability.

13. To better understand the characteristics of the DW market in Hong Kong, Panel members requested the Administration and SFC to conduct a comparative analysis of the development of DW markets in Hong Kong and other major financial centres and the respective DW regulatory regimes. They also requested SFC to provide quantitative analyses of the investors' participation and issuers' participation in the DW market. SFC subsequently provided the relevant information vide LC Paper No. CB(1)1091/05-06(01).

Need for strengthening the regulatory regime

14. Some members were concerned that the proposed measure of facilitating further issues and identical issues of DWs might increase the risk of the DWs concerned and jeopardize the interest of small investors. SFC explained that the measure aimed at addressing the concern about supply and demand imbalances, alleviating price anomalies, and enhancing market competition of DWs. The measure would not result in unlimited issuance of a DW as the issuance of DWs would still be subject to other rules of the regulatory regime. Overseas DW markets had also adopted similar measures to facilitate issuers in issuing DWs or other derivative products with a view to addressing the concern about supply and demand imbalances of the products.

15. Some members urged the Administration and SFC to tighten the regulation of media programmes covering the trading of DWs and their commentators. SFC advised that SFC's licensed or registered analysts making commentaries or recommendations on a DW through the mass media were required to declare interests relating to the DW and the issuer. The Broadcasting Authority advised that under the Radio Code of Practice on Programme Standards and the Generic Code of Practice on Television Programme Standards, the licensees were required to make every reasonable effort to ensure that the factual content of programmes was accurate, and to devise and institutionalize a mechanism whereby its presenters of news programmes and factual programmes would declare the relevant interests.

16. Some members suggested that apart from requiring financial analysts to disclose relevant interests, consideration should be given to prohibiting financial analysts from trading the securities concerned for a certain period. SFC advised, subsequent to the meeting, that there was requirement in the Code of Conduct for Persons Licensed by or Registered with SFC (the Code) restricting the analysts from dealing in or trading securities of the listed corporation concerned within certain specified periods.

Measures to protect investors

17. A number of members stressed the need to step up investor education on DWs. A member suggested implementing suitability checks on investors in Hong Kong and allowing only those who had passed certain thresholds, such as thresholds on product knowledge and investment experience, to invest in complex investment products.

18. SFC advised that the Code required licensees and registrants to assess the suitability of investors, including the level of risks investors could take, before marketing the financial instruments to investors. In providing services to a client in derivative products, a licensee or registrant was required to assure itself that the client understood the nature and risks of the products and had sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

19. A member commented that HKEx's website had not provided up-to-date information on the trading volume and activities of DWs, and urged HKEx to strengthen its services in this area to enable investors to better understand the performance and volatility of DWs. HKEx responded that it was revamping its website with a view to providing investors with useful information relating to DWs in a more efficient and user-friendly manner. HKEx would also cooperate with SFC in taking forward other proposals in enhancing investor education on DWs.

Recent developments

Incident of the suspension of trading and subsequent buyback of four DWs linked to the Nikkei 225 Index issued by Goldman Sachs Structured Products (Asia) Limited

20. On 31 March 2011, the trading of four DWs linked to the Nikkei 225 Index issued by Goldman Sachs Structured Products (Asia) Limited (GS) was suspended. GS issued on the same date two amendment notices stating that the formula for the "Cash Settlement Amount per Board Lot" and the definition of "Cash Settlement Amount" for the warrants concerned were erroneously stated in the relevant supplemental listing documents. The amendment notices also set out how the formula/definition should have been stated.

21. GS subsequently issued a notice on 21 April 2011 setting out the legal basis for the amendments to the terms and conditions of the warrants and GS's Buyback Offer to repurchase the warrants from existing warrant holders. Under the Buyback Offer, the buyback price

payable to an accepting holder would be the higher of 110% of the Total Net Purchase Price (as defined in the announcement) paid by the relevant accepting holder for such warrants or 110% of the total Buyback Value (as defined in the announcement) of such warrants. In addition, each accepting holder would receive a one-off fixed administrative fee of $5,000. The Buyback Offer Period commenced on 26 April 2011 and was previously scheduled to end on 16 May 2011. GS issued another announcement on 11 May 2011 to extend the Buyback Offer Period to 5:00 pm on 27 May 2011.

22. The Panel will discuss at the coming special meeting on 23 May 2011 the policy issues relating to the above incident. The Administration, SFC and HKEx have been invited to attend the meeting.

Relevant papers

23. The relevant papers are available at the following links:

Meeting of the Panel on 5 January 2006	• Background Brief prepared by the Legislative Council Secretariat • Minutes (paragraphs 9-38) • Follow-up paper provided by SFC in response to members' request
Notices issued by Goldman Sachs Structured Products (Asia) Limited	• First and second amendment notices issued on 31 March 2011 • Notice issued on 21 April 2011 • Notice issued on 11 May 2011

Council Business Division 1
Legislative Council Secretariat
19 May 2011

Appendix

Press Releases

31 March 2006

SFC Update on Six-Point Plan for the Derivative Warrants Market

The SFC today announces how it will take forward the Six-Point Plan proposed in the November 2005 Report on the Derivative Warrants Market in Hong Kong. The SFC's paper "*Hong Kong's Derivative Warrants Market – the Way Forward, Results of the Consultation on the SFC's Six-Point Plan*" takes into account the submissions received following the November Report.

The specific proposals under the Six-Point Plan aim to strengthen and enhance Hong Kong's derivative warrants market.

A total of 27 submissions from 29 respondents were received. Responses were generally supportive of the Six-Point Plan and of maintaining a derivative warrants market in Hong Kong. The specific proposals were also generally well received, though some attracted opposing views. Taking into account all responses, the SFC has decided to proceed with the Six-Point Plan subject to some modifications and refinements.

SFC Chairman, Mr Martin Wheatley, said: "We welcome the overall support for the Six-Point Plan. We will be progressing all the proposals. A few proposals have triggered strong and varied views, and we have proposed modifications or refinements to address the concerns raised. Many of the proposals will require changes to the Listing Rules and hence approval of the Listing Committee. We will work with the Exchange to achieve this within the shortest possible timeframe."

On the question of timing, Mr Wheatley said: "The proposal to enhance investor education and information dissemination is already underway and will continue. As for the others, the proposals to ban commission rebates, facilitate further and identical issues and issue new marketing guidelines are likely to progress first; followed by the proposals for appointing external liquidity providers and use of plain language; and then the remaining proposals."

Mr Wheatley added: "We believe that these changes will, over time, increase investors' awareness of the risks and features of derivative warrants, and contribute to the development of a healthy market where informed investors may participate with confidence."

Details of how the Six-Point Plan will be progressed are summarised below. Where Listing Rule changes are required, the SFC will work with the Exchange to bring the relevant proposals before the Listing Committee.

(1) Liquidity Provision

The SFC will proceed with the proposal to tighten liquidity provider minimum service levels. We will finalise details of the requirements with the Exchange and relevant stakeholders will be consulted in the process. The SFC will also work towards implementing continuous quoting in the medium to longer term.

The SFC will modify its previous proposal to prohibit the appointment of external liquidity providers, so that issuers can continue to appoint external liquidity providers, but subject to certain conditions. The conditions are designed to ensure that issuers have direct control over the liquidity provision. The SFC also notes that there appears no reason for external liquidity providers to be remunerated on the basis of turnover under the proposed arrangement.

The SFC will proceed with the proposal for information on liquidity providers' performance to be disclosed. We will finalise details of the requirements with the Exchange and relevant stakeholders will be consulted in the process.

(2) Further and identical issues

We maintain our position that a quota system will not be reinstated. We will also proceed with the proposals to facilitate further issues and identical issues.

For further issues, the SFC aims to increase from 20% to 50% the maximum of an existing issue that an issuer may hold when making a further issue. The Exchange will at the same time endeavour to process further issue applications within two days.

For identical issues, the SFC aims to relax the minimum term and minimum price requirements to three months and 15 cents, but with a degree of flexibility on the maturity date of an identical issue to better manage unwinding activities towards maturity. The relaxations will be kept under review and their suitability reassessed six months after implementation.

(3) Commission rebates and other incentive schemes

The SFC will proceed with the proposal to ban commission rebates and other incentive schemes offered by issuers. Implementation will require Listing Rule changes and this process may take some time. Issuers are however expected not to enter into new contracts or renew old ones in the meantime.

(4) Marketing guidelines

We will proceed to publish new marketing guidelines. A draft of the guidelines is attached to the Paper and interested parties are invited to send in their comments by 30 April 2006. We plan to finalise the guidelines by the end of June 2006. The guidelines aim to prevent misleading promotion of warrants and ensure commentators disclose any potential conflicts of interests.

(5) Plain language, summaries, etc

The SFC proposes requiring all listing documents relating to derivative warrants and submitted to the Exchange after 30 September 2006 to be in plain language. In the meantime, we will also discuss and finalise the content and format of summary documents as well as common definitions and standard terms for standard products. Relevant stakeholders will be consulted in this process.

(6) Investor education and information dissemination

The SFC will continue to enhance investor education on derivative warrants. The Exchange is also working on enhancements to its website which include various measures for improving the disclosure and dissemination of technical and other information on derivative warrants.

Hong Kong's Derivative Warrants Market – the Way Forward, Results of the Consultation on the SFC's Six-Point Plan is available at the SFC office and on the SFC website.

Ends

Note:

1. Please see SFC Press Release dated 25 November 2005 for details of the November Report.