



SECURITIES AND
FUTURES COMMISSION
證券及期貨事務監察委員會

Hong Kong's Derivative Warrants Market – the Way Forward Results of the Consultation on the SFC's Six-Point Plan

Hong Kong
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CHAPTER I: INTRODUCTION AND EXECUTIVE SUMMARY

Introduction

1. On 25 November 2005, the SFC published its report on Hong Kong's derivative warrants market entitled *A Healthy Market for Informed Investors – a Report of the Derivative Warrants Market in Hong Kong* (“**Report**”).
2. The Report proposed a Six-Point Plan for enhancing and strengthening our derivative warrants market. Interested parties and members of the public were invited to submit their views on our proposals. We received a total of 27 submissions from 29 respondents. Details of the respondents are set out at Annex I.

Way forward on the Six-Point Plan

3. The response suggests that most people saw benefit in keeping a derivative warrants market in Hong Kong. As for the specific proposals put forward in the Report, most of these were well received, although some attracted opposing views.
4. In the following Chapter, we summarise the comments received, our response to these and our position on whether and how to take each of the proposals forward. We have discussed our views on how to take the proposals forward with the Exchange. They have indicated that they will work closely with the SFC and the industry in taking the proposals forward.
5. In summary our views on progressing the specific proposals are as follows –

Proposal 1: Tightening liquidity provider provisions

- (1) We propose to proceed with the proposal to tighten *minimum service levels* for liquidity providers. We will work with the Exchange to determine sensible levels and relevant stakeholders will be consulted in the process. We expect however that this will include setting minimum lot sizes, maximum bid-offer spreads, maximum response times for quote requests and minimum periods for maintaining an order after entering it in the system. We expect the new levels to be expressed in terms of minimum levels (ie not in absolute terms).

Simultaneously, we will work with the Exchange and issuers to move towards continuous quoting in the medium to longer run.

- (2) We propose to modify our previous proposal which was to prohibit the appointment of *external liquidity providers*. We propose now to permit such appointments but only if the issuer –
 - (a) retains full control over the provision of liquidity in respect of its derivative warrants by connecting its own market making system directly with the external liquidity provider's Market Making Open Gateway and

sending orders directly to the Exchange's system for onward dissemination to the market without interference or work at the external liquidity provider's end; and

- (b) reports to the SFC and the Exchange the monthly amounts paid to each external liquidity provider.

We do not expect any amounts paid to external liquidity providers under such an arrangement to be based, either directly or indirectly, on turnover.

- (3) We propose to proceed with the proposal to require disclosure and dissemination of *information relating to the performance of liquidity providers*. We will work with the Exchange to finalise details regarding the information to be provided and the process of obtaining and disseminating such information. Again, relevant stakeholders will be consulted in the process.

Proposal 2: Changing the Listing Rules to facilitate further issues and identical issues

- (4) We maintain our view that a quota system should not be reinstated, and propose to proceed with the proposal to facilitate *further issues*. We aim to increase to 50% the maximum of an existing issue that an issuer may hold when making a further issue. The Exchange has indicated that it will endeavour to process applications for further issues within 2 days.
- (5) We also propose to proceed with the proposal to facilitate *identical issues* but with caution. We propose lowering the minimum life and minimum price requirements to 3 months and \$0.15 for derivative warrants that are identical versions of those already in the market, but with a degree of flexibility to better manage unwinding activities towards maturity.

Proposal 3: Banning commission rebates and other incentive schemes

- (6) We propose to proceed with the proposal to ban *commission rebates and other incentive schemes* provided by issuers. Implementation of this proposal will require changes to the Listing Rules and this process may take several months. However, we expect issuers not to enter into new contracts or renew old ones in the meantime. Issuers whose existing contracts will not expire until after June 2006 should approach the SFC as soon as possible.

Proposal 4: Publishing new marketing guidelines

- (7) We propose to proceed with publishing *new marketing guidelines* and have attached a draft of these at Annex II for comment by 30 April 2006.

Proposal 5: Requiring the use of plain language and summaries

- (8) We propose to proceed with the proposal to require *plain language and summaries* and agree *common definitions and standard terms*. We propose that all listing documents relating to derivative warrants that are submitted to the Exchange after 30 September 2006 be in plain language. The Exchange has indicated that it supports this proposal. In the meantime, we will 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.

Proposal 6: Enhancing investor education and information dissemination

- (9) Lastly, we will proceed with enhancing *investor education*. A number of initiatives are already underway or are planned. 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.

Time-table for implementation

6. Many of the above proposals will require changes to the Listing Rules for which there is a separate and independent process. This includes public consultation on the specific rule changes and approval by the Listing Committee and the SFC's board. Interested parties will therefore have an opportunity to comment on the specific rule changes in due course. We set out below the proposed timeline for bringing the proposals before the Listing Committee.
7. In terms of timing –
- (1) We expect the Listing Rule changes in respect of the proposals to ban *commission rebates* and incentive schemes and facilitate *further issues* and *identical issues* to be relatively straightforward. We will work with the Exchange with a view to its presenting a policy paper on these proposals to the Listing Committee at its next policy meeting (currently scheduled for May 2006).
- (2) As for the proposal to issue new *marketing guidelines*, the consultation period for commenting on the draft will end on 30 April 2006 and we expect the guidelines to be finalised and issued by the ***end of June 2006***. In the meantime, we will also work with the Exchange to determine how best to make these new guidelines binding on issuers who are not registered or licensed with the SFC.
- (3) The proposal to permit the appointment of *external liquidity providers* may necessitate more time. Issuers and liquidity providers will need some time to get the necessary system changes in place. We believe however that the market should be ready by the ***end of September 2006***. In the meantime, we will work

with the Exchange with a view to its presenting a policy paper on the specific rule changes to the Listing Committee before then.

- (4) The proposal to require the use of *plain language* may also necessitate more time as issuers and their legal advisers will need time to convert their listing documents into plain language. We believe however that the market should be ready by the ***end of September 2006***. In the meantime, we will work with the Exchange to determine how best to incorporate this as an obligation on issuers.
- (5) A few of the proposals require further consultation or discussion with relevant stakeholders – namely the proposals regarding *minimum service levels, disclosure of liquidity providers' performance, summary documents and common definitions and standardised terms*. Any specific Listing Rule changes regarding these proposals will follow such consultation or discussion. We will work with the Exchange with a view to its presenting a policy paper on the specific rule changes to the Listing Committee before ***the end of December 2006***.
- (6) As for our proposal to *enhance investor education and information dissemination*, this is an *on-going* initiative and we will be continuing our efforts in this regard.

DW Investor Survey

8. Since releasing the Report, the SFC commissioned a survey on the profile, trading experience and knowledge level of investors who trade in derivative warrants (“**DW Investor Survey**”). The results of this survey were published on 10 March 2006. Chapter III discusses the survey results in greater detail. That Chapter also sets out some of our more recent and upcoming investor education initiatives.

CHAPTER II: RESPONSES AND WAY FORWARD ON SPECIFIC PROPOSALS

9. This Chapter summarises the comments received on each of the proposals put forward in the Report and sets out our views on whether to take the proposal forward and how.

Proposal 1: Tightening the Liquidity Provider Provisions

10. The Report proposed tightening the liquidity provider provisions by –
- (1) tightening the minimum service levels;
 - (2) compelling issuers to appoint liquidity providers in-house; and
 - (3) enhancing the dissemination of information relating to the performance of liquidity providers to the market.

(1) Tightening the minimum service levels

11. The objective of tightening minimum service levels was to secure a higher level of commitment by liquidity providers as to their undertaking in the listing document.

Comments received

12. There were varied views on this proposal. Many raised concerns that any new levels set must be realistic, flexible enough to allow market participants to respond to changing market conditions and balanced against commercial feasibility and costs. One respondent also advocated continuous quoting. It noted that a quotes-on-request system is more appropriate to the OTC market, and that in an order-driven market, such a system reduces transparency and favours the issuer.
13. A main concern of those opposing this proposal was that it would be impossible for any new levels to be set in absolute terms. There was also concern that because a liquidity provider's ability to provide liquidity at a particular level depends on many underlying factors, any minimum set would have to be lower than otherwise possible to avoid raising false expectations among investors. It would also be necessary to provide for exceptions. Additionally, there would still be competition to provide after-issue services at levels better than the stipulated minimum. Consequently, the proposal might not address the problem of investors feeling aggrieved as a result of fluctuations in service levels. On the other hand, if the revised levels prevented this, it would discourage competition. Concern was also expressed that the SFC should not set levels which would effectively legitimize issuers' practice of using narrow bid-ask spreads and then widening them later.

Our views

14. We agree that any new levels set cannot be expressed in terms of absolute levels, and that exceptions will have to be provided. We also appreciate concerns about issuers needing a degree of flexibility to respond to changing market conditions when providing quotes; costs and commercial feasibility; setting levels that are realistic; and not discouraging

competition. We believe however that these concerns can be addressed and that service levels can be sensibly tightened to raise the specified minimums to a more realistic level.

15. We also believe that there is a need to implement continuous quoting in the medium to longer term. We understand however that there may be practical difficulties that need to be addressed first.

Way forward

16. We therefore propose to proceed with our proposal to tighten minimum service levels. More specifically:
 - (1) We will work with the Exchange to determine which service levels should be tightened and to what extent. Relevant stakeholders will be consulted in the process. We expect however that any tightening will include –
 - (a) setting minimum lot sizes, maximum bid-offer spreads, maximum response times for quote requests and minimum periods for maintaining an order after entering it in the system – and in this regard, we would expect any new levels set to be expressed in terms of minimum levels (ie not in absolute terms), and to provide for exceptions;
 - (b) requiring easily accessible disclosure of service levels in plain language using a common standard format in listing documents;
 - (c) strengthening the processes for monitoring compliance of liquidity provider services and obligations through the maintenance of appropriate reports, system records, and audit trails (including voice logging of quote requests received by telephone, electronic records of requests received through other electronic means, and system records of subsequent quotes); and
 - (d) encouraging computer-based quote requests.
 - (2) The Exchange has indicated that it has already requested issuers to submit on a daily basis the average price for each derivative warrant bought and sold in standardised, computer readable form (Excel format). This new information format will be accessible and available for downloading from the Exchange's web-based Derivative Warrant Resource Centre (see paragraph 61).
 - (3) In the meantime, we will also work with the Exchange and issuers to move towards adopting continuous quoting in the medium to longer term.

(2) Compelling the appointment of in-house liquidity providers

17. The objective of this proposal was to make it difficult for issuers to distance themselves from the activities of their liquidity providers.

Comments received

18. This proposal was perhaps the most controversial with strong views expressed both for and against it. Respondents who opposed the proposal included those who are external liquidity providers, while most issuers who do not appoint external liquidity providers tended to support the proposal.
19. Supporters of the proposal tended to agree that issuers could better supervise, monitor and control the activities of liquidity providers who were appointed in-house. Other comments included that: an in-house liquidity provider would have its interests aligned with the issuer's and be incentivised to provide high service levels, maintain reasonable prices and ensure compliance with the Listing Rules; issuers would be more responsible and accountable for activities of liquidity providers; issuers and liquidity providers would work together towards competitive pricing and market making services; and external liquidity providers might be remunerated according to turnover, thus giving a distorted picture of liquidity if the liquidity provider engaged in trades solely to increase turnover.
20. Those who opposed the proposal argued that it would not address the problem, and was unfair to external liquidity providers and to issuers who either did not have the necessary in-house facilities or preferred to use external facilities for commercial reasons. In particular, there was concern about the substantial capital investments made by many external liquidity providers in connection with their liquidity provision operations and that such operations constituted a major source of their income so that any ban would affect their livelihood.
21. Other comments included that: there was no basis for saying external liquidity providers were less likely to be properly supervised or controlled by issuers as issuers had sufficient incentive to monitor external liquidity providers and the provision of liquidity by many external liquidity providers was in fact controlled by issuers; there was no evidence that misconduct was more likely where an external liquidity provider was involved and no guarantee that issuers would exercise proper control over in-house liquidity providers; having a third party liquidity provider could avoid conflicts of interest, bring in tighter control and provide a check and balance; the proposal would reduce competition as the market would be dominated by the larger issuers; and the problems currently faced had arisen because of a lack of guidelines, not because of who the liquidity provider was.

Our views

22. We note the substantive concerns raised by opponents to this proposal, particularly concerns about the impact on external liquidity providers and on issuers who have no in-house facilities, and concerns about the proposal being anti-competitive.
23. However, we remain of the view that there is a need to ensure issuers properly control the activities of their liquidity providers. We believe therefore that it would be appropriate to allow external liquidity providers to be appointed, provided the relevant issuer has full control over the provision of liquidity in respect of its warrants. In this regard, we note

that one respondent has indicated that issuers can effectively retain full control by connecting their systems to the liquidity provider's Market Making Open Gateway and having the liquidity orders sent directly from the issuer's market making system to the Exchange's system for onward dissemination to the market without any interference or work at the external liquidity provider's end.

Way forward

24. We propose therefore to allow issuers to appoint external liquidity providers, but only if the issuer –
- (1) retains full control over the provision of liquidity in respect of its derivative warrants by connecting its own market making system directly with the Market Making Open Gateway of the external liquidity providers and sending liquidity orders directly from the issuer's market making system to the Exchange's system for onward dissemination to the market without interference or work at the external liquidity provider's end; and
 - (2) reports to the SFC and the Exchange the remuneration paid to each external liquidity provider.
25. Under such an arrangement an external liquidity provider would simply be providing the necessary facilities for connection to the Exchange and, as such, we would expect the issuer to retain full control and be responsible for the provision of liquidity in respect of its warrants. We also see no reason for liquidity providers to be remunerated on the basis of turnover under such an arrangement, and would expect any remuneration to be either on a flat fee basis or other basis that has no relation to turnover.

(3) Disclosure of information relating to liquidity providers' services

26. We proposed that liquidity providers disclose certain information to the market in a useful and user-friendly manner. The information to be disclosed was the intra-day prices executed by issuers on each derivative warrant together with the associated implied volatilities and possibly prices of the corresponding underlying asset at day end. The objective was to enable investors and the market in general to assess the quality of the services provided by different liquidity providers, and over time, to provide strong incentive for liquidity providers to offer better services. The disclosure of such information coupled with investor education would mean investors are better equipped to detect warrants with significant price anomalies, and to compare similar derivative warrants before deciding which suits them the best.

Comments received

27. Many respondents generally agreed that increased transparency would benefit the market. However, many (including both supporters and opponents) also expressed concerns about different issuers using different criteria and assumptions when calculating implied volatilities, adding that this would result in investors being misled and confused. Many respondents also noted that if such information was to be provided, it should be provided by a single source with a few also suggesting the Exchange as the possible source.

28. Other points raised included concerns about the usefulness of the information to be disclosed, particularly to investors; the labour and other costs of providing such information and the relative benefit to be gained; too much emphasis being placed on implied volatility; the adequacy of information currently available to retail and professional investors; and the need to consult the industry before formulating specifics.
29. One respondent also expressed concerns about there being too much transparency such that it would do more harm than good to the market as a whole. Specifically, the respondent indicated that if the proposal to facilitate further issues is implemented, then the daily trading summary (including in particular details of the outstanding position of each series of derivative warrant as at the end of each trading day), which is currently required to be disclosed to the public at large, should be disclosed to the Exchange only. The respondent noted that such information would be of little value to genuine derivative warrant investors as they just want an idea of whether the issuer will have adequate warrants to provide sufficient liquidity. Institutional investors however would be able to use such information to predict the hedging behaviour of issuers and take advantage of the issuer or create undue volatility. It was also noted that no other warrant market required issuers to make information on outstanding positions publicly available.

Our views

30. We remain of the view that the proposal will help investors and the market in general to assess the quality of services provided by different liquidity providers, and over time, provide a strong incentive for liquidity providers to offer better services. We also believe that the concerns voiced are matters that can be resolved through discussions with relevant stakeholders.
31. We agree moreover that any disclosure obligations put in place will have to –
- (1) be realistic, genuinely helpful to investors and not overly burdensome to issuers and their liquidity providers; and
 - (2) address the concerns about different issuers using different criteria and assumptions when calculating implied volatilities.

Way forward

32. We propose therefore to proceed with this proposal. We will work with the Exchange to finalise details regarding the information to be provided and the process of obtaining and disseminating such information. Relevant stakeholders will also be consulted in the process. The suggestion to disclose the daily trading summary to the Exchange only and not the public at large could also be considered in this context.

Proposal 2: Facilitating Further Issues and Identical Issues

33. We proposed that no quota system be reinstated and that both further issues and identical issues be facilitated. There was generally support for not reinstating a quota system, with

only a few respondents disagreeing or commenting negatively on this. We do not therefore intend to reinstate such a system.

(1) Facilitating further issues

34. On facilitating further issues, we proposed reducing the processing time from the current 4 days to 2 days, and increasing the maximum percentage of an existing issue (currently 20%) that may be held by an issuer when making a further issue. The objective of this proposal was to minimise price anomalies caused by shortages in supply of a particular derivative warrant.

Comments received

35. Most respondents supported the idea of facilitating further issues. A few respondents made specific suggestions as regards the extent to which the 20% limit should be increased. One suggested the limit should stay at 20%, another suggested it be increased to 40%, another suggested 50% and one suggested abolishing the limit altogether.
36. Other suggestions regarding further issues included permitting the use of an addendum to the original listing document rather than a new listing document and reducing listing fees and issuance costs as further incentives to encourage further issues. One respondent also raised concerns that a processing time of two days may not be enough.
37. Several respondents disagreed with this proposal. The main points they made were that facilitating further issues would not address price anomalies; that there was no need to facilitate further issues if short-selling were allowed; and that permitting further issues was fundamentally unfair and posed significant risks.

Our views

38. In view of the strong support for this proposal, we propose to raise the maximum percentage of an existing issue that may be held by an issuer at the time of making a further issue from 20% to 50%.
39. As for the suggestion to permit the use of an addendum, this will be considered when we design the summary documents discussed as part of Proposal 5 (requiring the use of plain language and summaries). As regards the suggestion to reduce the listing fees and issuance costs, this falls outside the remit of the current review and will be considered separately by us and the Exchange. As for concerns that two days may not be enough, we would note that there is no intention to compel processing within two days and that therefore issuers may take longer if they wish.
40. On the question of permitting investors to short-sell, there are a number of reasons why we do not consider this to be a viable option. It is not possible to explain all of these here. Suffice to say however, that there are significant difficulties with permitting short selling. For example, it would be difficult to borrow derivative warrants. Moreover, the price volatility of derivative warrants due to their embedded gearing effect would make it very

difficult for retail investors to manage the market risk of the derivative warrants that they have short sold, and for brokers to manage the credit risk arising from derivative warrants that their retail clients have borrowed.

Way forward

41. We therefore propose to proceed with this proposal and aim to increase the maximum holding at the time of a further issue from 20% to 50%. The Exchange has also indicated that it will endeavour to streamline its processes so that applications for further issues may be handled within two days on the Exchange's side.

(2) Facilitating identical issues

42. On facilitating identical issues, we proposed relaxing the current minimum price requirement (of 25 cents) and the current minimum life requirement (of 6 months) in respect of issues of identical versions of existing derivative warrants. The objective of this proposal was to enhance market competition and minimise price anomalies caused by shortages in supply.

Comments received

43. There were varied views on this proposal. Supporters tended to agree that facilitating identical issues would benefit the market through enhanced competition, better pricing and greater product choice. However, those who opposed were concerned about an increased supply of short-dated, low-value derivative warrants in the market and the consequent rise in speculative activities. There were also concerns that unwinding activities towards expiry would increase as different issues would mature at the same time and thus create a greater impact on the price and volatility of the underlying.

Our views

44. We appreciate the concerns about an increased supply of short-dated and low-value derivative warrants and the associated risks and problems that this may bring. However, we also believe the proposal will play a key role in enhancing competition and deterring price anomalies caused by supply shortages. As regards the concerns about unwinding activities and the resultant risks, we believe these can be managed, such as by building in a degree of flexibility that will allow for identical issues to have a different maturity date in certain cases. We therefore see value in pursuing this proposal but accept that it must be pursued with caution.

Way forward

45. We propose relaxing the minimum life requirement to 3 months and the minimum price requirement to 15 cents. We also propose that these relaxations apply in respect of identical issues of derivative warrants already in the market and incorporate a degree of flexibility to allow for different maturity dates as discussed above. Moreover, we will

keep these relaxations under review and reassess their suitability six months after they are implemented.

Proposal 3: Banning Commission Rebates and other Incentive Schemes

46. The Report proposed banning commission rebates and other incentive schemes but also welcomed views on this and other alternatives. The ban was proposed because it was felt such schemes were encouraging investors to invest in derivative warrants for the wrong reasons and without fully understanding the associated risks. It was also felt that such schemes could be deployed by issuers to influence warrant activity, potentially giving investors a misleading impression of turnover and liquidity, and that issuers did not have adequate control over schemes to ensure investors were getting the full benefit intended.

Comments received

47. Most respondents supported this proposal. The main points made by opponents were that such schemes helped attract and benefited investors, and that concerns about abuse could be addressed by imposing appropriate controls such as disclosure requirements, setting upper limits for the amount that could be given to each investor within a specified period and excluding account executives and employees from being eligible to benefit from such schemes.

Our views

48. In view of the strong support for this proposal, we propose to proceed with it. We do not believe imposing controls such as disclosure requirements and upper limits will adequately address the concerns we have about issuers not having adequate control over such schemes to ensure investors were getting the full benefit intended. Moreover, although the results of the DW Investor Survey indicate that most investors are knowledgeable, there remains a not insignificant number who continue to trade without fully understanding the nature and associated risks of derivative warrants. Commission rebates and other incentive schemes would only serve to encourage such investors.

Way forward

49. We propose to proceed to ban commission rebates and incentive schemes provided by issuers. Implementation of this proposal will require changes to the Listing Rules and this process may take several months to complete and is subject to approval by the Listing Committee and the SFC's board. However, we expect issuers to cease entering into new contractual arrangements for such schemes, or renewing existing arrangements, in the meantime. Issuers who have already entered into contractual arrangements that extend beyond June 2006 should approach the SFC as soon as possible.

Proposal 4: Publishing new Marketing Guidelines

50. The Report proposed publishing new marketing guidelines and possibly incorporating these in the Listing Rules. The objective of this proposal was to put in place improved guidelines which expressly cover all forms and media of marketing, adopt a principle-based rather than prescriptive approach and cover the whole spectrum of the marketing and promotion campaign.

Comments received

51. There was overwhelming support for this proposal, and no opposition. The main points made however were that any guidelines adopted must be sufficiently clear so as to be applied sensibly and reasonably and put out for consultation before being adopted. A few respondents also made specific suggestions as to what the guidelines should cover including suggestions as to what activities should or should not be permitted, what terms should be defined and what matters should be clarified.

Our views

52. We will be proceeding with this proposal. We welcome the market's desire to be given the opportunity to comment on any proposed guidelines before they are adopted. To that end, we have prepared and attach at Annex II a draft of our proposed guidelines. These are designed to apply to all structured products and not just derivative warrants.

Way forward

53. We welcome views on the draft at Annex II and would appreciate submissions being sent in by 30 April 2006. We will be seeking the Broadcasting Authority's views on the draft, and will continue to work closely with them in monitoring the marketing and promotion of derivative warrants.

Proposal 5: Requiring the use of Plain Language and Summaries

54. The Report proposed requiring issuers to use plain language in their listing documents, and prepare a 1 to 2 page summary document containing the key features, returns and risks of their product. The Report also recommended that the industry and regulators agree on common definitions and standard terms for standard products. The objective of this proposal was to facilitate investors' understanding of the features and risks of the derivative warrants they intend to purchase.

Comments received

55. Again, the majority of respondents supported the proposal to use plain language. Most also supported requiring summaries and agreeing on common definitions and standard terms. A few had reservations about requiring summaries and expressed concerns about the feasibility of distilling relevant material down to two pages, and the usefulness of

preparing such a summary. One respondent also noted that the proposal to use plain language may achieve the desired result without having to also require summaries.

Our views

56. We note the strong support for this proposal and note also the reservations that some respondents have about the use of summary documents. We believe the market should be able to adapt to using plain language for derivative warrants within a reasonable period. As for the other aspects of this proposal, we remain of the view that these will be useful to investors and propose to work closely with relevant stakeholders in finalising the details.

Way forward

57. We propose to require that all listing documents relating to derivative warrants and submitted to the Exchange after 30 September 2006 be in plain language. This should give issuers and their legal advisers adequate time to convert their existing pro forma listing documents into plain language. The Exchange has also indicated that it supports the proposed timeline.
58. Simultaneously, we will 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 the process.

Proposal 6: Enhancing Investor Education and Information Dissemination

59. The Report proposed enhancing investor education by stepping up the SFC's own initiatives and working with the Exchange to see how dissemination of information to investors may be further improved. This proposal was made in view of concerns that there was a fairly high level of misunderstanding and misconceptions about derivative warrants on the part of retail investors.

Comments received

60. There was overwhelming support for this proposal and no opposition.
61. We also understand that the Exchange is working on developing a web-based Derivative Warrant Resource Centre (**DWRC**), aimed at providing easy access to relevant information to investors for educational and reference purposes. Major planned enhancements include:
- (1) improving disclosure and dissemination of technical and other information about derivative warrants (including information on re-issuance and basic terms);
 - (2) requiring issuers to submit their Daily Trading Summary for posting on the HKEx website in Excel-like format instead of text format for ease of analysis;
 - (3) enhancing the user interface of the website to facilitate easy navigation and comparison of derivative warrants with similar terms;

- (4) allowing users to download historical data about derivative warrants;
- (5) providing derivative warrant related information in both English and Chinese where practicable;
- (6) adding links to other websites that provide investor education materials;
- (7) adding information about vendors who provide DW information including real-time technical data; and
- (8) supporting linkage to issuers' listing documents.

Our views

62. We welcome the strong support for this proposal. We also welcome the Exchange's initiatives in developing the DWRC. We will work with the Exchange to educate investors on how to use and benefit from the information available via the DWRC. We will also continue to work with the Exchange to see how dissemination of information to investors may be further improved.
63. We will also continue and follow up on our various investor education initiatives as set out in the Report. Details of action taken in this regard since the issue of the Report are set out in the next Chapter.

Other comments and suggestions

64. In addition to responding to the specific proposals put forward in the Report, there were also suggestions as to other areas that the SFC should look into. Some of these are discussed below.

Concrete timetable

65. One respondent urged the SFC to set a concrete timetable for implementing any of the proposals so as to reduce uncertainty in the market.

Our views

66. We appreciate the concern for certainty and have therefore attempted to set out as specific a timetable as currently possible. (See paragraph 7 above.)

Fundamental flaws not addressed

67. A few respondents stated that the Report failed to address the fundamental flaws in our derivative warrants market. The main issues highlighted were that under the current system, there is no yardstick or objective standard for measuring implied volatility or fair value vis-à-vis a derivative warrant, or for monitoring the fairness of an issuer's bid/ask quotes. Issuers are therefore free to determine these by simply adjusting implied volatility. Moreover, the current system also allows issuers to both trade in their own derivative warrants and control the price and supply of such warrants.

Our views

68. We believe the proposals substantially address these issues. In particular, the proposal to tighten minimum service levels will raise the level of commitment by liquidity providers and introduce control over the services a liquidity provider may provide. The proposal for better disclosure of information relating to a liquidity provider's services will help draw attention to the quality of liquidity provision offered by different issuers in respect of derivative warrants over the same underlying. This will provide incentive for offering better liquidity provision and fairer prices. Moreover, with more information available to them, investors will be better able to assess which derivative warrants better suit their needs. The proposal to facilitate identical issues will enhance competition and deter price anomalies in popular warrants. In the event that an issuer is not able to or does not proceed with a further issue, other issuers can step in to offer similar warrants, thus deterring prices of popular warrants from rising to unreasonable levels.

Suitability test and risk disclosure statements

69. There was a suggestion that brokers adopt a suitability test for clients wishing to trade in derivative warrants, and require clients to sign a risk disclosure statement.

Our views

70. The SFC's *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* already imposes various *Know Your Client* obligations on licensed or registered persons. In the case of derivative products, there is an added obligation under paragraph 5.3 of the Code which provides that:

"A licensed or registered person providing services to a client in derivative products, including futures contracts or options, or any leveraged transaction should assure itself that the client understands the nature and risks of the products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products." (emphasis added)

71. A general circular was issued in November 2005 reminding all licensed corporations of this requirement. In view of this requirement, we do not see the need to impose an additional requirement that brokers adopt a suitability test in respect of clients who wish to trade in derivative warrants, or require them to sign disclosure statements.

Investor attitude

72. One respondent asked if we had considered that trading in derivative warrants amounts to gambling and whether we had take into account the extent of money lost by investors. It also asked whether these losses would trigger other social problems.

Our views

73. We remain concerned about investors who trade in derivative warrants without understanding their full nature and associated risks. Our investor education messages

will therefore continue to stress the importance of having a proper investment attitude and remind investors that such products are not suitable for everyone.

Others

74. A few other issues and suggestions were also raised. These include proposals that Rule 15A.29 of the Listing Rules should be amended so as to recognize that Chinese wall arrangements can address concerns about conflicts of interest and proper control of price sensitive information; and proposals for changing the mechanism for calculating the settlement price on maturity.

Our views

75. Such issues fall outside the ambit of the current proposals and will be considered separately with the Exchange.

CHAPTER III: INVESTOR EDUCATION AND DW INVESTOR SURVEY

Investor education initiatives since releasing the Report

76. Since publishing the Report, we have carried out a number of investor education initiatives, including the following:
- (1) We have stepped up our investor education on derivative warrants, focusing on risk education, clarifying misconceptions about derivative warrants and reminding investors to look beyond promotions and recommendations on derivative warrants.
 - (2) We have launched new TV and radio commercials highlighting our theme “Before you invest, ask the right questions”. The TV commercial is being screened on 28 channels of 6 local TV stations and the radio commercial will be broadcast on local radio stations. We also placed a full-page advertisement in a widely circulated free newspaper to explain issues in the commercials. The advertisement included key questions to ask about warrants as well as an open quiz. We have also created a list of key things to know about warrants, which can be easily accessed on our investor education website at www.InvestEd.hk.
 - (3) We have organised an open Investor Story Competition. A total of 100 contestants participated with 26 sharing personal experiences in investing in warrants and the lessons learnt. The 10 best stories, including three on warrants, have been adapted into radio dramas which will be broadcast from March to May 2006 and supplemented by newspaper articles.
 - (4) We have launched a flash animation video explaining the pricing mechanism of derivative warrants to complement the existing text educational information on the InvestEd website. We will be launching more flash videos discussing factors to consider when investing in derivative warrants, the role of liquidity providers and exotic derivative warrants.
77. Going forward, we will be explaining in plain language the impact of any rule changes and the new marketing guidelines so that retail investors can better understand how the market works and what steps to take to protect their interests.

DW Investor Survey

78. Since issuing the Report, we engaged the Centre for Corporate Governance and Financial Policy of the Hong Kong Baptist University to conduct a survey on retail investors who trade in derivative warrants. The survey aimed to understand their objectives, level of understanding, and whether they made profits or losses from trading in warrants.
79. Details of the DW Investor Survey and its results were published on 10 March 2006. The following however highlights some of the more crucial findings of this survey.

- (1) *Profile:* A total of 250 warrant investors were interviewed in the DW Investor Survey. Of these, 61.2% were male; 79.1% were aged between 30 and 59; and 35.2% were degree holders or above and 30.8% were upper secondary school graduates.
- (2) *Trading objectives:* 76.0% said that they had some knowledge about warrants and hoped to make short-term gains; 10.8% said they knew nothing about warrants and simply bet on their luck; and 8.4% traded for risk management (eg hedging) or long-term investment purposes.
- (3) *What prompted them to trade:* 36.8% said they traded warrants on their own initiative; 31.6% were influenced by friends or family members who had traded warrants; 20% were persuaded by market commentators' views in newspapers, television or radio programmes to trade warrants; and less than 10% traded because of brokers' advice or issuers' advertisements, articles or their sponsored television or radio programmes.
- (4) *Risk perception:* 66% and 26.4% perceived the risks as being "very high" and "high" respectively; 4.8% considered the risk to be "medium"; 2.4% viewed the risks as "low" or "very low"; and 0.4% said they did not know.
- (5) *Level of understanding:* 47.6% of warrant investors understood that a higher implied volatility indicates that a derivative warrant is more expensive; 76% understood that the underlying asset's price is not the only factor that affects the price of a warrant – and of this 76%, 64.2% could at least cite one additional factor; and the three most commonly quoted factors were "time to maturity", "volatility of the price of the underlying" and "supply and demand of the warrant".
- (6) *Trading history:* 73.2% had been trading warrants for more than 12 months; 14% had 6 to 12 months experience; and 12.8% had been dealing for less than 6 months.
- (7) *Portion of portfolio :* 51.6% said that on average, their investments in derivative warrants in the past 12 months accounted for less than 10% of their investment portfolio; 19.2% said it accounted for 10%-29% of their portfolio; 8.4% said it accounted for 30%-49%; and 16.8% had invested over 50% of their portfolios in warrants.
- (8) *Reasons for choosing derivative warrants:* 52.0% were attracted by the higher volatility of warrants; 23.6% cited better liquidity as a reason; nearly 10% chose warrants because of the narrow bid-ask spread (9.6%) and the leverage effect of warrants (9.2%); and 5.6% were attracted by the lower commission, commission rebates or other incentives offered by their brokers.
- (9) *Basis for selecting a particular derivative warrant:* 76.8% said they did their own analysis; 19.6% were influenced by market commentators' recommendations in newspapers, television or radio programmes; 14.8% considered their friends or

family members' recommendations; 8.4% relied on recommendations in issuers' advertisements, articles or their sponsored television or radio programmes; and 8.0% took into account their brokers' recommendations. Moreover, 83.6% of warrant investors usually compared similar derivative warrants before deciding to trade a particular one.

- (10) *Research*: Of those who did their own analysis in warrant selection, 71.9% looked at the terms of warrants; 42.7% evaluated whether the warrants were value for money or reasonably priced; and 26.6% considered who the issuer was.
 - (11) *Profit/loss*: 30.8% said they had made a net gain from trading derivative warrants during the past 12 months; 47.2% suffered a net loss; 12% broke even; and 10% said they did not know.
 - (12) *Details of those who suffered loss*: Of those who suffered losses, 47.5% said that they would continue to trade; 44.1% said they would not; and 8.5% were not sure yet. The main reasons given by those who had suffered losses but would continue to trade were that: they understood the risk of investing and were prepared to take it (53.6%); they had learnt more about warrants and hoped to do better in future (41.1%); they hoped to recover their losses from further trading (37.5%); they were addicted to trading derivative warrants (10.7%); and they followed the advice of their brokers (1.8%).
80. The DW Investor Survey has helped us better understand the knowledge level and trading habits of retail investors. In particular:
- (1) *Investment attitude*: It appears that some investors, although not a large number, did trade derivative warrants even without knowing much about their nature or associated risks. We need therefore to continue to stress the importance of having a proper investment attitude and the risks associated with investing in a product which they do not understand.
 - (2) *Market commentators*: It appears that many investors have been persuaded by the comments in the media to trade warrants. We believe it is necessary to remind investors of the limitations of such advice. In particular that market commentators may not be able to list out all the assumptions behind their recommendations and that their advice will not have taken into account investors' personal circumstances. We therefore need to stress the importance of filtering market commentators' views and doing one's own research before making a trading decision.
 - (3) *Knowledge level*: The DW Investor Survey findings suggest that investors do have some knowledge of the pricing mechanism of warrants and the concept of implied volatility. We shall nevertheless continue to educate investors on how to look up and interpret warrant terms and other information about derivative warrants.

81. We will continue to explore innovative means to deliver educational messages on derivative warrants to the investing public. We will also continue our education work on warrants through the mass media (eg newspapers, magazines, TV and radio programmes), outreach activities for investors, preventative education programmes for teachers and students, and our InvestEd website and Investor Hotline.

Final note

82. Lastly, we would like to thank all the respondents who commented on the various proposals.

ANNEX I – DETAILS OF RESPONDENTS

Name

1. Berich Brokerage Ltd
2. BNP Paribas Hong Kong Branch
3. Deutsche Securities Asia Limited
4. Hong Kong Association of Banks
5. Hong Kong Exchanges and Clearing Ltd
6. Hong Kong Securities and Futures Industry Staff Union
7. Hong Kong Stockbrokers Association Ltd
8. ISS Derivate Ltd
9. Kimmy Yu
10. – 13. Linklaters for Bear Stearns Asia Ltd, Citigroup Global Markets Asia Ltd, Credit Suisse (Hong Kong) Ltd and JP Morgan Securities (Asia Pacific) Ltd
14. Macquarie Equities (Asia) Ltd
15. Messrs MK Lam & Co on behalf of a market participant in the SEHK
16. Messrs Richards Butler on behalf of Hing Shing Securities Limited
17. SG Securities (HK) Ltd
18. Wai Ming Chan
19. Warrant88.com (which submitted two responses – one in English and one in Chinese)
20. Yardley Securities Ltd
21. 散戶特別週
22. 本港認股證投資者 Diplomat
23. – 29. 7 respondents who wished to remain anonymous, including one who requested that their submission not be disclosed

Breakdown by nature

<u>Nature of respondent</u>	<u>Number</u>
Issuers and prospective issuers	14
External liquidity providers	4
Brokers (other than external liquidity providers)	1
Investors and investor group	6
Industry groups	3
Hong Kong Exchanges and Clearing Ltd	1
Total	29

Guidelines on marketing materials for listed structured products

General Principle

Marketing materials relating to listed structured products¹ should not be false, biased, misleading or deceptive and should include appropriate risk warnings.

Definition of marketing materials

“Marketing materials” are all advertisements, marketing, publicity and disclosure materials issued to the public in Hong Kong to disseminate information relating to structured products with the intention or effect of promoting structured products.

1. Marketing materials² include but are not limited to brochures, correspondence, newsletters, circulars, flyers, leaflets, posters, mail shots or promotional features in newspapers, magazines, television, radio, print media, electronic media (including the internet, ATM services, telephone hotlines and any form of wireless video or audio transmission), and any spoken presentation at a seminar or lecture.
2. Marketing materials include every form of communication whether made orally or produced mechanically, electronically, magnetically, optically, manually or by any other means to the public irrespective of whether targeted at or restricted to a particular audience or customer base.
3. Marketing materials do not include materials that only market the expertise of or services offered by a structured product issuer without reference to any particular structured product or group of structured products.

Identification of marketing materials

Marketing materials should be identified as such and should clearly identify the entity responsible for the material.

4. Marketing materials should not be disguised. For example, where marketing materials are included in a newspaper, the material should not give the appearance of being editorial comment.

¹ References to “structured products” refer to listed structured products.

² Where marketing materials falls within section 103(1) of the Securities and Futures Ordinance, they must be authorised by the Securities and Futures Commission unless exempted.

5. Where an issuer of a structured product sponsors an audio or audiovisual programme, seminar or lecture, or a written publication relating to structured products, the nature of the issuer's involvement and the nature of the material must be disclosed.
6. When:
 - (a) any of an issuer's employees; or
 - (b) a person with whom an issuer has a commercial or business relationship that may reasonably call into question the person's ability to give objective and independent opinions on structured products,
appears on any audio or audiovisual programme, seminar or lecture, or produces written materials discussing or promoting structured products, the issuer has a responsibility to ensure that such person make appropriate disclosure in such programme, seminar, lecture or written material. This disclosure would include:
 - (i) the nature of his role, for example, is he appearing or writing as the issuer's representative or in his personal capacity;
 - (ii) the nature of his relationship with the issuer; and
 - (iii) any other facts that may cause bias to his opinions.
7. Where the issuer has a commercial or business relationship with a person referred to in paragraph 6(b) above, the issuer should advise the SFC in writing as to the nature of this relationship.

Contents

Marketing materials should be accurate and not misleading.

8. Any trading recommendation in respect of a structured product should be based on factual analysis. Where the recommendation or suggested trading strategy is based on a projection or a particular view of the future market movement of the underlying securities, such projection or view should be given due emphasis and clearly set out in the body of the material.
9. Any statement of opinion regarding a structured product must be reasonable.
10. Any comparison of performance figures should be fair, accurate and relevant and compare "like with like". If comparisons are drawn with other structured products all relevant factors should be discussed.

Risks

Marketing materials should contain an appropriate explanation of the risks associated with investments in structured products and of the specific risks associated with the structured products referred to in the marketing materials.

11. The level of detail required in the explanation of the risks will depend on:
 - (a) the complexity and nature of the risks; and

- (b) the nature and form of the marketing materials.
12. As a minimum, all marketing materials should advise investors:
- (a) that the full details of the structured products are set out in the listing document;
 - (b) to make their own risk assessment and seek professional advice, where necessary;
 - (c) that prices of structured products may fluctuate;
 - (d) they may lose some or all their investments (as applicable);
 - (e) that at times there may not be any counterparty or that the issuer may be the only person quoting prices on the Exchange;
 - (f) of the significant risks specific to the structured products referred to in the marketing materials; and
 - (g) where past performance is referred to, that it is not indicative of future performance.

Presentation

Marketing materials should provide a balanced view of the structured product referred to.

- 13. Marketing materials should not directly or indirectly imply that investing in structured products is safe or not risky.
- 14. Marketing materials should give a balanced view of the potential gains and losses and the risks involved in investing in the structured products.
- 15. Marketing materials should not contain language, artwork or graphics that are inaccurate or inconsistent with the listing documents for the structured products.

Legibility and prominence

Information required by these guidelines to be included in marketing materials should be prominent and legible or audible as appropriate.

- 16. The information required under the section headed “Risks” above should be presented in the following manner:
 - (a) the font size of the text should be proportionate to the font size that predominates in the marketing materials and must not be presented in a style that is designed to reduce its impact. The text must be capable of being read with reasonable ease;
 - (b) for audio broadcast such as radio, the information should be delivered by way of a voice over that is sufficiently distinct from the rest of the content of the broadcast to be prominent; and
 - (c) for television and other screen-based media, the information should either be presented:
 - (i) orally, and comply with (b) above; or

- (ii) in writing, and in a font size and in a manner and for a time that allows a person to read the entire text with reasonable ease. The text must not be presented in a style that is designed to reduce its impact.