

Hong Kong's Derivative Warrants Market – Moving with Times amid Rapid Developments in Other Warrants Markets in Asia

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April 2006

Summary

- *The derivative warrants market in Hong Kong has been growing rapidly. Nevertheless, a fast-growing warrants market is not unique to Hong Kong. It is also observed in a number of markets in Asia. The objective of this research is to examine the latest developments in these markets and the implications for Hong Kong.*
- *This paper looks at the fast-growing trend of the market in the region. It is important to keep abreast of the latest developments in the region. Although Hong Kong is still the most active warrants market in the world, there is no room for complacency. On 31 March, the Commission released a report entitled “Hong Kong’s Derivative Warrants Market – the Way Forward, Results of the Consultation on the SFC’s Six-Point Plan” (“Report”). The Report sets out SFC’s proposals for further strengthening the regulatory framework of the market and enhancing investor education. These in turn will help ensure a healthy development of the market, which is necessary for its sustainable growth and long-term success.*
- *In August 2005, the trading of warrants resumed in the Mainland. The trading was very active, and the Mainland was indeed the most active warrants market in the world in December 2005. However, since January 2006, the activity level has retreated due to changes in market sentiment and the introduction of some market measures.*
- *The derivative warrants market in Singapore is also developing fast. It is interesting to note that on a few occasions, as soon as the listings of certain securities in Hong Kong took place, derivative warrants on those securities were listed on the Singapore Exchange (“SGX”). Such issuances were ahead of Hong Kong. Nevertheless, trading concentrated in Hong Kong after similar derivative warrants were listed on the Hong Kong Exchanges and Clearing Ltd (“HKEx”). This suggests that liquidity tends to move to the market where the underlying stocks are listed and traded.*
- *The derivative warrants market in Korea was launched in late November 2005. Within three months, it has already become the third most active warrants market in Asia (after Hong Kong and the Mainland, and ahead of Australia and Singapore).*

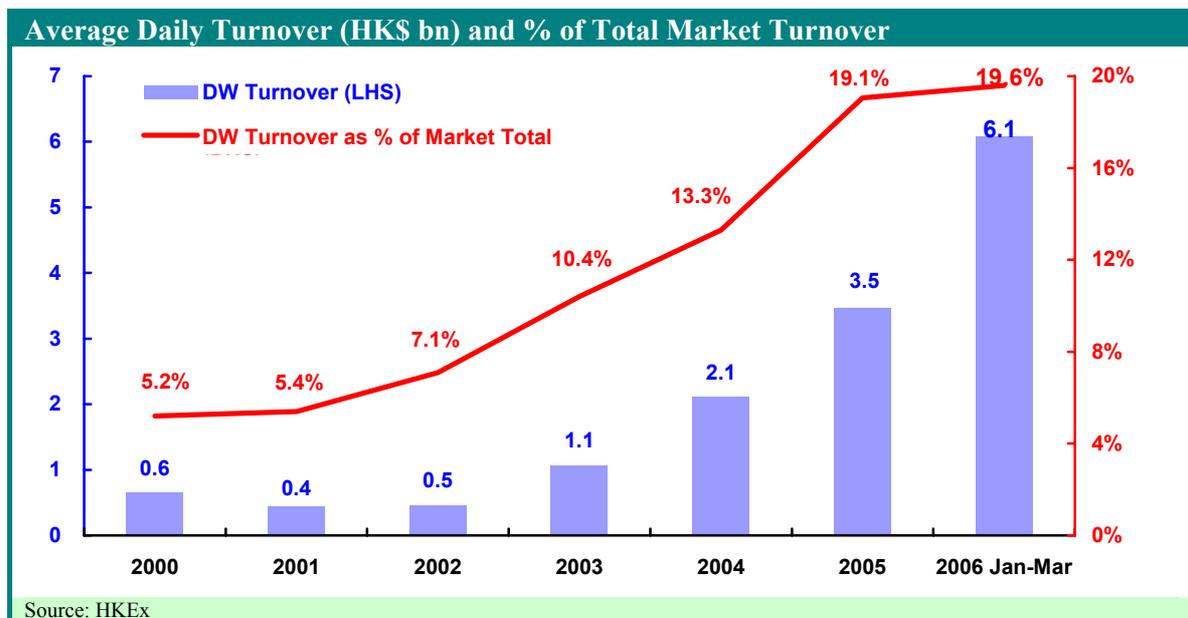
¹ This paper is for pure fact-finding and research purposes, and is not an attempt to comment on the developments of any markets/companies or interpret the policies concerned. The views expressed in this paper do not represent those of the SFC.

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Warrants Markets in Asia

Hong Kong

1. In 2004 and 2005, Hong Kong's derivative warrants market was the most active market in the world. The market has been growing rapidly in recent years. The average daily turnover rose by 6 times during 2002-2005. During the first quarter of 2006, the average daily turnover of derivative warrants in Hong Kong was HK\$6.1 bn (US\$780 mn), 75% higher than the 2005 level. As trading activities on the stock market as a whole also surged over the period, the share of derivative warrants in the total market turnover remained stable at about 19%.



2. In particular, the growth in trading activities was driven by the trading of derivative warrants issued on Mainland stocks. For instance, the trading of derivative warrants issued on the top 3 Mainland stocks, namely China Life Insurance, China Construction Bank and China Mobile, surged by some 90% during the first quarter of 2006 from the second half of 2005 (the growth for the whole derivative warrants market was about 50%). The strong interest in Mainland securities was also reflected in the trading of H-shares which soared 83% whilst the turnover of the total market turnover increased 58% over the same period.

3. Currently, there are about 18 active derivative warrants issuers in Hong Kong; most are international investment banks. They provide a critical mass of expertise in the market, which is able to develop a wide range of derivative warrants to meet different risk appetites of different investors.
4. Even with the China factor and the necessary expertise, there have to be a sound regulatory regime and informed investors to sustain the growth of the derivative warrants market. The Report released by the Commission on 31 March aims at further strengthening the regulatory framework of the market and enhancing investor education. After all, a healthy development of the derivative warrants market is important for the Hong Kong market because it widens product breadth and deepens the market by generating additional liquidity to the underlying market. These help reinforce our role as a business hub, safeguard practices we adopt are up to international standards and ultimately provide protection to our investors.

Mainland

5. In August 2005, the trading of warrants resumed in the Mainland. As of the end of March 2006, there were 12 warrants listed (8 on the Shanghai Stock Exchange and 4 on the Shenzhen Stock Exchange). The first warrant was listed on the Shanghai Stock Exchange in August 2005, and 6 warrants in Nov-Dec 2005. 3 other warrants were listed in early March 2006 and 2 on 31 March. It should be noted that all the 12 warrants are company warrants², and are therefore not strictly comparable to derivative warrants in Hong Kong. Warrants in the Mainland were issued as a result of the share reform³.

Number of Warrants Listed (As of period end)						
	2004	2005	Feb 2006	2005 / 2004	Feb 2006 / 2005	
Hong Kong	863	1,304	1,391	+51%	+7%	
Mainland*	n.a.	7	7	n.a.	+0%	
Singapore	146	455	492	+212%	+8%	
Korea [#]	n.a.	72	203	n.a.	+182%	
Australia	1,771	2,447	2,915	+38%	+19%	
Taiwan	191	540	485	+183%	-10%	
Malaysia	10	12	12	+20%	+0%	

*Trading of warrants resumed in the Mainland on 22 Aug 2005, with only one warrant listed on that day. Six warrants were listed during Nov- Dec 2005, whilst five were listed in Mar 2006.

[#]The derivative warrants market in Korea was launched on 28 November 2005.

Sources: Bloomberg, WFE and websites of various exchanges

² A company warrant is a warrant issued by the company. This is in contrast to a derivative warrant which is issued by a third party who is usually an investment bank. However, in recent months, certain brokers in the Mainland are allowed to issue warrants identical to the existing ones to address the issue of supply shortage.

³ Due to historical reasons, shares of listed companies in the Mainland can be broadly classified into two types, tradable and non-tradable. Share reform aims at listing non-tradable shares of listed companies in the Mainland.

6. In December 2005, the average daily turnover of the warrants market was about US\$782 mn, 38% of the total market turnover⁴. The Mainland warrants market was actually the most active in the world for that month.

Trading Activities on the Warrants Markets in Asia										
	Average daily turnover (US\$ mn)						Share in total market turnover			
	2004	2005	Dec 2005	Jan – Feb 2006	2005 / 2004	Jan – Feb 2006 / 2005	2004	2005	Dec 2005	Jan – Feb 2006
Hong Kong	270.0	444.6	510.0	783.2	+65%	+76%	13.3%	19.1%	21.0%	19.4%
Mainland	n.a.	801.8*	781.9	348.3	n.a.	-55%	n.a.	38.0%^	38.0%	11.4%
Singapore	3.4	26.0	20.0	32.9	+655%	+27%	0.8%	5.6%	5.5%	4.7%
Korea	n.a.	26.3*	26.3	85.0	n.a.	+223%	n.a.	0.4%^	0.4%	0.9%
Australia	11.0	19.8	17.8	28.1	+80%	+42%	0.5%	0.7%	0.7%	0.9%
Taiwan	25.0	17.8	28.4	25.2	-29%	+42%	0.9%	0.8%	0.8%	0.8%
Malaysia	2.5	1.1	0.4	0.2	-56%	-82%	1.0%	0.5%	0.3%	0.1%

*The averages of the Mainland and Korea market were calculated based on available trading period of each warrant.
 ^The market shares of the Mainland and Korea market were based on the trading of December 2005 only.
 Sources: Bloomberg, WFE and websites of various exchanges

7. There was strong investor interest in the product, as illustrated by the buoyant performance of the warrants and the heavy trading activities on debuts. All of the first 7 warrants recorded strong debuts. Once launched, the warrant prices jumped to the upper limit of price fluctuation⁵ prescribed by the exchanges on the first trading day.
8. Since January 2006, the warrants market has cooled off somewhat due to changes in market sentiment and the introduction of market measures such as allowing brokers to issue identical warrants to address the issue of supply shortage. In March 2006, despite the launch of 5 new warrants, the average daily turnover of the warrants was US\$152 mn (7% of the total market turnover). This was 80% lower than the December 2005 level. Nevertheless, many believe that these would help promote a long-term sustainable development of the market. Moreover, as more listed companies undergo the share reform and they may issue warrants in their compensation schemes, the number of warrants in the Mainland markets will continue to grow. In the meantime, as the stock market in the Mainland develops, there will be demand for a greater variety of financial products (including warrants) to address different needs of different investors.

⁴ This combines the trading on the Shanghai Stock Exchange and the Shenzhen Stock Exchange.

⁵ The upper price limit varies from warrant to warrant, depending on the price of the warrant and the price of the underlying stock.

Singapore

9. The derivative warrants market in Singapore grew rapidly in 2005 in terms of both the number of derivative warrants listed and trading activities. During Jan-Feb 2006⁶, again, both the number of derivative warrants listed and trading activities grew further.
10. It is interesting to note that on a few occasions, as soon as the listings of certain securities in Hong Kong took place, derivative warrants on those securities were allowed to be listed on the SGX. Such issuances were ahead of Hong Kong, as HKEx has a requirement that a new security would become eligible as an underlying asset for derivative warrants only after it has been listed on HKEx for a certain period.
11. Nevertheless, the trading of these derivative warrants was not as active as in Hong Kong and it appeared that such trading concentrated in Hong Kong after similar derivative warrants were listed on HKEx. This suggests that liquidity tends to move to the market where the underlying stocks are listed and traded.
12. For example, in the case of China Construction Bank (“CCB”), as soon as the stock was listed on HKEx on 27 October 2005, derivative warrants on it were listed on the SGX on the same day. The first batch of derivative warrants on CCB was listed on HKEx on 5 December 2005. Before the listings of these warrants on HKEx, the average daily turnover of CCB derivative warrants on the SGX was US\$1.0 mn. Nevertheless, when CCB derivative warrants were listed on HKEx, trading of such warrants on the SGX dropped 71.3% to an average of US\$0.3 mn a day (compared to US\$79.6 mn in Hong Kong). A similar phenomenon is observed for derivative warrants listed on the Link REIT.

Trading of Derivative Warrants on HK Stocks in Singapore and Hong Kong								
Underlying stock (listing date on HKEx)	Listing date of 1 st derivative warrant		No. of derivative warrants		Average daily turnover on SGX (US\$ mn)			Avg daily turnover on HKEx (US\$ mn)
	SGX	HKEx	SGX	HKEx	Before derivative warrants listed on HKEx	After derivative warrants listed on HKEx	% Change	
CCB (listed on 27 Oct 05)	27 Oct 05	5 Dec 05	4	56	1.0	0.3	-71.3%	79.6
Link REIT (listed on 25 Nov 05)	25 Nov 05	23 Jan 06	8	11	3.1	0.6	-81.4%	5.7

Sources: Bloomberg and SFC Research

⁶ Figures for Singapore and other Asian markets are up to February 2006.

Korea

13. The derivative warrants market in Korea was launched only in late November 2005, but it has grown robustly since then. As of the end of February 2006, there were 203 derivative warrants listed. Trading activities have already surpassed those in Singapore and Australia, and Korea has become the 3rd most active warrants market in the region.
14. Behind the robust growth of the derivative warrants market is the broad investor base. It appears that retail investors in Korea are interested in and are familiar with the trading of leveraged products such as options. This is illustrated by the high turnover of its index options of 2.5 bn contracts in 2005. To the extent that options and derivative warrants are very similar products, some investors may also start trading derivative warrants.
15. In addition, local brokerages are encouraged to cooperate with investment banks in the derivative warrants market⁷. Currently, most issuers of the derivative warrants are local brokerages, whilst some liquidity providers are international investment banks. Such cooperation enables local brokerages to raise their exposure and improve their competitiveness whilst adopting international standards and practices. This is also important for the development of the stock market as a whole. As far as developing local brokerages is concerned, such experience is valuable to the rest of the region.

Australia

16. The Australian warrants market lists the largest number of derivative warrants in Asia. As of the end of February 2006, there were 2,915 warrants listed. More importantly, there are more varieties of derivative warrants listed on the Australian Stock Exchange (“ASX”). Broadly speaking, derivative warrants can be classified into investment-style warrants and trading-style warrants; the former accounted for some 60%. Investment-style warrants are generally longer-dated, tend to be less frequently traded and have a lower risk/return profile. Some are more sophisticated as they are entitled to dividends and/or offer certain tax advantages whilst others can be rollover for a longer period of time. A greater variety of derivative warrants is important to the development of a market, as it serves and supports a larger base of investors.

⁷ “Korea Opens Equity-Linked Warrant Market”, Korea IT Times, 2 Dec 2005

17. Trading activities of derivative warrants also grew rapidly. During 2005, the average daily turnover of derivative warrants was US\$19.8 mn, accounting for 0.7% of the market turnover. The corresponding figures for the first two months of 2006 were US\$28.1 mn and 0.9%.

Taiwan, Malaysia and Japan

18. In Taiwan, there were a larger number of derivative warrants during 2005, but trading activities shrank. As of the end of 2005, there were 540 derivative warrants (191 as of the end of 2004). However, the average daily turnover of derivative warrants was US\$17.8 mn in 2005, lower than the US\$25 mn in 2004. Nevertheless, the drop in trading activities appeared to be roughly in line with the broad market.
19. The derivative warrants market in Malaysia is relatively small and less active. As of the end of 2005, there were 12 derivative warrants listed. During 2005, the average daily turnover of derivative warrants dropped 56% to US\$1.1 mn. Again, trading activities on the stock market also declined last year.
20. The derivative warrants market in Japan is even smaller. There are only a few warrants listed on the Tokyo Stock Exchange (“TSE”). However, it is important to note that investors in Japan may be less interested in derivative warrants because there are many other derivative products traded actively on the TSE and the Osaka Securities Exchange.

Conclusion

21. The derivative warrants market in Hong Kong has been growing rapidly, but such high growth is also observed in a number of markets in Asia. It is important for Hong Kong to keep abreast of the latest developments and moving with the times. The Report released by the Commission on 31 March aims at further strengthening the regulatory framework and enhancing investor education. After all, a healthy development of the derivative warrants market is important for Hong Kong because it widens product breadth and deepens the market by generating additional liquidity to the underlying market. These help reinforce our role as a business hub, safeguard practices we adopt are up to international standards and ultimately provide protection to our investors. Having a healthy derivative warrants market is necessary for its long-term growth and success.