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# HKEx Invites Comments On The Derivative Warrants Market

## Introduction

Hong Kong Exchanges and Clearing Limited ("HKEx") has published an article on derivative warrants ("DW") that includes a discussion of the listing rule requirements for DW and a summary of the recent discussion and debate on DW and the views of HKEx on the key issues raised. Comments are invited on the DW market and the matters discussed in the article, the full text of which is available on the [HKEx website](http://www.hkex.com.hk).

The purpose of this note is to summarise the principal issues raised by the article.

## Listing Rules' Requirements For DW

### 1. Issuer Eligibility

DW holders are unsecured creditors of the issuer with no preferential claim to any securities held by the issuer to hedge exposure arising from a DW issue. In an attempt to reduce investors' exposure to the credit risk of the issuer, HKEx has imposed strict entry criteria for issuers. Issuers are required to:

* have net assets of at least HK$2 billion; and
* either have a credit rating (which must be at least an "A" grade) or be regulated by the SFC or HKMA.

### 2. DW Liquidity

Issuers are required to provide liquidity for DW issues by appointing a Liquidity Provider ("LP"). Liquidity may be provided by means of market-making in which either two-sided quotes are made on a continuous basis or are made in response to a quote request. Listing documents must state the applicable spread interval between the bid and ask prices. Liquidity is required to be provided from no later than 5 minutes after the market opens and must be for a minimum of 10 board lots. Exemptions exist for fast markets and for when the issuer has no DW to sell. All dealings by an issuer in its DW must be conducted through the LP.

### 3. Further Issues of DW

As noted above, one of the exceptions to the requirement to provide liquidity for DWs is where the issuer has sold the entire approved supply of the DW. An issuer may (but is not required to) create an additional supply of a particular issue, by way of a further issue, when over 80% of the original issue has been sold. Further issues are allowed because they help to eliminate pricing anomalies when DW issues have been fully sold: the additional supply helps ensure that the DW's price is determined by fundamental market factors rather than by supply and demand for the DW.

### 4. Eligible Stocks

The eligibility requirements for DW issuance are that the stock must be either a constituent of the Hang Seng Index or be on a list published by HKEx. To be included on the HKEx list, the stock must have maintained a public float capitalization of HK$4 billion for approximately 3 months. Newly listed stocks may be exempted from the 3 month requirement if their public float capitalization is at least HK$10 billion.

These requirements are intended to restrict issuance to liquid stocks and so minimize the potential impact of DW on the price of the underlying shares. In fact, the vast majority of DWs are issued on the Hang Seng Index and on 10 to 15 stocks which are among the highest in terms of liquidity and market capitalization.

A quota system which previously limited DW issuance over a company's shares to 20% of its issued share capital or 30% of its public float was repealed in 2002. It was considered by HKEx that issuers generally limit issuance or use alternative hedging mechanisms to minimize the impact of their DW issuance and hedging activities on the price of the underlying shares. The imposition of a quota system could also restrict the ability of issuers to make further issues which might result in pricing anomalies for the DW.

### 5. Transparency

All DW launches and upcoming expirations are published on HKEx's website. Issuers also publish daily trading reports showing the aggregate sales and purchases of each DW and the related average prices, and the total amount of that issue in the market. Trading by the issuer's LP can be seen by the market as the LP for each DW has a unique broker number commencing with "95" or "96".

### 6. Trading Rules

The LP for each DW is allowed to short sell the DW and receives an exemption from the "tick rule" in this regard. Other market participants are not allowed to short sell DWs. DW Hedging Participants may also be appointed by issuers to conduct hedging activities and receive an exemption from the tick rule for hedging in the underlying stock.

## Concerns Regarding The DW Market And HKEx's Response

### 7. That the DW market unduly influences prices of the underlying stocks and increases market volatility

#### *HKEx's Response*

By virtue of DW issuers' hedging transactions, the DW market adds liquidity to trading in the underlying stocks and so benefits all market participants. In addition, many DW are hedged with options and other instruments rather than underlying stock.

DWs are leveraged and have lower transaction costs (eg. no stamp duty for cash-settled DW) than the underlying stocks. Market forces may therefore appear in the DW market before they do so in the market in the underlying shares. This also occurs in the futures and options markets in Hong Kong and overseas.

While DW activities have grown over recent years, market volatility in Hong Kong has generally been low. Overseas experience also suggests that if DW are not traded on the Exchange or the Exchange environment is not conducive to their trading, they are likely to trade in over-the-counter or overseas markets.

### 8. That DW prices and trading activity may be manipulated

#### *HKEx's Response*

DW prices can be compared to similar derivatives on the underlying stock (eg. other DWs and Exchange-traded stock options). HKEx's educational programmes encourage investors to learn about the factors affecting DW prices and to compare product prices. Such information is also often available on DW issuers' websites. HKEx is considering ways to improve the disclosure and dissemination of technical information about DW.

Market feedback suggests that a particular DW may trade at a premium to similar DWs and Exchange-traded stock options due to buying demand that results when a DW has sold out or before a further issue can be completed. In these situations, arbitrage activity may not operate freely, for example because supply is fixed and the DW is not eligible for short selling other than by the issuer's LP. While issuers may increase the available supply by launching a further issue once 80% of an issue has been sold out, some issuers claim that there may not be enough time to complete the further issue to keep up with demand, potentially leading to a higher price than for similar products. When the further issue is launched, it may result in a correction of the DW price. However, this may be seen by some as manipulation. Issuers would like to see a change to the rules to allow further issues to be completed more quickly which would help to prevent these overvaluations. In other derivatives markets such as those for futures and options, supply is not fixed and new short positions are allowed making pricing anomalies less likely.

There have also been concerns that there is misconduct in the DW market, specifically that issuers create "wash sales" in DW to create the appearance of trading activity and pay incentives to those generating trading activity. In this regard, issuers' trading activity may be conducted only through the designated LP whose trading (as noted above) is transparent to the market. The HKEx will continue its monitoring for washsales and other suspicious activity and referral of cases to the SFC where appropriate.

### 9. That DW issuers are able to reissue additional DWs which can drive down prices

#### *HKEx's Response*

This is likely to result from the factors mentioned in paragraph 8 above. HKEx considers that a less restricted issuance system would be more efficient and less likely to produce pricing anomalies, for example no specific limit on each issue or allowing faster completion of further issues.

### 10. That DW do not always reflect movements in the underlying share price

#### *HKEx's Response*

This concern may result from a failure to understand the different factors affecting a DW price. HKEx's educational programme for DW covers a variety of factors including implied volatility, premium, gearing, time to expiry and the "delta" (or hedge ratio) of DW. Issuers' websites often provide information on these factors.

Examples given of how market forces may affect DW include:

* DW prices may fall even though the underlying asset price has not changed. This may result from a decrease in the implied volatility determined by market forces. Likewise, DW prices may fall as they approach expiry.
* The delta of a DW will determine how sensitive the DW is to changes in the underlying asset price. DW with strike prices far "out of the money" may not respond to changes in the underlying asset price whereas those far "in the money" may move nearly one-to-one with the underlying asset.

### 11. That DW issuers pay incentives or rebates to selected brokers or investors trading in their warrants

#### *HKEx's Response*

While discounted commissions and other sales incentives may be part of normal competition and consistent with market rules, there are suggestions that some trading in DW may be generated solely to receive sales incentives. HKEx proposes to discuss with the SFC the appropriateness of DW issuer incentives or commission rebates being the sole reason for the conduct of DW trades.

### 12. That insufficient effort is made in providing education about DW

#### *HKEx's Response*

HKEx has a continuing educational effort to explain the characteristics and risks of DW to market participants including the investing public. The principal message is that DW carry a high degree of risk and may not be suitable for all investors, particularly small retail investors whose market knowledge may be inadequate to enable them to understand the risks and whose financial resources may be insufficient to allow them to bear the potential loss.

## Consultation

Comments should be sent to Hong Kong Exchanges and Clearing Limited at 11th Floor, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong (Re. Understanding Derivative Warrants/Request for Comments). Comments may also be sent by fax to (852) 2868 5223 or by email to feedback@hkex.com.hk.

*This note is intended as a summary only of the HKEx's article on Derivative Warrants. Specific advice should be sought in relation to any particular situation.*

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