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# SFC Launches a Six-Point Plan for the Derivative Warrants Market

## Introduction

The Securities and Futures Commission (the 'SFC') has released its 'Report on the Derivative Warrants Market in Hong Kong' (the 'Report') which includes its Six-Point Plan for improving the market and is available on the [SFC's website](http://www.sfc.hk).

The Report contains a detailed review of the characteristics and practices of the Hong Kong derivative warrants market and an assessment of the impact of derivative warrant activities on the overall stability of the stock market. It then identifies the areas of the regulatory regime that need strengthening and assesses the need for further investor education initiatives.

The Report notes that trading in the Hong Kong derivative warrants market is the most active in the world. Turnover is high: during the first ten months of 2005, the average daily turnover was HK$3.3 billion, up from HK$2.1 billion in 2004. The Report concludes however that the derivative warrants market has not adversely affected the stability of the stock market.

The Report sets out proposals for strengthening the regulatory regime in six areas to address certain market practices which give rise to concern. The SFC has asked for comments on the proposals to be submitted before the end of January 2006. Formal consultation will then take place on changes to the Listing Rules or to the SFC's Codes and Guidelines.

The Six-Point Plan is summarised below.

## 1. Changes To The Liquidity Provider System

### 1.1 Tightening of Minimum Service Levels

The Report notes that the levels of service and prices offered by liquidity providers are often significantly more favourable than those which issuers undertake to provide in the listing document. The potential problem is that investors assume that the high level of service is the norm and feel aggrieved if the liquidity provider subsequently offers quotes that are more in line with the undertakings in the listing document. To encourage more realistic expectations on the part of investors, the SFC proposes tightening the minimum service levels so that the actual service level offered by liquidity providers cannot deviate significantly from the level undertaken in the listing document.

The SFC has asked for views on which standards need tightening and to what extent.

### 1.2 Prohibition on Use of External Liquidity Providers

It is proposed that issuers should be required to appoint in-house liquidity providers in order to encourage issuers to supervise liquidity providers' activities more closely and to discourage liquidity providers from misbehaving. Transitional arrangements will be considered for issuers who do not have a local brokerage arm in Hong Kong who are Exchange Participants.

### 1.3 Disclosure of Information

It is proposed that liquidity providers should be requested to disclose to the market information on the intra-day prices executed by them on each derivative warrant together with the associated implied volatilities and possibly prices of the corresponding underlying asset at day end. Such information will have to be provided in a user-friendly manner. It is intended that enhanced disclosure will enable investors to better assess the quality of liquidity providing services.

## 2. Facilitate Further Issues And Identical Issues

### 2.1 Further Issues

Another concern noted in the Report is that the price of derivative warrants may be driven up by excessive demand. The following changes to the Listing Rules are proposed to make it easier for issuers to issue additional units in popular warrants:

1. to reduce the current 4-day period for processing further issues to 2 days; and
2. to increase the 20% limit on the maximum number of existing derivative warrants that may be held by an issuer when making a further issue. The SFC has asked for comments on the feasibility and extent of such changes.

### 2.2 Identical Issues

To encourage market competition, the SFC proposes the following changes to the Listing Rules to allow other issuers to issue identical versions of an existing derivative warrant:

1. for issues of identical versions of existing warrants, to either eliminate the requirement for a derivative warrant to have a minimum life of 6 months or set a shorter minimum life; and
2. to lower the minimum issue price for such identical warrants from HK$0.25 to HK$0.01.

The Report notes concerns that these proposals could make the market even more speculative with too many short-dated, low-value warrants available to investors. Views are invited on the extent of any relaxations.

## 3. Banning Commission Rebates And Other Incentive Schemes

The SFC is concerned that the main motive for a number of trades is to enable investors to benefit from commission rebates. Such trades can create a false impression as to the level of investor interest in the derivative warrant itself. It is also difficult for investors to identify whether a change in turnover of a particular derivative warrant results from a change in market sentiment for that derivative warrant or a change in a related rebate scheme. There is also concern that such schemes are open to abuse.

The Report proposes a ban on commission rebate and other incentive schemes and asks for comments on this proposal or other alternatives.

## 4. Publishing New Marketing Guidelines

The Report notes that high penetration marketing strategies are used by many issuers to promote their derivative warrants. As a result, derivative warrants are now considered a mainstream financial product available to retail investors. The SFC is however concerned about retail investors' lack of understanding of derivative warrants' complexities and the higher risks associated with investing in them.

A further concern is that promotional practices give a distorted view of derivative warrants: marketing material commonly gives a positive analysis only and it is sometimes unclear whether the material is an advertisement or commentary.

The SFC therefore proposes publishing new guidelines on marketing for derivative warrants that expressly cover all forms and media of marketing, including radio, television and the internet. A principle-based approach will be adopted rather than a prescriptive approach. The issue will also be raised with the Broadcasting Authority to ensure that all marketing activity is caught.

## 5. Plain Language And Summaries

The Report proposes that:

1. issuers should be required to use 'plain language' in their listing documents for derivative warrants;
2. issuers should prepare a 1-2 page summary setting out the key features, benefits and risks of their product; and
3. the industry and regulators agree on common definitions and standard terms for standard products. Issuers would then only be required to disclose departures from the standard terms in their listing documents, particularly the supplemental listing document.

The Report asks for comments on these proposals.

## 6. Launching New Investor Education Initiatives

The Report announces the SFC's new investor education initiatives in its continued drive to increase retail investors' understanding of the complexities and risks of investing in derivative warrants. It also notes that the Stock Exchange is proposing to improve the information on derivative warrants provided on its website.

## B. Revised Notes 1 And 2 To Rule 8 Of The Takeovers Code Take Effect From 1 January, 2006

Notes 1 and 2 to Rule 8 of the Takeovers Code (as amended on 1 October, 2005) in relation to documents being made available for inspection on websites will become effective from 1 January, 2006.

The Notes will apply, where applicable, to any transaction subject to the Codes which is announced on or after 1 January, 2006.

Note 1 provides that documents required to be put on display must be posted on the website of the issuer of the offer document or offeree board circular, as appropriate. The offer document or offeree board circular must additionally state the website address where inspection of documents can be made.

Note 2 requires copies of all display documents to be provided in electronic form for display on the SFC's website before the despatch of the offer document or offeree board circular. The Documents on Display (DoD) Submission Form and a 'How to Use' guide will be available for downloading in the 'Forms - Takeovers & Mergers Related' section of the SFC website from 1 January, 2006.

To see our newsletter on the October 2005 amendments to the Codes on Takeovers and Mergers and Share Repurchases, please click [here](/newsletters/hklaw/en/2005/25/nl-hklaw-20050728-25.html).

## C. Extension Of Consultation Period For Sfc Proposals On Possible Reforms To The Prospectus Regime

The SFC has announced that the consultation period for its proposals on possible reforms to the prospectus regime in the Companies Ordinance will be extended from 30 November, 2005 to 31 December, 2005.

A summary of those proposals is included in our September newsletter, which can be viewed by clicking [here](/newsletters/hklaw/en/2005/28/nl-hklaw-20050929-28.html).

*This note contains a summary only of recent regulatory developments in Hong Kong. Specific advice should be sought in relation to any particular situation.*

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