Press release

LCQ1: Measures to enhance regulation of financial derivative products to protect the interest of investors

Wednesday, November 23, 2011

Following is a question by the Hon Paul Chan Mo-po and the reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (November 23):

Question:

It has been learnt that in the face of the drastic fluctuations in stock prices in recent months, in order to reap maximum return within a short period of time, some investors are keen on buying structured derivative products which are of low costs, high volatility and high leverage, in particular the "non-collateralized" callable bull/bear contracts (CBBCs). In addition, quite a number of investors participate in short-term speculative activities (including day trading or even half-day trading). Given that the Hang Seng Index and the prices of the underlying stock of derivatives have been fluctuating substantially in recent months, many CBBCs were mandatorily called by their issuers when the prices of their underlying assets reached the Call Price, causing quite a number of investors to suffer huge losses, and those issuers who did not have sufficient additional hedging had to make up and pay for the price difference using their own money, as the fluctuations in prices had exceeded their expected ranges. In this connection, will the Government inform this Council:

(a) whether the authorities are aware of the measures employed by the issuers and liquidity providers of the aforesaid derivative products to deal with the risks arising from the short-term speculative activities of mega investors involving huge sums of money; whether they have stepped up the efforts in monitoring if those derivative products already issued are sufficiently hedged, collateralized or guaranteed, so as to ensure that investors will not be affected by the reduction of the financial or credit capacity of the issuers or securities dealers;

(b) whether the authorities have conducted random checks to affirm if the relevant securities dealers and clients are financially sound enough to deal with day trading or half-day trading transactions; furthermore, as some securities dealers have reduced their commission rates to compete for clients, how the authorities monitor the financial position of registered dealers, with a view to safeguarding the interests of investors; and

(c) whether the authorities have in place any measure to step up its efforts in monitoring if the intermediaries have conscientiously conducted due diligence checks with regard to their clients who are trading high-risk products; if so, of the details, and whether they have assessed the effectiveness of such measures; if not, the reasons for that; before the establishment of the Investor Education Council, how the authorities will enhance investor education, so as to make investors understand the various risks they are exposed to; whether they will consider setting eligibility criteria for investors investing in derivative products (e.g. completing a specified course, attending and passing a specified examination, as well as setting position limits)?

Reply:

President,

Under the current regulatory framework, the Hong Kong Exchanges and Clearing Limited (HKEx) is the frontline regulator of listed structured products in Hong Kong and is responsible for their approval and on-going regulation. The requirements for listing structured products and the approval of issuers are set out in Chapter 15A of the Exchange Listing Rules. The Securities and Futures Commission (SFC) approves the Listing Rules pursuant to section 24 of the Securities and Futures Ordinance and monitors market operation. The Government is responsible for overall policy formulation to maintain Hong Kong's financial stability, provide sufficient protection to investors, and facilitate market development in order to enhance the competitiveness of Hong Kong's financial market.

My reply to the three parts of the question is as follows:

(1) The combined share of derivative warrants (DW) and callable bull/bear contracts (CBBC) in total market trading had remained stable at a level of around 20-25% for the past few years. In October 2011, the trading of DW and CBBC increased to 30% of total market trading on average. This was partly due to the reduced turnover in the stock market. Since the launch of CBBC in June 2006, the highest average daily turnover was about HK$39 billion in October 2007. In 2011, the daily turnover ranged between approximately HK$17 billion and HK$21 billion, except for May 2011 when it was about HK$14 billion.

As at end October 2011, the market value of DWs and CBBCs was HK$2.33 billion and HK$0.57 billion respectively. Based on the current market value, our estimate is that the total hedging positions held by issuers of DW and CBBC in the underlying securities represent about 2% of the average daily trading of the underlying securities. According to the data above, the DW and CBBC market does not give rise to any systemic risk concerns. We have requested SFC to closely monitor the situation. At the same time, HKEx is conducting discussions and studies on ways to strengthen the regulatory regime. SFC is following the development closely.

Currently, the Listing Rules prescribe a minimum entry level for structured product issuers. Issuers or guarantors are required to have an 'A' grade credit rating i.e. to have one of the top three grades of investment grade ratings. If an issuer does not have a credit rating, it must be regulated by SFC or HKMA. In addition, the Listing Rules require the issuers to have net assets of HK$2 billion and adequate risk management systems and procedures.

Should an issuer fail to meet the credit rating requirement, the HKEx may employ a series of measures, such as prohibiting further launch of new issues, apply col lateralisation arrangement, etc.

HKEx also requires the structured product issuers to update the market through announcements about any changes to its credit ratings to ensure that investors are trading on a fully informed basis. In light of the recent Euro debt crisis, HKEx has stepped up its monitoring measures on the change of issuers' credit ratings.

In view of the latest market situation, in September 2011, HKEx held discussion forums with all structured product issuers to discuss proposals on enhancing regulation of the structured product market. The proposals include streamlining of documentation to facilitate comparison of competing product offerings, tightening of liquidity provision obligations, the requirement for col lateralisation, and strengthening internal control as well as investor education, etc.

If the proposals are accepted, HKEx would need to apply to SFC for revising the Listing Rules. We have requested SFC to closely monitor whether there is a need to introduce additional measures to maintain the orderly market operation and provide sufficient protection to investors.

(2) Under the Securities and Futures (Financial Resources) Rules (FRR), SFC requires brokers to ensure that they have sufficient financial resources for the proper performance of their business activities and meet the related risks. In relation to DW trading, the FRR impose very stringent requirements. For example, positions in DW in calculating the liquid capital of brokers and DW for margin lending purposes are subject to a 100% haircut under the FRR.

SFC has been monitoring brokers' financial positions through reviews of financial returns submitted by brokers and stress testing of brokers' capital for adverse market movements. SFC also carries out onsite inspections.

In addition, in accordance with the "Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC" (Internal Control Guidelines), intermediaries should establish risk management policies to evaluate and manage the credit, market and other risks faced by the firm.

As regards the clients, SFC, in accordance with the "Code of Conduct for Persons Licensed by or Registered with the SFC" (Code of Conduct), requires brokers to perform a "know your clients" procedure, which includes understanding their clients' financial situation. SFC's Internal Control Guidelines also require brokers to properly manage clients' credit risks.

(3) SFC, in accordance with the Code of Conduct, Internal Control Guidelines and the "Questions and Answers on Suitability Obligations" (Suitability FAQs), requires intermediaries to perform the "know your clients" procedures by seeking information from their clients about their financial situation, investment experience and investment objectives. The intermediary should assess the client's knowledge of derivatives and characterise the client based on his knowledge of derivatives. When providing services to a client in derivative products, the intermediary should assure itself that the client understands the nature and risks of the derivative products and has sufficient net worth to be able to assume the risks and bear the potential losses of trading in the products.

In respect of investor education, SFC has made use of available channels to remind investors of investment risks. SFC has issued a variety of education resources reminding investors of the features and risks of DWs and CBBCs (e.g. CBBC's call feature), pointing out specifically that they are not suitable for all investors. In the past 12 months, SFC has featured these topics in two issues of its investor e-newsletter "InvestEd Intelligence". In addition, SFC has also separately published five articles in local newspapers and magazines and run nine short segments on different TV and radio channels.

HKEx also carries out investor education work. Currently, the corporate website of HKEx contains DW and CBBC education materials, including information about the risks involved in trading these products. In light of the recent market volatility, HKEx has issued a news release to remind investors to pay attention to the credit risks associated with structured product issuers.

We will continue to remind investors to understand the features and risks of any products before investing in them through continuous investor education.

The Government would continue to closely monitor the development.

Ends