Press release

LCQ18: Regulation of callable bull/bear contracts

Wednesday, May 23, 2012

Following is a question by the Hon Starry Lee Wai-king and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (May 23):

Question:

The Hong Kong Exchanges and Clearing Limited (HKEx) launched callable bull/bear contracts (CBBCs) on June 12, 2006. According to the information provided by HKEx, the number of newly listed CBBCs increased from 391 in 2007 to 6,541 in 2010, and the turnover reached $1,460 billion. In the past three years, almost three quarters of CBBCs were mandatorily called. In this connection, will the Government inform this Council:

(a) whether it will consider requiring issuers to provide collaterals for their CBBC products (and setting up flexible and reasonable collateralisation requirements with reference to the issuers' credit ratings, changes of credit ratings or other reference data), so that investors will stand a greater chance of getting compensation when the credit conditions of issuers change significantly or even when issuers breach the contracts;

(b) whether it knows if the regulatory authorities regularly conduct investigation into the issuers' statements on their products, so as to ensure that investors will not be misled; if they do, the details; if not, the reasons for that;

(c) whether it knows if the regulatory authorities will require issuers to add explicit warning clauses for reminding investors that such products may cause significant losses, and if they will step up their efforts in monitoring and regulating media advertisements and soft-selling activities relating to CBBCs; and

(d) whether it will consider producing more targeted media publicity programmes on CBBCs to explain the risks concerned through illustration by cases involving investment losses, so as to enhance investor education?

Reply:

President:

CBBCs are instruments for leveraged investment and have a unique feature of knockout which is designed to limit a CBBC holder's loss on its investment upon knockout at any time prior to expiry. CBBC tends to follow closely the price movement of the underlying asset. We note that investors tend to trade CBBCs based on their short term views of their expected price movements of the underlying linked asset. They do not necessarily hold onto their CBBC investment for a long time until the CBBC expiry or knock-out. CBBCs provide an alternative choice to trading in other structured products, i.e. Derivative Warrants (DW).

With this, I would like to reply to the four-part question as follows-

(a) The Stock Exchange (the Exchange)'s Listing Rules allow listing of both collateralised and uncollateralised structured products. Similar to overseas markets, issuers in Hong Kong generally issue uncollateralised structured products. Under the Listing Rules, an issuer of uncollateralised structured products must either be regulated by the Hong Kong Monetary Authority (HKMA) or the Securities and Futures Commission (SFC), or have a credit rating of the top three investment grades awarded by a recognised credit rating agency.

Issuers not regulated by HKMA or the SFC must follow the following measures in the event that they no longer fulfill the requirement under the listing rule due to a credit rating downgrade:

(i) the issuer must publish announcement regarding the credit rating downgrade and its continuing obligation to provide liquidity and perform settlement obligation upon expiry;

(ii) the issuer must not launch new issues or further issues; and

(iii) the issuer must apply for withdrawal of products launched but not yet listed and products with no outstanding position in the market.

To enhance the regulation of CBBCs, HKEx has invited issuers to provide concrete proposals on collateralisation including the value and form of collateral and possible ways to mitigate credit risk on outstanding structured products position. Issuers nevertheless have expressed concerns on practical and legal difficulties relating to collateralisation. HKEx will continue the discussion with issuers on proposals related to collateralisation. SFC is monitoring closely HKEx's discussion with issuers in relation to strengthening regulation of CBBC for better protection of investors.

Meanwhile, HKEx will request issuers to include in their marketing materials that structured products are uncollateralised and investors are relying on an issuers' credit worthiness when investing in a particular issuer's structured products by second half of this year.

(b) As one of the review criteria for listing documents of structured products, these documents are required to contain a set of "Risk Factors" for the products and a prominent risk warning statement on the front cover. Investors are reminded to read them carefully, among other terms and conditions, before investing in the structured products. Issuers' listing documents are available on the HKExnews website before listing of the products.

The "Risk Factors" include, among others, structured products are complex instruments and their values at any time prior to expiry are governed by a number of factors (including but not limited to the time left till expiry, the price or level of the underlying asset compared with the exercise price / strike level of our warrants, the volatility of price or level of the underlying asset, market interest rate movements, etc.), the value of the structured product may not correlate with the movements of the underlying, the possibility of losing all the investment in the structured product, the volatile nature of the structured products and a possible limited secondary market in that structured product.

An example of the actual risk warning statement appeared on the front cover of the listing documents is at Annex A.

Apart from the listing documents, the marketing/advertising materials for structured products also contain an appropriate explanation of the risks associated with investments in structured products. Please refer to our response at (c) below in relation to the "Guidelines on Marketing Materials for Listed Structured Products" issued by the SFC.

(c) Issuers are required to make full disclosure on risks of trading in uncollateralised structured products in listing documents. Structured product issuers' credit rating information is contained in issuers' listing documents and also summarised in DW and CBBC product webpages of the Exchange.

Specifically, SFC's Guidelines on Marketing Materials for Listed Structured Products require marketing materials to contain an appropriate explanation of the risks associated with investments in structured products. All marketing materials should advise investors (a) to make their own risk assessment and seek professional advice, where necessary; (b) that prices of structured products may fluctuate; and (c) that they may lose some or all their investments (as applicable). An example of an actual advertisement for risks associated with structured products is at Annex B.

These Guidelines are intended for use primarily by structured products issuers and all persons or entities responsible for marketing materials promoting listed structured products. Although these Guidelines do not have the force of law, a failure to comply with any of the requirements of these Guidelines will, in the absence of extenuating circumstances, reflect adversely on the fitness and properness of a licensed or registered person.

(d) The SFC has recently produced a three-minute video featuring the negative experience of an investor in trading a CBBC to explain its high risk nature, increased volatility of its price when the underlying stock moves close to the exercise price and the knock-out mandatory call feature. This video has been broadcast on pay-TV channels since March 2012. Screening of this video on TV is expected to continue. At the same time, the video was promoted on popular news websites, and is viewable on YouTube and the SFC's investor site (InvestEd website).

Besides, the SFC made use of the January issue of its investor e-newsletter to explain the mandatory call feature in detail and how a credit rating downgrade of a CBBC issuer may affect investors. The e-newsletter was published together with a press release, and the SFC's educational messages received good media coverage at the time of release. The SFC also reiterated these messages in its newspaper column articles.

The SFC is committed to continuing its risk education work in all kinds of SFC-regulated products. The SFC will explain the features and risks of these products, including CBBCs, through the print and electronic media, as well as the Internet as part of its on-going investor education work. This will be one of the themes of the education work of the Investor Education Centre to be established by the SFC later this year.

Ends