

**INDUSTRY PRINCIPLES ON LIQUIDITY PROVISION
FOR LISTED STRUCTURED PRODUCTS**

July 2012

1. Introduction

- 1.1 The structured product issuers (the “**Issuers**”) express their strong support for the continuing success of the Listed Structured Products market and their desire to uphold a consistent high standard. The Issuers also agree with the objective of the Exchange and the Securities and Futures Commission to create an informed market in which investors in Listed Structured Products understand the issuance and regulatory framework, as well as the potential risks associated with such investments.
- 1.2 These industry principles are intended to encourage improved market conduct and the development of consistently high standards across the Listed Structured Products’ industry. While Issuers should comply with these industry principles, the principles are not intended to be binding commitments nor should they give rise to enforceable obligations or duties. Occasional failure to comply with these industry principles will not in itself render an Issuer or its liquidity agent liable to any sanction or enforcement action. However, compliance with these industry principles is relevant to the Exchange’s assessment of an Issuer’s suitability to list structured products.
- 1.3 Each Issuer accepts that in conducting its Listed Structured Products’ business, it should conduct itself in a manner consistent with preserving the integrity of the Listed Structured Products’ market and consistent with not bringing that market or the Exchange into disrepute.

2. What is liquidity and why is it required?

- 2.1 The provision of liquidity is an important feature of Listed Structured Products, because it facilitates investors buying and selling Listed Structured Products that may otherwise be illiquid.
- 2.2 Issuers provide liquidity in respect of each of its Listed Structured Products on each trading day, either through itself or a designated liquidity agent (in such capacity, “**Liquidity Provider**”). Liquidity Providers are not required to support prices of Listed Structured Products. In practice, like other market participants, a Liquidity Provider is free to buy and sell at any price.
- 2.3 The obligations of Liquidity Providers are set out in the listing documents which typically include:
 - (a) the maximum response time – i.e. the maximum time it will take to submit a pair of quotes after a request is received;
 - (b) the maximum spread between the bid and ask price;
 - (c) the minimum quote size; and
 - (d) situations in which the Liquidity Provider will not provide a quote.

2.4 The Liquidity Providers may provide liquidity either by:

- (a) entering orders into the Exchange's trading system in response to an investor's request for quotes ("**Quote Request**"). Section 3 sets out the new tightened liquidity standards to be adopted by each Issuer in its listing documents. Quote Request standards are the minimum service level for all Listed Structured Products applicable to all possible market conditions; or
- (b) actively inputting orders into the Exchange's trading system ("**Active Quotes**"). The market has developed practices with respect to certain products where performance standards are better than those set out in the listing documents. Section 4 describes a new Active Quote standard which will be offered on a voluntary basis for most products with an active underlying. Active Quotes are not strictly continuous because there may be short interruptions where quotes are not provided due to the reasons set out in paragraph 4.11.

3. Quote Request

3.1 Subject to specific exemptions set out in paragraph 3.3, Quote Request should be available for all Listed Structured Products, regardless of the underlying.

3.2 Minimum service levels for Quote Request are:

- (a) maximum quote response time : 10 minutes
- (b) maximum bid-ask spread : 20 spreads
- (c) minimum quote size : 20 board lots
- (d) minimum holding time : 5 minutes¹

3.3 Quote Request is not required to be provided in the following circumstances:

- (a) during a pre-opening session or a closing auction session (if applicable) or any other circumstances as may be prescribed by the Exchange;
- (b) during the first 5 minutes of each morning trading session or the first 5 minutes after trading commences for the first time on a trading day;
- (c) when the Listed Structured Product or the underlying is suspended from trading for any reason;
- (d) when there is no Listed Structured Product available for market making activities;
- (e) if the theoretical value of the Listed Structured Product is less than HK\$0.01;

¹ If the price of the underlying or the prevailing market circumstance changes, Issuers can refresh the quote by posting a new pair of quotes. A quotation lapses if any investor has proceeded with a trade during the five minutes holding period.

- (f) in the case of CBBCs upon the occurrence of a mandatory call event;
- (g) in the case of any Listed Structured Product with an index underlying, if there occurs or exists any suspension of or limitation imposed on trading of options or futures contracts relating to the index or if the index level is not calculated or published as scheduled for any reason;
- (h) when there are operational and technical problems beyond the control of the Liquidity Provider hindering the ability of the Liquidity Provider to provide liquidity; or
- (i) if the underlying or the stock market experiences exceptional price movement and high volatility² over a short period of time which materially affects the Liquidity Provider's ability to source a hedge or unwind an existing hedge.

4. Active Quotes

4.1 Issuers will, without any need for a request from an investor, provide Active Quotes on selected Listed Structured Products as a service to investors. Active Quotes save investors the inconvenience of having to request quotes and promote transparency. This can be achieved when Liquidity Providers display "live" benchmark changes in product prices. The target service levels under Active Quotes are tighter than those that apply to Quote Request.

Criteria for Active Quotes

4.2 A large number of Listed Structured Products are not actively traded. Inactive underlying, close to expiry, too deep-out-of-the-money or too deep-in-the-money are possible reasons for the lack of market interest. Issuers consider that their resources should be focused on products with higher investor demand and will therefore offer Active Quotes for Listed Structured Products with:

- (a) an active underlying (*as defined in paragraph 4.3*);
- (b) 50% or less of their aggregate number outstanding in the market (*as elaborated in paragraph 4.4*);

² Examples of situations where exceptional price movements or high volatility has occurred include:

- (i) *financial uncertainty* - exceptionally volatile market conditions linked to financial uncertainty (called a "fast market" by certain other exchanges) - for example, the period following Lehman Brothers' bankruptcy in September 2008 and the "flash crash" of 6 May 2010 (when the Dow Jones Industrial Average suffered its worst intra-day point loss). A "fast market" occurs when financial markets experience unusually high levels of volatility over a short period of time with unusually heavy trading resulting in a sudden increase in risk and uncertainty. It is generally more difficult to provide quotes momentarily when prices are changing rapidly; or
- (ii) *underlying uncertainty* - the occurrence of events causing the intraday market price of the underlying stock or index to experience significant fluctuation and/or material reduction in liquidity of the underlying momentarily - for example, Japan's earthquake on 11 March 2011 which resulted in a drastic fall in Nikkei index in the immediately following period and fluctuation in prices of the related warrants.

- (c) in the case of a warrant, time to maturity is one month or more (*as elaborated in paragraph 4.5*);
- (d) in the case of a warrant, “moneyness” is between 20% in-the-money and 20% out-of-the-money (*as elaborated in paragraph 4.6*); and
- (e) in the case of a CBBC, the prevailing price of the underlying stock falls outside 2% of the call price or the prevailing level of the underlying index falls outside 1% of the call level (as elaborated in paragraph 4.7).

4.3 An active underlying means:

- (a) any local index (such as Hang Seng Index, Hang Seng China Enterprises Index); or
- (b) any stocks eligible for the issuance of CBBC published by the Exchange from time to time³, representing stocks with highest turnover in the market (“**Actively Traded Stock**”).

4.4 Active Quotes need not be provided for Listed Structured Products with more than 50% of the aggregate number outstanding in the market because there is sufficient public holding of the product to facilitate market demand and supply.

4.5 The time value of a warrant erodes rapidly towards expiry, making it more difficult to provide Active Quotes. Active Quotes are therefore only able to be provided for a warrant the value of which is not materially affected by the erosion of its time value. For the purpose of these industry principles, Issuers will provide Active Quotes for warrants with time to maturity of one month or more.

4.6 In the case of a warrant, one of the criteria for Active Quotes is moneyness. “Moneyness”, also known as “in-the-money” or “out-of-the-money”, describes where the underlying price is in relation to the warrant’s exercise price. For example, in the case of a call warrant, if the underlying price is below strike price, the warrant is said to be “out-of-the-money”. If the underlying price is above the strike price, the warrant is said to be “in-the-money”. Structured products which are either deeply in, or out, of-the-money generally have lower investor interest. Accordingly, issuers will only provide Active Quotes for warrants with ±20% moneyness.

4.7 The price of a CBBC becomes more volatile as the underlying price or level moves towards the call price or level. It therefore becomes more difficult to provide quotes within the tightened spreads specified in paragraph 4.9 when the underlying price of a stock is within 2% of the call price or the underlying index is within 1% of the call level.

³ See CBBC eligible list posted under *Eligible Single Hong Kong Stock for CBBC Issuance in Current Quarter on HKEx website*.
(link: http://www.hkex.com.hk/eng/prod/secprod/cbbc/underlying_latest.htm)

Period for Active Quotes

- 4.8 Issuers will provide Active Quotes during the period (the “**Qualified Period**”) when:
- (a) the criteria for Active Quotes set out in paragraph 4.2 are met; and
 - (b) the circumstances do not fall under the exemptions set out in paragraph 3.3.

Minimum service levels for Active Quotes

- 4.9 Maximum bid-ask spread under Active Quotes is:
- (a) 5 spreads for warrants with local index underlying
 - (b) 10 spreads for warrants with an Actively Traded Stock underlying
 - (c) 10 spreads for CBBCs with local index underlying
 - (d) 15 spreads for CBBCs with an Actively Traded Stock underlying

Issuers provide Active Quotes within a range of spreads according to changing circumstances such as variable market conditions, hedging cost, spread of the underlying and the terms of a particular product.

Spreads for CBBCs are wider than the spreads for warrants because the price of a CBBC is more sensitive to movements in the price of the relevant underlying, meaning that it is more costly to hedge that underlying, which is reflected in the wider spread.

- 4.10 The minimum quote size for Active Quotes is 20 board lots.

Active Quotes may not be continuous

- 4.11 Active Quotes may not be continuous because Liquidity Providers may need time to pause the provision of Active Quotes for a reasonably short period of time to adjust quote parameters in response to market conditions or operational needs. Common causes of these short interruptions include the following:
- (a) a sudden or material change in the trading pattern of a Listed Structured Product, such as where a relatively inactive warrant suddenly becomes active;
 - (b) news (concerning the underlying such as a change in forecast earnings or proposed dividends) is published which might have an impact on the market price of the underlying;
 - (c) the underlying or the stock market experiences exceptional price movement or high volatility over a short period of time which materially affects the Liquidity Provider’s ability to source a hedge or unwind an existing hedge;

- (d) the underlying stock trades at a wider bid-ask spread than normal which causes the spread in Listed Structured Products to exceed the maximum level specified in paragraph 4.9;
 - (e) the Liquidity Provider reasonably suspects any potential mispricing / system issue /error;
 - (f) the Liquidity Provider reasonably suspects abnormal trading in respect of the underlying;
 - (g) operational and technical problems such as computer network disconnection, a loss of a data feed, loss of connectivity with the Exchange or technical issues which arise in the Issuer's computer system; or
 - (h) the Liquidity Provider will suffer, or expects to suffer, a financial risk due to frequency of trades and quantity of trades in relation to its Listed Structured Products.
- 4.12 Issuers should provide explanations for not fulfilling the Active Quotes service and any prolonged interruption of service to the Exchange upon request.

Voluntary provision of Active Quotes

- 4.13 Where circumstances do not meet the criteria set out in paragraph 4.2, Issuers are not required to provide Active Quotes. Nevertheless, Issuers may choose to provide Active Quotes even if not required to do so. If Issuers provide Active Quotes on a voluntary basis, the requirements on bid-ask spread set out in paragraph 4.9 will not apply. The requirements on bid-ask spread set out in paragraph 3.2 will apply if Issuers act in response to Quote Requests.
- 4.14 When Active Quotes are not provided for whatever reasons, an investor may instead rely on minimum liquidity provision service levels provided by way of a Quote Request as described in paragraph 3.2.

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