

CONSULTATION PAPER

THE LISTING RULES OF

THE STOCK EXCHANGE OF HONG KONG

RELATING TO DERIVATIVE WARRANTS

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Hong Kong Exchanges and Clearing Limited

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Summary

Introduction

1. The first derivative warrant was listed on the Stock Exchange of Hong Kong Limited (the “Exchange”) in 1989. At that time derivative warrants were regarded as a novel product and as such there were no specific provisions in the Listing Rules for the listing of warrants. The first listings of derivative warrants were accomplished by adapting the rules for the listing of equity securities to the characteristics of derivative warrants. As the Exchange developed further experience with the listing of warrants, a body of practices became established for the listing of such warrants. In May 1991 those practices were codified and product specific rules, for the listing of derivative warrants, were added to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (the “Listing Rules”).
2. The derivative warrant market has been characterised by its rapidly changing nature. The number and range of derivative warrants listed on the Exchange has expanded. Initially warrants on single stocks were listed: the market has now developed to the stage where warrants on single stocks, baskets of stocks, indexes, currencies and some commodities have been listed. The type of warrants has also expanded. Puts and calls have been listed, warrants with more exotic pay-off features have been listed, warrants which are cash settled or physically settled are also listed. Early derivative warrants were fully collateralised (i.e. the assets underlying the warrant were deposited with a custodian). Since 1994 all derivative warrants listed on the Exchange have been non-collateralised.
3. In view of these developments it has been necessary for the Exchange to continue to keep the warrant rules under review through a process of internal reviews and public consultations. Public consultations on the rules were conducted in 1992 and 1995. The 1995 review, which led to amendments to the Listing Rules in August 1996, saw the rules in relation to derivative warrants consolidated and placed into a separate chapter of the Listing Rules, Chapter 15A, which is dedicated to the listing of derivative warrants. The most recent internal review of the rules was conducted in 1998 – which resulted in amendments to the Listing Rules being introduced in June 1998.
4. There have continued to be further developments in the derivative warrant market, both regionally and internationally. Regionally, the exchanges in Singapore and Australia have sought to develop markets for derivative warrants. A number of exchanges in Europe – in particular, in Germany, Switzerland and Italy – have also developed markets for the listing and trading of derivative warrants. In light of these developments, and to continue to develop the derivative warrant market, the Exchange considers that it is appropriate to conduct a further review of the Listing Rules and to seek comments from the public and market participants on its proposals.

Objectives

5. In developing these proposals the Exchange has sought to accomplish the following objectives:
 - a) Continue to make available a range of derivative products to provide investors with a range of investment opportunities.
 - b) Provide a regulatory regime that is more tailored to the specific requirements of derivative products. In this respect, the early decision to list warrants by adapting the rules for equity securities has shaped the current contents of the Listing Rules. In addition, it is also recognised there is a substantial retail involvement in the secondary market trading of derivative warrants.
 - c) Further develop the market, to maintain both the Exchange's position as a centre for the listing of derivative warrants and Hong Kong's position as a leading international financial centre.
6. Certain of the Exchange's proposals are – subject to comments received in the consultation exercise – intended to be introduced as expeditiously as possible following the conclusion of the consultation exercise. In other areas, the Exchange's proposals are not at a sufficiently developed stage where detailed rules can be proposed. In these cases the Exchange is seeking comments from market participants to enable it to develop rules.

Overview of Proposals

7. An overview of the principal proposals is set out below:
 - a) At present although other methods of listing are permitted, derivative warrants are almost always listed by way of placing. Warrants listed by means of placing are required to have a minimum of 100 places (or 50, subject to further conditions being met) at the time of listing and the issuer is permitted to retain no more than 15% of a derivative warrant issue. The Exchange will continue to permit warrants to be listed by means of placing and now proposes to abolish the requirement to place warrants to a minimum number of places and to abolish the current 15% limit on the percentage of an issue which an issuer may retain at launch. As an alternative to abolishing the current limit on the percentage of a warrant issue which an issuer may retain at launch, the Exchange seeks comments on whether the limit should be increased to 75%. These are discussed further in paragraphs 11 to 33 below and the Exchange's proposals are set out in paragraphs 49 to 52.

- b) At present there is no requirement for issuers of derivative warrants to maintain buy and sell orders throughout the life of the warrant, nor is there a requirement obliging issuers to respond to requests for quotes on warrants they have issued. In practice, many issuers provide liquidity for their warrants by being prepared to re-sell or repurchase warrants throughout their life. It is proposed to formalise these arrangements by utilising the quote request function that will be available in the Exchange's AMS/3 trading system. On receipt of a quote request, issuers will be obliged, subject to some exceptions, to provide a bid and offer price for a derivative warrant they have issued for a minimum of ten board lots of that warrant. Trading in derivative warrants will also continue on the current basis of auto matching purchase and sales orders entered into AMS/3. Once it has been brought into operation, the Exchange will keep the quote request system under review and may subsequently introduce a requirement for continuous market making. This is discussed further in paragraphs 34 to 48. Further details of the Exchange's proposals are set out in paragraphs 60 to 63.
- c) The Listing Rules limit the number of shares of Hong Kong listed companies which may be the subject of warrant issuance. By permitting issuers to retain a greater percentage of warrant issues when they are launched it is anticipated that average issue sizes may increase, thereby leading to the existing issuance limits being utilised more quickly. It is therefore proposed to introduce a limit on the size of individual derivative warrant issues. This limit could be set by limiting issue sizes to a multiple of the average daily turnover of shares underlying a proposed warrant issue. Alternatively, issue sizes could be limited by reference to the initial market capitalisation of the warrant issue. The Exchange seeks comments on whether that limit should be set by reference to average daily turnover in the underlying security or by reference to the initial market capitalisation of the derivative warrant issue. This is discussed further in paragraphs 71 to 84.
- d) A number of changes are proposed in relation to Further Issues (as defined in the Listing Rules). The existing aggregate limit on Further Issues of HK\$50 million will be replaced with a limit that will apply to each Further Issue. Each Further Issue will be limited in size in the same manner as initial issue sizes. At present Issuers are not permitted to launch a Further Issue if they have any holding of the existing issue. Issuers will be permitted to launch Further Issues when they hold 25% or less of an existing issue. It is proposed to allow Further Issues with a minimum period to expiry of two months compared to the current six months. This is discussed in paragraphs 85 to 96.
- e) No changes are proposed to the existing requirements in relation to the criteria that issuers are required to meet to become eligible to issue derivative warrants. This is discussed further in paragraphs 97 to 106.

- f) The Listing Rules provide that to be eligible for warrant issuance a company listed on the Exchange must have a “public float capitalisation” of HK\$4 billion, for single stock warrants, and HK\$1 billion for basket warrants. No changes are proposed to these limits. It is proposed that those stocks which are constituents of the Hang Seng Index will be eligible for single stock warrant issuance. This is discussed further in paragraphs 107 to 125.
- g) The Listing Rules provide for the automatic exercise on the maturity date of all cash settled derivative warrants which are in the money at expiry so that warrant holders are not required to serve a notice of exercise. The cash settlement amount for these warrant is, in accordance with the Listing Rules, based on the average closing price for the underlying security for the five business days before the exercise date. For American-style cash settled warrants exercised prior to maturity it is now proposed to permit the cash settlement amount to be based on the closing price of the underlying security on the exercise day. The existing five-day formula (and the automatic exercise provision) will continue to apply when determining the cash settlement amount for warrants automatically exercised on the maturity date. This is discussed further in paragraphs 126 to 141.
- h) Warrant issuers are required to disclose details of any dealings in the securities underlying a warrant issue (including dealings in options and warrants) for the six-week period before the warrant issue is launched. The disclosure is to be made to the Exchange and is included in the Listing Document. Many of the dealings disclosed may not be related to the warrant issue and it is noted that other exchanges do not require such disclosure. It is now proposed to repeal the requirement for this disclosure to be made in the Listing Document and to the Exchange. This is discussed further in paragraphs 142 to 148.
- i) The Listing Rules prohibit warrant issuers from issuing warrants over assets or securities where they have issued or updated an analyst’s research report on the asset or security one week before the launch of the warrant. Other exchanges do not impose such a restriction. It is now proposed to repeal this prohibition and to require issuers to state in the listing document whether they or companies associated with them have published research on the securities or assets underlying a warrant issue. This is discussed further in paragraphs 149 to 152.
- j) To simplify the contents of listing documents it is proposed to allow issuers to omit their financial statements from listing documents. Issuers will be required to include their balance sheet, profit and loss account, cash flow statement and statement of changes in equity in the listing document. Issuers will be required to submit their full financial statements to the Exchange for publication on the web site of Hong Kong Exchanges and Clearing Limited (“HKEx”). This is discussed further in paragraphs 153 to 167.

- k) To simplify the contents of Listing documents it is proposed to eliminate the requirement to include information in respect of the company over whose shares warrants have been issued where that company is listed on the Exchange. This is discussed further in paragraphs 168 to 172.
 - l) It is proposed to reduce the minimum market capitalisation of a derivative warrant issue at the time of launch from the existing HK\$50 million to HK\$10 million. This will bring the minimum market capitalisation level for derivative warrants into line with that for company warrants. This is discussed further in paragraphs 198 to 202.
 - m) The Listing Rules provide that where the securities underlying a warrant issue trade in board lots then the board lot of the warrant must be exercisable into a whole number of board lots of the underlying security. To provide additional flexibility to warrant issuers, for cash-settled warrants only, the Exchange proposes that a board lot of warrants shall represent either a whole number of board lots of the underlying security or one-tenth of a board lot of the underlying security. This is discussed further in paragraphs 203 to 207.
 - n) The Listing Rules provide that derivative warrants must normally expire not less than six months and not more than two years from the date of listing. No changes are proposed to the minimum and maximum lives of warrants on launch. This is discussed further in paragraphs 208 to 212.
 - o) The Listing Rules currently require warrant issuers to publish announcements in the newspaper on the launch of warrants and before they expire. It is proposed to repeal this requirement and replace it with a requirement to release these announcements through HKEx's web site. This is discussed further in paragraphs 213 to 222.
 - p) Certain other changes to the disclosure requirements in listing documents for derivative warrants are also proposed.
8. The Exchange is seeking comments to assist in the further development of the market for derivative warrants over shares listed on overseas markets and indexes based on overseas markets. This is discussed further in paragraphs 223 to 236.
9. At present the document issued in connection with the listing of a derivative warrant issue does not constitute a prospectus for the purposes of the Companies Ordinance. The Exchange is considering introducing a requirement for the listing document to be registered as a prospectus. This approach would facilitate the listing of low exercise price warrants or warrants where all or part of the initial subscription price was guaranteed to be returned to investors. This is discussed further in paragraphs 241 to 244.

Comments

10. The Exchange now invites comments on the proposals set out in this paper. Comments may be submitted by completing and returning the questionnaire set out in Appendix 4. Comments or completed questionnaires should be addressed to Head – Listing, Regulation & Risk Management. Comments may be submitted by post, to Hong Kong Exchanges & Clearing Limited, 11/F, One International Finance Centre, 1 Harbour View Street, Central, Hong Kong; by fax, on 2971 0171; or by email addressed to warrants@hkex.com.hk. Responses should arrive no later than the close of business on 30th June, 2001.

Listing Procedures for Derivative Warrants

Present Requirements & Procedures

11. The Listing Rules permit warrants to be listed by any of the means, which may be used for the listing of equity securities: offer for sale, offer for subscription, introduction or placing. However, substantially all issues of derivative warrants are listed on the Exchange by way of placing and are therefore subject to the requirements of the placing guidelines for derivative warrants which are set out in Appendix 6A to the Listing Rules.
12. The placing guidelines for warrants are based in part on the placing guidelines for equity securities. Many of the provisions in these equity-placing guidelines have been incorporated into the placing guidelines for warrants. In some cases the requirements have been modified to reflect the particular nature of warrants. In other cases the requirements have not been modified.
13. The placing guidelines for equity securities include a requirement that: “*...securities to be placed must have an adequate spread of holders...as a guideline there should be not less than three holders for each HK\$1,000,000 of the placing with a minimum of 100 holders.*”¹ This guideline has been slightly modified for the placing of derivative warrants. There is still a requirement for “an adequate spread of holders”. However this requirement will be met if, upon listing, there are at least 100 holders (the so-called “100 placee rule”) or there are at least 50 holders who each take up not less than HK\$100,000 of warrants (the so-called “50 placee rule”).
14. The placing guidelines for derivative warrants include limits on the categories of persons to whom warrants may be placed. For example, not more than 25% of an issue may be placed with “discretionary managed portfolios” (as defined in the Listing Rules) and not more than 10% of the total placing may be offered to employees or past employees of the issuer. There is also a limit on the extent to which equity securities may be placed to “connected clients” as defined in the Listing Rules. These restrictions mirror similar restrictions set out in placing guidelines for equity securities.
15. Any lead broker, distributor and Exchange Participant with whom or through whom warrants are placed must complete and return to the Exchange a marketing statement as set in Appendix 5 to the Listing Rules. The marketing statement sets out a summary of the distribution of the placing. It also includes a declaration that the warrants have not been placed with the directors of the issuer or their associates or any existing shareholder of the issuer or any nominee of any these parties. In

¹ Listing Rules, Appendix 6, paragraph 4.

addition, details of placees (names, addresses, identity card numbers and number of warrants subscribed for) are supplied to the Exchange by either the issuer or the placing agent.

16. The placing guidelines for derivative warrants allow issuers to retain no more than 15% of an issue by requiring issuers to place a minimum of 85% of an issue. The placing guidelines apply only on the listing date. Thereafter, issuers may repurchase warrants, thereby reducing the number of warrants which are held by investors, and may resell warrants in the market. At the end of each week issuers are required to submit details of their sales and purchases of warrants they have issued. This also includes information on the number of warrants for each issue which remain in the market (rather than being held by the issuer and parties associated with the issuer). The reports submitted by issuers are published on the Exchange's teletext system and web site, generally on a Monday or Tuesday following receipt of the information on a Friday or Monday.
17. The Listing Rules require the minimum expected market capitalisation for a warrant issue on launch to be at least HK\$50 million. Thus, for a minimum-sized warrant issue, to comply with the placing guidelines, on launch at least HK\$42.5 million (85% of HK\$50 million) of warrants must have been placed to 100 investors or to 50 investors each subscribing for a minimum of HK\$100,000 of warrants.

Discussion

18. It has been suggested that it is in the area of the launching of warrants that the results of the early decision to base the rules for the listing of derivative warrants on those for equity securities is still most evident. It is also in relation to the procedures for the launching of warrants that the Exchange receives the most comments and enquiries in the course of its day-to-day contact with derivative warrant issuers.
19. As noted earlier the placing guidelines are based on the requirements for equity securities. In the case of such securities it is the interplay of buyers and sellers that will determine share prices. In the case of equity securities, the rules are designed to establish a broad base of shareholders. Having a wide base of shareholders is seen as increasing the potential number of participants who may take part in subsequent trading in the shares, resulting in a potentially "deeper" market against which price formation can take place. For equities therefore, a wide spread of shareholders is seen as means of ensuring subsequent liquidity in a security.
20. In the case of derivative warrants, whilst availability of sellers and buyers will affect derivative warrant prices, there are other factors which will affect the value and hence the price of a warrant. The price of the underlying security relative to the warrant strike price is a very significant factor in determining the price of a warrant. Other factors which affect warrant values are: the anticipated volatility of the price

of the underlying asset²; the time remaining until the warrant expires³; and the current level of the risk free interest rate⁴.

21. For many warrants, at the time of listing, the number of placees marginally exceeds the minimums required by the Listing rules. However, notwithstanding this uniformity in placee numbers at the time of launch there is a substantial difference in the value of turnover in warrants. Thus for example there were ten warrants whose turnover exceeded HK\$500 million in December 1999. This included three warrants with turnover in excess of HK\$1 billion and one warrant with turnover slightly in excess of HK\$2.5 billion. Also in December 1999 there were ten warrants where turnover was less than HK\$2 million, including three warrants where turnover was below HK\$200,000.
22. The above factors suggest that the number of holders of a warrant may be less important factors in determining the price of warrants and also the subsequent liquidity in warrants.
23. The placee requirement was also introduced in part to ensure that there was sufficient interest in the derivative warrant to justify its listing on the Exchange. It has been suggested that whether there is sufficient interest in a warrant is a commercial matter which, provided there are safeguards in place to protect investors, can be left to market forces to determine.
24. It has also been suggested that in the current economic environment it is increasingly difficult to distribute warrants to 100 placees – especially as limited marketing of derivative warrants is allowed by both the Exchange and securities legislation. Certain former issuers of derivative warrants have advanced this as one of the reasons for their decision to cease issuing derivative warrants. These former issuers, and other existing issuers, also point to the difficulties of “selling” HK\$42.5

² Volatility can be viewed as a measure of the dispersion of the possible values of the underlying security. The higher the volatility, the greater the likelihood that the underlying will do either very well or very poorly. The holder of a call warrant will be able to capture the full benefit of favourable price outcomes but will not suffer a loss from unfavourable outcomes since in this case the warrant will not be exercised. Consequently, the higher the price volatility the higher the value of the warrant, everything else being equal. (Adapted from *Futures & Options* by Franklin R Edwards and Cindy W Ma)

³ The time remaining to the expiry of a warrant affects values because of its relationship to volatility. Over a long period of time much can happen. Even a security with a low volatility may eventually experience a favourable price move. Other factors being equal the longer the period to maturity the greater the value of the warrant. (Adapted from *Futures & Options* by Franklin R Edwards and Cindy W Ma)

⁴ The higher the interest rate the lower the present value of the strike price, thus a higher interest rate has the effect of lowering the strike price. Therefore for call warrants higher interest rates will result in a higher value, other factors being equal. For put warrants the reverse is the case. (Adapted from *Futures & Options* by Franklin R Edwards and Cindy W Ma)

million of warrants in order to comply with the requirement that at least 85% of a minimum-sized issue is placed out before listing.

25. Issuers and their advisors have indicated to the Exchange that the requirement to submit details of placees and the relevant statements of compliance with the placing guidelines is a time-consuming process, which produces a substantial number of documents which are required to be retained by issuers, their advisors and also by the Exchange.
26. Issuers have been permitted to retain no more than 15% of a warrant issue at launch in order to provide them with an inventory of warrants to meet demand which arises after listing. There have been instances where warrant prices have demonstrated unexpected pricing characteristics (e.g. put warrants rising in value following increases in the price of the underlying security). Issuers have represented that in these cases an ability to issue further warrants may have helped overcome pricing anomalies. One way to facilitate the easier issuance of warrants would be to allow issuers to retain a greater proportion of a derivative warrant issue at launch.
27. A number of other stock exchanges permit the listing of warrants by means of placing. The rules of those exchanges contain provisions in relation to placing but in some cases these are not expressed in the same quantitative terms as the rules for placing in Hong Kong. Thus the rules of the Australian Stock Exchange (the “ASX”) provide that the issuer, “*shall ensure that the initial issue of Warrants has a spread of Warrant-Holders which, in the opinion of the Exchange, is adequate and reasonable.*”⁵ The rules for the Italian Stock Exchange and the Swiss Stock Exchange include requirements framed in comparatively similar terms.⁶ The Stock Exchange of Singapore (the “SES”) which permitted the listing of derivative warrants comparatively recently has adopted a 100-placee guideline rule similar to that of the Exchange.
28. The percentage of an issue which issuers are permitted to retain also varies. The Italian and Swiss Exchanges appear to have no specific requirements in this respect.

⁵ Australian Stock Exchange Business Rules, Rule 8.4.2

⁶ The rules of the Italian Stock Exchange state that warrants must be distributed among the public or professional investors to an extent deemed adequate by the Italian Stock Exchange to meet the conditions for the regular operation of the market. The rules of Swiss Exchange require warrants to have been adequately distributed to the public. The rules also indicate that this requirement will be deemed to have been satisfied if the lead manager submits a declaration to the effect that the placing in the hands of the public is such as to imply that the market will operate properly.

29. It can be seen from the above that a number of European exchanges (and also the ASX) have adopted a system where there are no minimum limits on the initial number of placees or limits on the amount of an issue which might be retained by the issuer. The Exchange considers that there are a number of merits in this type of launch mechanism (referred to hereafter as the “European-style launch mechanism”).
30. The current practice in Hong Kong will tend to drive issuers to issuing the most popular types of warrants (i.e. those which may be sold most easily). Thus, for example, there may be a demand for warrants which are substantially out of the money at the time of issue. However, an inability to find 100 (or 50) placees may limit the ability of issuers to launch such warrants. Therefore, investors wishing to acquire such warrants will likely only be able to buy them in the secondary market after warrants with more typical terms have reached a level where they are out of the money. Permitting warrants with a lower number of initial placees to be listed might therefore result in a wider choice of warrants being made available to investors. The Exchange notes that exchanges, which have adopted this “European-style launch mechanism”, are characterised by a greater number of warrants at a wider range of exercise prices, thereby providing a greater choice to investors.
31. The requirement for a warrant issue to be placed before listing will also mean that the issuer will be required to enter into the appropriate hedge for the underlying security before the listing date. An ability to launch warrants with a smaller number of placees or where a larger proportion of the issue is retained by the issuer, would mean that the issuer would be able to enter into hedging transactions at the time the underlying warrants were taken up by investors. This might reduce the possible effect of issuer hedging activity on underlying share prices.
32. The Exchange also notes that a move to the European-style launch mechanism would reduce the administration associated with warrant issue launches (e.g. completion of marketing statement, submission of placee details to the Exchange). This might reduce issuers’ costs of launching warrants and might also permit the period between the launch date of a warrant and its listing date to be shortened.
33. The Exchange also notes that if issuers were permitted to list derivative warrants without having placed part of the issue to investors, then the size of individual warrant issues may increase. It may also lead to an increase in the number of derivative warrant issues over individual stocks as issuers sought to provide a wider range of warrants. Together, these factors may lead to the existing warrant issuance limits over individual stocks being utilised more quickly than at present. It has also been suggested that issuers might seek to utilise the issuance limits in individual stocks to deprive rival issuers of the opportunity of issuing warrants over those stocks. These issues might be addressed: by requiring issuers to have placed part of an issue before listing (through a limit on the percentage of an issue which the issuer may retain on launch); by limiting individual issue sizes; by modifying the existing issuance limits; or by some combination of all of these.

Post-Listing Liquidity

34. After listing derivative warrants are traded on the Exchange's cash market trading platform, the Automatic Order Matching and Execution System ("AMS"). AMS is an order-driven system that accepts only Limit Orders, Enhanced Limit Orders and Special Limit Orders⁷. Orders (to purchase or sell securities) are entered into the system by Exchange Participants. These orders are then matched on a strict price and time priority basis. An order entered into the system at an earlier time must be executed in full before an order at the same price entered at a later time is executed.
35. The Exchange has noted that markets which have adopted the European-style launch mechanism generally impose some form of market making obligation on issuers. For warrants listed on the ASX, issuers undertake to the ASX to make markets by maintaining buy and sell orders in the market for the life of the warrant. A similar obligation applies for warrants listed on the Italian Stock Exchange⁸ and the European Warrant Exchange⁹ ("Euwax"). The Exchange has therefore considered whether to introduce some form of market making requirement for derivative warrant issuers which would operate in parallel with and as a supplement to the existing AMS trading system.
36. Although there is no market-making obligation for issuers of warrants listed on the Exchange, issuers are permitted to, and do, repurchase and resell their warrants throughout the life of those warrants. Details of this activity are made available to the market via HKEx's web site and teletext system. Issuers have suggested to the Exchange that it is not necessary to introduce some form of specific market making obligations for derivative warrants. These issuers have argued that market forces will drive issuers to ensure that they quote bid and offer prices for derivative warrants they have issued throughout the life of those warrants. Issuers have

⁷ A Limit Order will be matched at the input price only. An Enhanced Limit Order is similar to a Limit Order except that it will allow matching of up to two price queues at the same time. The input order price of an Enhanced Limit Order can be matched at up to one spread better than the best price on the other side of the market. A Special Limit Order is a market order which matches up to two price queues (i.e. the best price queue and the next queue one spread away) as long as the traded price is not worse than the input limit price.

⁸ In accordance with the Rules of the Italian Stock Exchange warrant issuers must undertake to display continuous bid and offer prices for a quantity at least equal to the minimum trading lot of the covered warrants. The Italian exchange retains a right to increase the quantity obligation at the time an issue is listed on the exchange. The exchange may suspend this obligation at the request of the issuer. The obligation to display continuous prices may be satisfied by a third party appointed for that purpose by the warrant issuer (Source: *Rules of the Markets Organised and Managed by the Italian Stock Exchange* Article 2.2.19)

⁹ Applications for listings of derivative warrants on Euwax must specify: "...the name of the market participant charged with making quotes and executing orders (market maker)...the minimum trade volume to which a price quoted by a market maker shall apply...the maximum spread between buying and selling price in Euro..." (Source: *Guidelines for the European Warrant Exchange – EUWAX at the Baden Wurttemberg Securities Exchange*)

maintained that warrants are a “branded” financial product and as such are readily identified with the issuer by investors. Issuers have maintained that this branding (or the “visibility” which follows from it) provides them with an incentive to ensure favourable treatment to investors. One of the ways issuers can provide that treatment is by being prepared to repurchase and resell warrants during the life of a warrant issue. If that treatment is not forthcoming, then investors would not invest in warrants issued by that issuer in future. For this reason, issuers maintain that competitive pressure would lead them to making a market in their warrants for investors and hence there is no need to introduce some form of mandatory market making requirement for warrant issuers.

37. Other issuers have also noted that where a warrant is popular – a so-called “hot issue” – it will not be necessary for the issuer to step into the market to provide liquidity, as that liquidity would be provided by investors purchasing and selling warrants in the secondary market. As noted earlier, the turnover for the most actively traded derivative warrant issue in December 1999 was approximately HK\$2.5 billion. From reviewing the weekly sale and purchase reports for December 1999 submitted to the Exchange by the issuer of that warrant it would appear that the issuer’s purchases and sales of this warrant accounted for slightly over 20% of the turnover of that warrant. A review of issuers’ trading activity in December 1999 would suggest that issuers’ turnover as a percentage of market turnover decreases as turnover for a warrant increases. However, the degree of correlation is very low and is in any event based only on one month’s data.
38. It might be argued that a possible lack of liquidity after listing is one of the inherent risks that investors face when they invest in derivative warrants; and that the Exchange should seek to address this point by means of disclosure rather than by mandating some form of market making requirement. It should also be noted that the Exchange has received few complaints about a lack of liquidity in the derivative warrant market.
39. It has also been suggested that introducing some form of market making requirement may not assure the subsequent liquidity of warrants.¹⁰

¹⁰ “There is a risk that you [i.e. investors] will not be able to sell your warrants for a reasonable price in the market. This could be because there are insufficient orders to buy your warrants, or the price at which others are prepared to buy them is very low. Warrant issuers undertake to the ASX to make markets by maintaining buy and sell orders in the market for the life of the warrant. This is to ensure that there is sufficient liquidity in a warrant series so that you can readily buy and sell warrants. However, there are no spread or quantity obligations applied to the market making requirements. The quality of market making will depend on competitive pressures. In times of extreme volatility the reliability of market makers will be put under stress. You should be aware that in these situations, the presence of suitable quotes in the market cannot always be assured.” (Source: *Understanding Trading & Investment Warrants* published by the Derivatives Division of the ASX)

40. It has also been suggested to the Exchange that any possible lack of liquidity is not necessarily a cause for regulatory concern and that it is necessary to consider the effect of the lack of liquidity on investors. Where there is a lack of liquidity because there are no sellers of a warrant then desires of investors wishing to purchase warrants will be unsatisfied. A failure to satisfy market demand in this way might be seen as more in the nature of a “missed opportunity” than an area to be addressed by regulation.
41. Alternatively, a lack of liquidity arising because there are no purchasers of a warrant would suggest that there are investors who are unable to realise their investment and that this is perhaps an area that the Exchange should seek to address. This would suggest that if the Exchange is to introduce a market making obligation on issuers it should take the form of an obligation to maintain purchase orders throughout the life of the warrant (a so-called “buy back” obligation).
42. A further alternative form of market making which has been suggested to the Exchange is to introduce a so-called “quote request” system. Under this approach issuers would not be obliged to provide continuous bid and offer prices throughout the life of a warrant. Instead, issuers would be obliged to provide quotes only in relation to those warrants where there were no existing market orders and then only when “requested” to do so. Under such an approach it would be possible to submit “quote requests” to warrant issuers, who would be obliged to respond to those “requests” by providing a quotation. Proponents of this system maintain that it would be compatible with the existing trading system for warrants. It is also suggested that such a system would oblige issuers to provide liquidity solely in those warrants which were illiquid (i.e. those for which there were no purchase and sales orders to be matched in AMS). For warrant issues which were being actively traded through the AMS system it is unlikely that quote requests would be submitted to issuers.
43. An additional form of market making which has been suggested to the Exchange is continuous market making. Under this type of market making, derivative warrant issuers would be obliged to provide continuous bid and offer prices for all of their warrants listed on the Exchange throughout each trading day. This type of market making might be felt to be the most transparent form as market participants with access to a teletext or similar terminal would be able to observe the prices at which issuers of warrants were prepared to purchase and sell their own warrants. Where a number of warrant issuers had issued warrants on the same underlying security it would be possible to compare prices without submitting quote requests to issuers. A number of issuers in the Hong Kong market – through their warrant operations in overseas markets, particularly European markets – have experience of continuous market making. The Exchange anticipates that many of these issuers will seek to adapt the systems used in their European operations to the Hong Kong market.

44. As set out above market making could take many forms: a requirement to provide continuous bid and offer prices throughout the life of a warrant; a buyback obligation; or a quote request system. In whatever form it was introduced a number of “technical” issues would arise. Consideration would need to be given as to whether it would be necessary to impose limits between bid and offer prices (a “spread limit”) or to require minimum order sizes (a “volume limit”) for any quotes provided. If these were introduced it would be necessary to consider how frequently they would be reviewed. It would also be necessary to consider the position where issuers have no inventory of a particular warrant issue and whether issuers in these circumstances would be obliged to quote only a “bid” price.
45. As noted earlier, the price of the underlying security relative to the strike price of a warrant is a significant factor in influencing the value of a warrant. Thus, if a price has not been established for the underlying security on the cash market then it may be appropriate to relieve issuers of any proposed obligation to provide bid and offer prices for the related warrants. To allow the opening price of the underlying security to become established it may also be appropriate to allow an interval at the market opening before issuers are obliged to provide price quotes for warrants.¹¹ A warrant which is out of the money shortly before expiry has little or no value and in such circumstances it may be inappropriate to require issuers to provide bid prices for such warrants. For similar reasons it may also be appropriate to relieve issuers of the obligation to provide bid prices for warrants at other times where the warrant is substantially out of the money.
46. If a quote request system is introduced it would be necessary to specify the time period allowed to respond to a quote request.¹²
47. In any consideration of whether to introduce some form of market making requirement it is important to have regard to the capability of the Exchange’s trading system. The Exchange’s trading platform, the Automatic Order Matching and Execution System (“AMS”) is an order-driven system that accepts only Limit Orders, Enhanced Limit Orders and Special Limit Orders. Orders (to purchase or sell securities) are entered into the system by Exchange Participants. These orders are then matched on a strict price and time priority basis. An order entered into the system at an earlier time must be executed in full before an order at the same price entered at a later time is executed.

¹¹ On the Exchange’s Traded Options Market, market makers’ obligations to quote prices commence at 10:05 a.m. (i.e. five minutes after the cash market has opened) or when the bid offer spread of the underlying security is the minimum allowed under the Exchange Rules, whichever occurs earlier.

¹² On the Exchange’s Traded Options Market, market makers’ are obliged to respond to quote requests within 90 seconds of receipt.

48. The newly introduced trading system, AMS/3, includes an additional function (known as Registered Trading) which supplements the existing capability of the AMS system. The Registered Trading Function (the “RT Function”) provides the capability to support a market making system that would operate in addition to the existing system of automatically matching purchase and sales orders entered by Exchange Participants. That market making system could take the form of a requirement for issuers to quote bid and offer prices for warrants continuously throughout the life of those warrants or the form of a quote request system.

Proposals

The Placing Guidelines

49. The Exchange recognises that one of the reasons that issuers have chosen to adopt placing as the listing mechanism for warrants is the difficulties that would be encountered if it was made necessary to launch warrants by means of a public offer. The Exchange also notes that issuers and their advisers have become accustomed to launching warrants by means of a placing exercise. The Exchange therefore continues to consider that it is appropriate to allow the listing of warrants by means of placing and that the placing guidelines should be modified.
50. *The Exchange proposes to abolish the current placing requirement under which issuers are required to place warrants to a minimum of 100 placees or to 50 placees each of whom takes HK\$100,000 of warrants. The Exchange also proposes to abolish the current 15% limit on the percentage of an issue which an issuer may retain at launch. As a consequence there would be no minimum number of placees to be reached, or minimum percentage of an issue to be placed, before a warrant issue could be launched. Indeed, it would be possible to launch an issue without having placed any of that issue. The requirements to disclose details of any placees to the Exchange would continue. However, in view of comments received from Issuers, the Exchange anticipates that on launch warrants would be placed to a substantially smaller number of placees, if at all.*
51. *The Exchange invites comments on this proposal. In particular the Exchange seeks views on:*
- (a) Whether to abolish the requirement to place warrants to a minimum of 100 placees or 50 placees each of whom takes HK\$100,000 of warrants; and*
 - (b) Whether to abolish the current 15% limit on the percentage of an issue which an issuer may retain on launch*

52. *As an alternative to the proposal in paragraph 50 above, the Exchange seeks views on whether to abolish the current placing requirement (as proposed above) and increase the limit on the percentage of an issue which an issuer may retain at launch from the current 15% to 75%. Under this proposal it would be possible to launch a warrant if 25% of that issue had been placed to one investor. Requiring issuers to have placed 25% of an issue before listing, might help ensure that the existing warrant issuance limits are not utilised more quickly than at present – particularly through the listing of warrants for which there was no market demand at the time of launch. In providing views on this alternative proposal, respondents are invited to comment on:*
- (a) The retention level of 75% and whether it should be higher or lower; and*
 - (b) Whether under this proposal it would be necessary to limit warrant issue sizes, as proposed in paragraph 84.*

Market Making

53. The Exchange considers that it is appropriate to take steps to introduce measures directed at providing some assurances as to the post-listing liquidity of derivative warrants listed on the Exchange. The Exchange accepts that for “hot” issues some form of market-making requirement would probably not add to the liquidity of the derivative warrants. The Exchange has also noted the comments made to the effect that market forces would tend to ensure that issuers make a market in those derivative warrants which they have issued. It is also the case, as noted before, that the Exchange has not received significant numbers of complaints regarding a lack of liquidity in the derivative warrant market.
54. The Exchange’s current trading platform, AMS/3 has been introduced comparatively recently. The functions within that system which would support either quote request or continuous market making have not currently been brought into operation. Thus, the Exchange and Exchange Participants have not experienced the operation of these systems in a “live” trading environment. If any requirement is to be introduced for market making it is important that issuers are provided with sufficient time to introduce and test the systems that would be required to support this.
55. Of the two types of market making, request for quote would impose the least immediate burden on issuers, as they would be required to provide bid and offer prices when they received a quote request. A quote request system could be introduced as a first step towards introducing a comprehensive market making requirement. Whilst the quote request system operated issuers would be able to develop systems to support continuous market making (which the Exchange understands would probably be accomplished by issuers introducing systems to the Hong Kong market that they have used in other, principally European, markets.)

56. The Exchange, does, however, believe that it is appropriate to introduce measures which would provide some measure of liquidity to warrants where market forces (i.e. purchase and sales orders in AMS/3 entered by Exchange Participants) had not provided liquidity. It is proposed to accomplish this by introducing a quote request regime and configuring the AMS/3 system accordingly. At this stage the Exchange has not determined whether it is ultimately appropriate to impose an obligation for continuous market making and will keep this matter under review once the quote request system comes into operation. The Exchange will also be guided in this area by the responses to this consultation paper.
57. The Exchange proposes to introduce the quote request regime primarily for the benefit of retail investors, who are considered to be active participants in the warrant market. The Exchange considers that it is appropriate to reflect this in terms of the quote request obligation that issuers would be expected to comply with. The Exchange would therefore propose to set the volume obligation at a comparatively low level. This would ensure that investors holding amounts of warrants which might be thought of as being typical of retail investor interest would have an outlet for the sale, or purchase, of warrants.
58. The Exchange notes that in many cases issuers of warrants are not Exchange Participants and therefore do not have access to the Exchange's trading system. It will therefore be necessary for issuers to be able to nominate an entity that will be obliged to respond to quote requests. The Exchange would envisage that in many cases that entity would be a member of the issuer's group. However, the Exchange considers it would not be necessary to make membership of the issuer's group a mandatory requirement, provided it is clear who has been designated by an issuer to respond to any quote requests.
59. The Exchange understands that for marketing and other commercial reasons some derivative warrant issuers may seek to provide continuous bid and offer prices for all warrants they have issued throughout the life of those warrants. Introducing a quote request regime would not constrain issuer's ability in this respect, provided they had the appropriate systems and software. If, as expected, a substantial number of issuers move to continuous market making the Exchange may determine that it would be appropriate to embody a requirement for continuous market making in the Listing Rules.

Proposals

60. *The Exchange proposes to introduce an obligation for warrant issuers (or an entity nominated by them, which must be an Exchange Participant acceptable to the Exchange) to respond to quote requests submitted via the AMS/3 trading system. For derivative warrants over the shares of companies listed on the Exchange it is proposed to set the volume obligation at that number of board lots of the warrant that would be exercisable into ten board lots of the underlying share. For other derivative warrants the volume obligation is proposed to be set at ten board lots of*

the warrant.¹³The Exchange would also propose to set the spread obligation at 5 spreads. Thus, to constitute a valid response to a quote request, in general an issuer would be obliged to quote prices where the ask price was no more than 5 spreads¹⁴ above the bid price for a quantity of at least ten board lots of a warrant issue.

61. *The Exchange envisages that there are a number of circumstances under which issuers should not be obliged to respond to quote requests. These include: the first five minutes after the market opens, to allow prices in the underlying to become established; the five trading days before the expiry of the warrant, because of the volatility in the warrant price that may be experienced in this period and as this period is used to determine the cash settlement amount for cash settled warrants; a fast market; and those occasions where the warrant is valueless (i.e. where the issuer's bid price would be less than HK\$0.01). It is proposed that Issuers would be required to respond to quote requests within a period of three minutes.*
62. *It is also proposed to introduce a requirement for an additional risk factor to be disclosed in listing documents for warrants. This risk factor is to emphasize to investors that there is a liquidity risk in buying warrants.*
63. *The Exchange invites comments on these proposals. In particular the Exchange invites comments on:*
 - (a) *Whether the Exchange should introduce a buyback obligation for derivative warrant issuers,*
 - (b) *Whether the Exchange should introduce an obligation to respond to quote requests,*
 - (c) *Whether the Exchange should introduce an obligation to respond to quote requests as a transitional measure before introducing a requirement for continuous market making,*
 - (d) *Whether the exchange should introduce a continuous market making requirement,*

¹³ Listing Rule 15A.40 provides that at the time of listing one board lot of a derivative warrant issue should be exercisable into one board lot of the underlying security. This paper includes a proposal to allow the board lot for cash settled warrants to be one-tenth of the board lot of the underlying security which is set out in paragraph 203 onwards. Listing Rule 15A.41 requires the board lot of warrants relating to an index, currency or basket of shares to be 10,000.

¹⁴ In accordance with the existing spread table 5 spreads would represent:

- HK\$0.005, for warrants priced between HK\$0.01 and HK\$0.25;
- HK\$0.025, for warrants priced above HK\$0.25 up to HK\$0.50;
- HK\$0.050, for warrants priced above HK\$0.50 up to HK\$2.00
- HK\$0.125, for warrants priced above HK\$2.00 up to HK\$5.00;and
- HK\$0.250, for warrants priced above HK\$5.00 up to HK\$30.00

- (e) *the proposed spread obligation of 5 spreads,*
- (f) *the proposed volume obligation of ten board lots,*
- (g) *the proposed permitted response time of 3 minutes,*
- (h) *whether issuers should be relieved of the obligation to respond to quote requests in the five trading days before the expiry of the warrant,*
- (i) *whether there are circumstances, in addition to those in paragraph 61 above under which an issuer should not be obliged to respond to quote requests.*

Related Changes

Publicising the Issuer's Retention Level

- 64. The Exchange has considered whether additional changes are required following the modification of the retention guidelines and the placee requirement and the introduction of the quote request regime. As issuers would be permitted to retain more than the current limit of 15% of an issue, the Exchange considers that it would be important for investors to be provided with information as to the extent to which an issuer has retained an issue on launch.
- 65. Issuers are required to publish an announcement in the newspapers regarding warrants that they have launched¹⁵. That announcement is required to be published on the first business day following the day of the launch of the derivative warrant issue. The Exchange considers that this announcement would be a suitable medium for providing the market with information in respect of an issuer's holding of warrants.
- 66. As issuers are permitted to repurchase and resell warrants throughout an issue's life the percentage of that issue which remains "in the hands of the issuer" will vary throughout the life of the warrant. It may also vary between the launch date and the listing day. For example an issuer might repurchase some of an issue before the listing date. (Trading in the period before listing is often referred to as "grey market" trading.) Thus by the time a warrant is listed – typically a week or so after launch – the issuer's interest in the warrant may have changed.
- 67. A question therefore arises as to whether the disclosure should be updated on the day of listing. One means of doing this would be to require issuers to notify the Exchange of the retention level of a warrant on the listing date. The Exchange could then disseminate that information over its teletext system and web site. This approach would ensure that any investor who traded warrants on listing would do so on the basis of current information as to the level of interest held by the issuer.

¹⁵ Proposals to require warrant issuers to publish announcements on HKEx's web site rather than in the newspapers are discussed in paragraphs 219 to 222.

68. It is also noted however that because issuers are required to provide weekly details of warrants outstanding (as discussed above in paragraph 16) it may not be necessary to update the market with details of the Issuer's revised holding of the warrant. Any investor trading derivative warrants should recognise that the level of the issuer's holding of those warrants is dynamic, not static, and that any disclosure of the level of interest on the day of listing may itself cease to be correct shortly after trading commences.

Proposal

69. *The Exchange proposes to introduce a requirement for issuers to disclose in the launch announcement the percentage of an issue that has been retained by the issuer. The Exchange therefore proposes to amend rule 15A.61, which deals with the contents of launch announcements, to require disclosure of: "...the percentage of the issue which has been retained by the issuer. In calculating the proportion of the total issue retained by an issuer, derivative warrants held by the issuer's holding company, its subsidiaries and associates for the account of the issuer or for their respective accounts shall be counted as belonging to the issuer."*
70. *The Exchange seeks comments on the above proposal. The Exchange also seeks comments on whether to require updated details of issuers' retention levels to be provided to the Exchange and disseminated to the market on the day of listing.*

Issue Sizes & Quota

71. The listing Rules at present impose a limit on the number of shares of Hong Kong listed companies which may be the subject of warrant issuance. This limit is often referred to as "quota". The quota is presently the lower of: 20% of a company's issued share capital (or class of capital, if there is more than one class); and 30% of the aggregate number of issued shares which are in the hands of the public.
72. The Exchange would anticipate that as a consequence of amending the placing guidelines there might be an increase in the size of warrant issues (measured in terms of the number of shares in the underlying company to which the warrant issue relates). The Exchange expects this, as issuers would no longer be required to "sell" substantially all of an issue before it was listed. Consequently the issue limits for a security listed on the Exchange may be utilized more quickly than is currently the case. The Exchange considers that it would be undesirable for the supply of available "quota" to be utilised more quickly than at present, although the requirement to pay Transaction Levy on an issue of derivative warrants based on the issue size may militate against this.
73. Other possible measures to address a shortage of quota would be to increase or remove the existing warrant issuance limits, to require issuers to place part of an issue before listing, to limit individual issue sizes, or some combination of these.

74. The Exchange first considered the quota limits at a time when the prevalent form of warrant issuance was collateralised warrants. At that time there was a concern that those shares which were deposited with custodians as part of the warrant collateralisation arrangements would not be traded until the warrant expired or was exercised. Subsequently, as issuance moved in favour of non-collateralised warrants, there was a concern that if too great a number of warrants were issued then warrant prices might begin to affect the price of companies' shares rather than being a function of them. The Exchange considers that these concerns are still valid. The Exchange also notes that other exchanges limit the number of shares over which warrants can be issued. In some cases these limits are in the form of aggregate limits like those currently applied by the Exchange.¹⁶ Others adopt limits which are more closely related to the individual warrant issue.¹⁷
75. Issuers have advised the Exchange that one of the factors they will consider in launching a warrant is the number of days average turnover represented by the shares underlying a proposed warrant issue. Issuers have advised the Exchange that they would limit warrant issue sizes to ensure that they were below 5 to 10 times average daily turnover. This is because issuers are concerned about the liquidity of the underlying stock – in particular that the stock is typically available in quantities which will allow the issuer to hedge the exposure arising from a warrant issue and that such activity will have limited effect on the underlying company's share price. In this respect the interests of the warrant issuer and the Exchange are to some extent aligned, as one of the Exchange's concerns is to minimise the effect of hedging activity on share prices. This suggests that the average turnover of an underlying share might be an appropriate means to limit the size of individual derivative warrant issues over that share (and hence in turn ensure that "quota" is not utilized unduly quickly).
76. The Exchange has conducted a review of single stock derivative warrants launched during the period 1st June, 1997 to 30th June, 1999 (excluding those launched during the period 17th August 1998 to 28th November 1998). In this review the number of shares into which a warrant issue is exercisable has been compared to the average daily turnover (in shares) of the underlying stock for the sixty days preceding the date of launch.

¹⁶ The ASX will not permit the listing of a warrant where the number of securities to be acquired on exercise together with those of other outstanding warrant issues would exceed 10% of the underlying company's share capital. The Singapore Stock Exchange ("SES") imposes a similar 10% limit.

¹⁷ The SES listing rules provide that warrants issued by each issuer should not exceed 2.5% of the total outstanding warrants on the same underlying company. This limit applies irrespective of whether the share is listed on the SES or another exchange. The Italian exchange prohibits warrant issues which relate to more than 2% of the underlying company's shares.

77. In the vast majority of cases the number of shares underlying a warrant issue is no more than five times the 60-day average daily turnover.¹⁸ In cases where the number of shares under warrant represents a significant multiple of daily turnover, there is a possibility that issuers' hedging activity may affect the underlying stock. A limit based on average daily turnover might address this possibility.
78. Average daily turnover may be calculated over various periods. In the above analysis the sixty-day average was taken as this follows the period used to determine whether an underlying company meets the public float capitalisation criteria. Operationally, it is necessary to check whether the share price of a company underlying a warrant issue meets the level necessary to comply with the public float criteria for the qualifying period set out in the Listing Rules. Reviewing turnover levels at the same time should therefore be comparatively straightforward. It also noted that information vendors, such as Reuters and Bloomberg, allow the average daily turnover to be calculated relatively easily, thereby allowing compliance with the rule to be monitored comparatively easily by both issuers and the Exchange.
79. One of the limitations of using the average daily trading volume as the basis for a limit is that it has no regard to the issue price of the warrant and hence the number of shares which an issuer might (in the case of a call warrant) be required to hold in the underlying company for hedging purposes. In very general terms, other factors being equal, the further out of the money that a call warrant is issued the fewer shares that an issuer would need to hold to hedge the issue. Conversely, the deeper in the money a call warrant is the greater the number of shares in the underlying company that would need to be held by the issuer to hedge its exposure.
80. An alternative means of limiting issue sizes would be to base the limit on the initial market capitalisation of a warrant – as is the case for Further Issues.¹⁹
81. The use of a limit based on market capitalisation would factor the issue price into the limit, thereby partially addressing the criticism in paragraph 79 above. Such a limit would also be easy to apply and would require less calculation than a limit based on the sixty-day average turnover of the underlying share. Other factors being equal if a warrant is deep in the money then the value per warrant will be higher than a warrant which is not in the money. This being the case then fewer warrants

¹⁸ In the period 1st June to 31st December 1997 89 single stock derivative warrants were launched. For 85 (96%) of these the number of shares over which the warrant was issued represented five or less times the average 60-day turnover in the underlying stock. Similar percentages apply for issues in 1998 (excluding the period 18th August to 27th November) where the equivalent percentage is 97% and for issues in the six months to 30th June, 1999 where the equivalent percentage is 94%.

¹⁹ "The market capitalisation of the Further Warrants (or, where there has been a series of Further Warrants, the aggregate market capitalisation of such Further Warrants) shall not exceed HK\$50 million." (Listing Rules, Practice Note 14, paragraph 3.3)

would need to be issued to meet the minimum market capitalisation rules. If fewer warrants are issued then the number of shares to which they relate will also be lower. However, as the warrant is issued in the money then a relatively higher percentage of those shares might be required to be held to hedge the issue.

82. For warrants issued out of the money then other factors being equal the value per warrant will be lower. Therefore a greater number of warrants would need to be issued to meet the minimum market capitalisation requirements. If a greater number of warrants are issued then they will relate to a greater number of shares. However, a comparatively small proportion of those shares would be required to be held given that the warrant would be issued out of the money.
83. The Exchange has reviewed the initial market capitalisation of derivative warrants issued in 1998, 1999 and in the eight months to 31st August, 2000. In this period the average market capitalisation on launch has varied from HK\$89.9 million, in 1998; HK\$101.6 million, in 1999; and HK\$104.8 million, in the first eight months of 2000. During this period the majority of warrants have an initial market capitalisation of HK\$150 million or less and only two warrants had an initial market capitalisation in excess of HK\$200 million.²⁰

Proposal

84. *The Exchange proposes to introduce a limit on issue sizes, which will apply to initial issues and also to Further Issues. The Exchange seeks comments on this proposal; in particular:*
- a) Whether the limit should be based on initial market capitalisation of the warrant issue or average turnover of the underlying share (or shares in the case of basket warrants).*
 - b) If an initial market capitalisation limit is set should it be HK\$100 million, HK\$125 million, HK\$150 million or another amount.*
 - c) If the limit is set by reference to average daily trading volume over what period should that trading volume be calculated.*
 - d) If a limit is set by reference to average trading volume what multiple of average daily trading volume should be used.*
 - e) Whether the Exchange should limit individual issue sizes and retain the current quota limits.*
 - f) Whether the Exchange should limit individual issue sizes and increase the current quota limits.*
 - g) Whether the Exchange should limit individual issue sizes and remove the current quota limits.*
 - h) Whether the Exchange should impose no limit on individual issue sizes and remove the current quota limits.*

²⁰ In 1998 94% of warrants had a market capitalisation on launch of HK\$150 million or less; in 1999 87% met this criteria and in 2000 84% of warrants met this criteria. Only two warrants (both issued in 1998) had an initial market capitalisation in excess of HK\$200 million.

Further Issues of Warrants

85. Under the existing Listing Rules, issuers are required to place a warrant, in accordance with the placing guidelines, before listing. Issuers are permitted to retain no more than 15% of an issue to meet any demand for the warrant that arises after the listing. If this is insufficient to meet additional demand issuers are permitted to make a further issue or issues of warrants to form a single series with an existing issue which is already listed on the Exchange or which has been approved for listing. This type of warrant issue is generally referred to as a Further Issue and the additional warrants issued in a Further Issue are often referred to as Further Warrants.
86. If the proposals in paragraphs 50 to 52 are adopted the limit on the proportion of a warrant issue which may be retained by an issuer will be increased from the current 15%. In addition, it will no longer be necessary to place warrants to 100 (or 50) places. In these circumstances the Exchange has considered whether it continues to be necessary to provide issuers with the flexibility afforded by Further Issues.
87. Further Issues have been permitted as means of allowing derivative warrant issuers to meet demand that arises for a warrant issue subsequent to its listing on the Exchange. Even though issuers will be permitted to retain a higher percentage of an issue than at present there may still be occasions where demand for a warrant issue exceeds the available supply of that issue – particularly as it is proposed to limit initial issue sizes, as set out in paragraph 84. Thus, the proposed changes to the Listing Rules will not remove the original rationale for allowing Further Issues of warrants.
88. The proposed changes to the Listing Rules will result in issuers being under an obligation to respond to quote requests submitted through the AMS system. Where an issuer ceases to have any holding of a warrant its responses to quote requests will be limited to quoting prices at which it would be prepared to purchase warrants. Allowing issuers to create additional warrants before their own holding (which might be thought of as their inventory) fell to nil might help address this issue.
89. The existing Listing Rules prohibit the launching of a Further Issue until the issuer has no holding of the warrant.²¹ In addition the Further Warrants are to be placed to investors and there are limits on the proportion of the Further Issue that the issuer may retain.²² These Rules constrain an issuer's ability to create additional warrants to add to inventory in order to meet future demand.

²¹ “An issuer must...confirm in writing to the Exchange that, at the date of issue of the Further Warrants, the issuer (and any member of its group) does not hold as principal any Existing Warrants.” (Listing Rules, Practice Note 14, paragraph 3.7 (b))

²² “An issuer may retain up to but not more than 15% of the aggregate of the Existing Warrants and Further Warrants.” (Listing Rules, Practice Note 14, paragraph 3.8)

90. One of the principal reasons for introducing limits on issue sizes at launch of warrants is to ensure that available quota is not used up more quickly than would otherwise be the case. If Further Issues were to be permitted without restriction then the reduction in quota utilisation achieved through limiting initial issue sizes would be negated. One means of overcoming this would be to apply the limit on initial sizes to Further Issues. Thus, if initial issues were limited to a market capitalisation of HK\$100 million, then each Further Issue would be limited to HK\$100 million. Alternatively, if the initial limit was set by reference to the average daily trading volume of the underlying security then the limit for each Further Issue could be set in the same way. Under either of these approaches it would be necessary to repeal the current limit on Further Issues (of HK\$50 million in aggregate²³), which has generally resulted in Further Issues being limited to one per warrant issue.
91. In addition to limiting their size Further Issues might also be prohibited unless a substantial proportion of an issue was in the market (i.e. where the issuer's holding or inventory was low). Thus, for example Further Issues might be prohibited unless 75% or more of the original issue size (or 75% of the issue as enlarged by any previous Further Issue or Issues) was in the market. In this way Further Issues would only be permitted where an issuer held 25% or less of an issue. In this way issuers would be permitted to create and issue warrants in anticipation of demand, rather than being obliged – as is currently the case – to have “sold out” of an issue before being permitted to make a Further Issue.
92. At present, a Further Issue is not permitted where there will be less than 6 months to the expiry of the warrant. This impedes issuers' ability to satisfy additional demand for warrants which may arise shortly after a warrant is launched. Permitting Further Issues with less than six months to expiry would allow issuers greater flexibility in meeting demand for a warrant that arose after it was listed. Eliminating this requirement altogether would provide issuers with the greatest flexibility in this respect. However, the Exchange considers that there should be some minimum life requirement to allow investors a reasonable period to realise a return on their investment.

Proposal

93. *The Exchange proposes to repeal the existing limitation on the aggregate market capitalisation of Further Issues of derivative warrants. It will therefore be possible for several Further Issues of a warrant to be launched. Each such Further Issue will be subject to a size limit as set out in paragraph 84.*

²³ “The market capitalisation of the Further Warrants (or, where there has been a series of Further Warrants, the aggregate market capitalisation of such Further Warrants) shall not exceed HK\$50 million. (Listing Rules, Practice Note 14, paragraph 3.3)

94. *The Exchange proposes to repeal the existing requirement that issuers have no holding of a warrant issue at the time a Further Issue is launched. The Exchange proposes to permit issuers to launch Further Issues where they hold up to 25% of the warrant issue (including any previous Further Issues). The Exchange also proposes to repeal the existing 15% retention limit on the aggregate of the existing issue plus the Further Issue.*
95. *The Exchange proposes to provide further flexibility in relation to Further Issues by permitting these issues where the minimum period to expiry, calculated by reference to the launch date, is at least two months.*
96. *The Exchange invites comments on the above proposals. In particular the Exchange seeks comments on the proposed minimum life of two months and whether this should be shorter or longer.*

Issuer Eligibility

Discussion

97. The derivative warrant rules divide derivative warrants into two categories: collateralised warrants and non-collateralised warrants. A collateralised warrant is one where the performance of the obligations of the issuer is secured by the deposit of the securities or assets underlying the derivative warrant with an independent trustee, custodian or depositary who holds the securities or assets for the benefit of the holders of the collateralised warrants.²⁴ No collateralised warrants have been listed on the Exchange since 1994.
98. A non-collateralised warrant is one where the performance of the issuer's obligations is not secured by the deposit of the underlying securities or assets with an independent party. Instead the issuer will normally adopt hedging strategies to provide for its obligations under the derivative warrants. Those hedging strategies will involve purchasing or selling the underlying security or asset; derivative products on those assets or securities; or assets the performance of which is closely correlated with the underlying security for a warrant throughout the life of that warrant. Certain regulatory concerns arise from this feature of non-collateralised warrants, some of which are addressed in this section, some of which are addressed in the sections dealing with suitability of shares which are eligible for warrant issuance.
99. Non-collateralised warrants constitute unsecured obligations of the issuer of the warrants (and where appropriate, the guarantor of the warrant issue). Investors in such warrants are creditors of the issuer and they will have no preferential claims over any securities which an issuer may hold to hedge its exposure arising from the warrant issue. The holders of such warrants are therefore relying on the creditworthiness of the issuer and, if appropriate, the guarantor, of the warrants.
100. If access to the derivative warrant market was restricted to professional investors only, it might be felt that there would be no need for requirements as to creditworthiness to be introduced. Professional investors would have the means by which to assess for themselves the creditworthiness of counterparties. However, as noted earlier, a characteristic of the Hong Kong warrant market, is the high level of retail participation. Such investors will not necessarily be in a position to assess, to

²⁴ The Exchange would normally only accept a collateralised warrant as one where the issuer (or its subsidiary) owns the underlying securities to which the warrant relates. Where the securities are held by a subsidiary, the issuer is required to enter into an arrangement with the subsidiary to acquire the underlying securities. Collateralised warrants with the underlying securities held by other connected or unconnected parties would not be acceptable to the Exchange.

the same level of detail, the creditworthiness of warrant issuers. The Exchange has therefore sought to establish criteria, to provide some assurance – although it must be recognised that such assurance can by no means be absolute – that issuers will be able to honour the obligations under the derivative warrants they have issued.

101. The existing Listing Rules therefore provide that Issuers or their guarantors must have minimum net assets of HK\$2 billion. The net assets of issuers currently active in the derivative warrant market are substantially in excess of this requirement. The Exchange sees this requirement as demonstrating a minimum level of commitment to the business of warrant issuance. It is recognised that the off-balance sheet nature of much derivative warrant issuance activity means that this requirement alone provides little assurance as to the ability of the issuer to honour the obligations arising under a warrant issue.
102. The Listing Rules therefore also provide that Issuers (or guarantors) must meet either a regulatory requirement or a credit rating requirement. The regulatory requirement is that the Securities and Futures Commission (SFC), the Hong Kong Monetary Authority (HKMA) or a regulatory authority acceptable to the Exchange regulates the issuer. Where the issuer is not regulated warrant issuance will be permitted where the credit rating of the issuer (or guarantor) falls into the top three categories of investment grade credit rating issued by a credit rating agency acceptable to the Exchange. The agencies acceptable to the Exchange are Moody's Investor Service and Standard & Poor's.
103. The exchanges in London, Singapore and Australia require issuers to meet a combination of net asset, regulatory requirements and credit rating requirements in order to be eligible to issue warrants.²⁵ The Exchange considers that its current requirements are in line with the requirements of other exchanges.
104. The Exchange considers that its existing entry standard is a relatively high level one, which provides a reasonable degree of assurance that issuers will be able to honour the obligations arising from the issuing of derivative warrants. Current issuers in the derivative warrant market are organisations having an international name and reputation. The minimum level of credit rating acceptable to the Exchange is currently equivalent to the sovereign rating ceiling assigned to the HKSAR government. The requirement for issuers to be regulated, where they cannot meet the

²⁵ To be eligible to issue warrants in the United Kingdom an issuer must be regulated by the Financial Services Authority (the "FSA"), authorised under the Banking Act 1987, or regulated by an overseas regulator whose function is similar to that of the FSA. Alternatively issuers must have an investment grade credit rating and net assets of at least £50 million. In Singapore issuers must have shareholders funds of US\$500 million and be supervised by a monetary or securities regulatory authority. Alternatively the issuer must have an acceptable credit rating.

credit rating requirement, means that the issuer will be subject to a regulatory regime which is directed at protecting the interests of parties dealing with the issuer. In cases where the HKMA regulates an issuer one of its purposes is to protect depositors – whose position, as creditors – is similar to that of warrant holders. Similar considerations apply where the SFC regulates the issuer.

105. It has been suggested that where an issuer has two credit ratings, one of which meets the criteria for warrant issuance and one of which does not (so-called “split ratings”), then the lower rating should be the one taken for assessing compliance with the Listing Rules. In such a case the issuer would not be regarded as complying with the minimum level for warrant issuance. The Exchange considers that such an approach would penalise those issuers with two ratings and would provide issuers with little incentive to obtain a credit rating from more than one rating agency. The Exchange therefore proposes to continue with its current practice, of requiring disclosure of both ratings, for issuers with two credit ratings.

Proposal

106. *The Exchange proposes no changes to the issuer eligibility requirements and invites comments on this.*

Stock Eligibility

Introduction

107. As noted earlier, issuers of non-collateralised derivative are not required to deposit the securities underlying a warrant with a bank or other custodian. However, issuers will seek to provide for their obligations by entering into hedging transactions. Those transactions will generally involve the purchase or sale of the underlying security. It is also possible that they will involve transactions in other derivative products based on that security (for example derivative warrants issued by another issuer) or other securities where the price movement is expected to be closely correlated with that of the underlying security.
108. Where an issuer issues a single stock call warrant it may hedge its exposure through maintaining a holding of shares in the underlying security. The number of shares which an issuer will be required to hold to hedge its exposure arising from a warrant issue often relates to “delta” – which is the rate of change of the warrant price with respect to the share price underlying the warrant issue. Its value may range between -1 and 1.
109. Delta is a function of a number of factors such as time remaining to maturity of the warrant, the volatility (i.e. a measure of price changes) of the underlying stock and the extent to which the warrant is in the money or out of the money. The relative importance of these factors will change during the life of the warrant. Thus, for example, a call warrant near maturity may be substantially in the money. Such a warrant is extremely likely to be exercised by warrant holders. In these circumstances delta will be high – probably 1, meaning that the issuer usually holds one share for each share underlying the warrant issue or other financial instruments to the same effect. Conversely, where near maturity, a warrant is substantially out of the money delta will be low – probably 0 – meaning that the issuer would not hold any shares of the underlying company to hedge the warrant.
110. Delta changes throughout the life of the warrant and hence issuers will be adjusting the number of shares they hold in the underlying security during this period. There is therefore a possibility that those hedging transactions may affect the price performance of the underlying security. The Exchange has therefore established criteria to determine whether individual stocks listed on the Exchange are eligible for either single stock or basket warrant issuance; and there are limits over the number of shares which may be subject to warrant issuance at any one time.
111. The current Listing Rules provide that to be eligible for warrant issuance an underlying company (if it is listed on the Exchange) must have a “public float capitalisation” of HK\$4 billion, for single stock warrants, and HK\$1 billion, for basket warrants. The public float of a company broadly comprises the issued share

capital of a company less: shares held by directors; shares held by Substantial Shareholders (i.e. those holding 10% or more of the issued share capital); and shares subject to “lock up” arrangements. The public float capitalisation is required to be maintained for a qualifying period of either: 60 consecutive business days, during which there have been no suspensions of dealings; or a period of up to 70 business days where suspensions in aggregate do not exceed ten business days. Other exchanges use market capitalisation as a criteria to determine whether a company’s shares are suitable for derivative warrant issuance but do not require that capitalisation to have been maintained for a qualifying period or base it on the public float of a company.²⁶

The Public Float Capitalisation Requirement

112. The initial eligibility requirement for warrant issuance has been subject to a number of refinements in various reviews of the Listing Rules. Prior to the review of the Listing Rules in 1995, to be eligible for warrant issuance, companies were required to have a market capitalisation of HK\$10 billion and a public float capitalisation of HK\$5 billion. The public float capitalisation requirement was lowered, to the existing HK\$ 4 billion, following the 1995 review and the HK\$1 billion requirement for basket warrant issuance was also introduced at that time. Companies not meeting the HK\$4 billion requirement were eligible for single stock warrant issuance where it could be demonstrated that liquidity in the underlying stock was high. This flexibility was eliminated following the review of the Listing Rules in 1998, primarily on the basis that issuers had not sought to list warrants using this criterion.
113. The purpose of the public float capitalisation criteria is to establish that a company is suitable for warrant issuance. Suitability might be thought of as meaning that the company has reached a level where it is widely followed such that issuance is likely to be attractive and that the issuance of such warrants will have a limited effect on underlying share prices. These factors are considered further below.
114. Although whether a company has reached a stage where warrant issuance is likely to be attractive is in part a commercial issue, the Exchange considers that it is not appropriate, from a regulatory point of view, for all companies listed on the Exchange to be eligible for warrant issuance. However, the Exchange is also conscious that by setting too high a threshold for issuance, warrants may be issued on the OTC market, thereby losing much of the transparency which accompanies a listing of warrants on the Exchange.

²⁶ For example the SES requires a company to have a market capitalisation of S\$200 million, Switzerland requires a market capitalisation of SWFr25-50 million.

115. The Exchange considers that eligibility criteria based on public float capitalisation continue to provide a reasonable indicator of companies which are suitable for warrant issuance. This will limit issuance to larger companies which are more likely to have a wider following among investors. The number of stocks meeting these criteria are reviewed at quarterly, previously six monthly, intervals – for the purposes of determining eligibility for short selling.
116. As at June 1999, 81 companies were eligible for warrant issuance. As at December 1999, 97 companies were eligible. These represent approximately 14% of companies listed on the Exchange. The Exchange considers that these levels are reasonable in relation to the number of companies listed on the Exchange. The Exchange therefore continues to regard the public float capitalisation test as an acceptable indicator of general eligibility for warrant issuance. However, its usefulness in terms of determining the suitability for listing of specific warrant issues may be limited.
117. An implicit assumption behind the public float criteria is that larger capitalisation stocks are more liquid than those with a smaller market capitalisation. In a period of rising share prices a company may reach the eligibility level for warrant issuance without a corresponding increase in the liquidity of that stock. Conversely, in a period of falling prices, stocks may cease to be eligible because of a fall in their share price. An appropriate way to address this deficiency would be through limits on individual issue sizes. A further discussion on proposals to introduce limits on issue sizes is set out in paragraphs 71 to 84 above.

Hang Seng Index Constituent Stocks

118. The Exchange has noted that at various times in 1997 and 1998 certain stocks which were members of the Hang Seng Index (“HSI”) did not meet the public float capitalisation level and therefore ceased to be eligible for issuance.²⁷ The HSI is a widely followed benchmark of the Hong Kong market. As at both 31st December, 1999 and 1998 the market capitalisation of members of the index accounted for approximately 79% of the equity capitalisation of the Hong Kong market. They accounted for approximately 48% of market turnover in 1999 and approximately 70% of market turnover in 1998. Membership of the index is often viewed as conferring “blue chip” status on the constituent stocks.

²⁷ For example as at 31st August, 1998 there were only 23 companies listed on the Exchange which had a public float capitalisation above HK\$4 billion.

119. To become eligible for selection as a constituent of the HSI a company:
- should be among those that constitute the top 90% of the total market capitalisation of all ordinary shares listed on the Exchange. Market capitalisation for these purposes is taken as an average for the past 12 months;
 - should be among those that constitute the top 90% of the total turnover on the Exchange. Turnover for these purposes is aggregated and individually assessed for eight quarterly sub-periods for the past 24 months;
 - should have a listing history of 24 months; and
 - should not be a foreign company as defined by the Exchange.
120. The Exchange considers that these selection criteria are not inconsistent with certain of the objectives it is trying to accomplish in establishing eligibility requirements for stocks over which warrants may be issued. It is also noted that stocks which are members of the HSI are designated securities for short selling.

Proposals

121. *As noted earlier, as at December 1999 approximately 14% of the companies listed on the Exchange were eligible for derivative warrant issuance. The Exchange considers that in relation to the number of companies listed on the Exchange that these levels are reasonable and accordingly proposes no changes to the current public float capitalisation level or to the qualifying period. However, the Exchange will keep the number of stocks under review to determine the continuing appropriateness of the HK\$4 billion and HK\$1 billion thresholds. Where the number of stocks which become eligible for warrant issuance as a proportion of stocks listed on the Exchange increases significantly under this criteria, the Exchange may reset the public float capitalisation levels.*
122. *The Exchange proposes to amend the eligibility criteria for single stock warrants such that constituents of the HSI will be regarded as eligible stocks for the purposes of single stock warrant issuance. Stocks which are not constituents of the HSI will be required to meet the public float capitalisation criteria to be eligible for single stock or basket warrant issuance.*
123. *As noted earlier, shares used for the purposes of calculating the public float capitalisation requirement exclude those held by substantial shareholders. The existing definition of substantial shareholder – for these purposes – includes shareholders holding 10% or more of a company’s share capital. This follows from a definition in the Securities (Disclosure of Interests) Ordinance (the “SDIO”). The Securities and Futures Bill includes proposals to reduce the disclosure threshold from 10% to 5%.*

124. *Should such a change be effected the Exchange does not at this stage intend to regard shares held by persons holding 5% to less than 10% of the issued share capital as not being part of the public float – unless such a shareholder is otherwise regarded as a connected party of the company whose shares underlie the warrants.*
125. *The Exchange invites comments on the above proposals.*

Cash Settlement Formula

Listing Rule Requirements

126. Single stock warrants may be listed on the Exchange with terms and conditions that require them to be settled in cash (“cash settlement”) or by the delivery of underlying securities (“physical settlement”). Prior to 1998 many warrants were issued with the so-called “issuer’s cash option”. This allowed issuers (at their option) to settle a physically settled warrant by means of a cash payment. The Listing Rules contained provisions to ensure that warrant holders were not disadvantaged by the operation of this option in terms of the cash settlement amount. To provide certainty as to the means of settlement for warrant investors the issuer’s cash option has been prohibited since June 1998. Issuers are now required to specify whether a warrant will be cash or physically settled at the time of launch.
127. Where warrants, on securities listed on the Exchange, are to be cash settled the Listing Rules provide that the method used to determine the cash settlement amount shall be:
- the average of the daily closing prices of the underlying security (as derived from the daily quotation sheet of the Exchange, subject to any adjustments as may be necessary to such closing prices to reflect any capitalisation, rights issue, distribution or the like) for the five business days prior to and up to and including the business day before the exercise date.

This formula applies to all exercises of warrants, whether they are on the expiry of the warrant or in the case of American style warrants during the life of the warrant. Both American and European style cash-settled warrants are exercised and settled automatically if they are in the money on expiry.²⁸

Discussion

128. In introducing the above rule an attempt was made to strike a balance between providing certainty as to the amount which a warrant holder would receive when a warrant was exercised, whilst at the same time, lessening the impact of individual closing prices on the cash settlement amount.

²⁸ “...the terms and condition [of cash settled warrants] must provide for automatic settlement on expiry (i.e. so that warrant holders are not required to serve a notice of exercise) if the warrants are “in the money” at expiry.” (Listing Rule 15A.46(3))

129. Where a warrant is exercised by the warrant holder prior to maturity it is reasonable to assume that the warrant is in the money, otherwise there would be no advantage in exercising the warrant. If the warrant is in the money then the issuer will be holding the underlying security (or some other instrument) as a hedge for the warrant. When a warrant is exercised it will no longer be necessary for the issuer to continue to hedge the exposure. The issuer will therefore most likely unwind that part of the hedge, which relates to the warrants which were exercised. The proceeds from this sale would then be used to fund the payment to the exercising warrant holders. The issuer's risks will be minimised if the amount received by the exercising warrant holder is based on the amount at which the issuer is able to sell the underlying shares.
130. Warrant issuers have maintained that the use of the current formula makes it impractical for them to effectively manage the exposure which arises when an American style warrant is exercised prior to maturity. This is illustrated in the following example. Assume that the closing share of an underlying share on days 1 through 5 is HK\$106, HK\$103, HK\$100, HK\$97, and HK\$94. The average closing price, in this example, is HK\$100. If a warrant holder exercised the warrant on day 6, the cash settlement amount to be paid to that warrant holder will be based on the average share price for the five days preceding the exercise day. In this case the average for days 1 to 5 which is HK\$100.
131. Where warrants are exercised before the expiry date of the warrant, the issuer will have no means of knowing that a warrant holder intends to exercise the warrant until the exercise notice is received, in this example on day 6. The issuer will therefore be unable to realise the hedge for the warrant until receipt of the exercise notice. However it will be required to make a settlement based on prices prevailing before the warrant was exercised. The amount, which the issuer will be able to realise when it sells the underlying shares, will depend on the prices achieved in day 6. For example, if the underlying share trades at below HK\$100 the sale of the issuer's hedge will not be sufficient to fund the payment to the warrant holder.
132. It should also be noted that, since this rule was introduced, the only cash settled warrants that have been issued have been European style – adding further weight to issuers' representations.
133. The Exchange considers that from a policy standpoint, and with a view to providing investors with a choice of warrants, it is undesirable to continue with a formula for cash-settled warrants that has effectively resulted in no American style warrants being issued. The Exchange therefore considers that an alternative formula should be adopted for exercises before the expiry date of derivative warrants.

134. The formula used to determine the cash settlement amount may have an impact on issuers' hedging strategies. If the cash settlement amount for a warrant on exercise is to be based on the closing share price of the underlying security, there will be an incentive for issuers to realise their hedges in the market close to the close of trading. Such a strategy will reduce the potential difference between the price at which the underlying hedge is sold and the amount used to determine the cash settlement amount to be made to investors.
135. To reduce this impact, it would be possible to require the cash settlement amount to be based on closing prices for the underlying security for a number of days subsequent to the date of exercise. This, however, would delay calculation of the settlement amount due to warrant holders by the number of days, which are required to calculate the settlement amount. This would also be at the expense of certainty to warrant holders as to the amount they will receive on exercising a warrant.
136. Issuers have represented that the number of warrants which are exercised before maturity is comparatively small and consequently the effect of unwinding individual hedges for such exercises would be small. A possible approach to dealing with large numbers of exercises during the life of a warrant would be to limit the number of exercises which can take place on any one day. This limit could be set at a fixed number of warrants or a fixed percentage of the warrant issue.
137. Whether a warrant holder will exercise a warrant prior to maturity is an event that cannot be foreseen by issuers. This is not the case in relation to exercises of warrants on expiry. The expiry date of a warrant is known and cash settled warrants include an automatic exercise feature where they are in the money. Where the warrant is in the money it can be expected that the warrant will be exercised. Where the warrant is out of the money, it can be expected that the warrant will not be exercised.
138. Where the warrant is in the money near expiry delta will be high, as discussed earlier. To meet their obligations under (for example, a call warrant) issuers can therefore be expected to be realising those underlying shares that they hold to hedge the warrant issue. In this case basing the cash settlement amount on security price levels prevailing on the expiry day of the warrant would mean there would be a considerable incentive for issuers to unwind the hedge on that day. Such activity may affect the price of the underlying security. The existing five-day formula (combined with the Listing Rule provisions for the automatic exercise of all cash settled derivative warrants, which are in the money at expiry) will provide an incentive to issuers to unwind the hedge during the five-day period that precedes the expiry date. This more orderly unwinding of hedges is consistent with the Exchange's objective of lessening the impact of warrant issuance on underlying share prices.

Proposals

139. *The Exchange proposes to amend the formula used to determine the amount to be paid to warrant holders who exercise American style warrants prior to the expiry of those warrants. In such cases the settlement amount may be based on the closing price of the underlying security on the day of exercise as shown in the daily quotation sheet of the Exchange.*
140. *For calculation of the cash settlement amount on expiry, for either European style or American style warrants, the Exchange proposes to continue with the existing settlement formula, which is based on closing prices for each of the five business days before the expiry of the warrant, and the requirement that these warrants include automatic exercise features.*
141. *The Exchange invites comments on the proposals set out in this section. In particular the exchange invites comment on the following:*
- a) Whether a limit should be introduced for the number of warrants in a warrant which might be exercised each day;*
 - b) If a daily limit is introduced whether it should be a fixed number of warrants or a fixed proportion of an issue;*
 - c) Whether an average price (rather than the closing price) should be taken to determine the settlement amount on exercises through the life of the warrant; and*
 - d) Whether an average price (rather than the closing price) should be taken to determine the settlement amount on the maturity of a warrant.*

Disclosure of Securities Dealings

Listing Rule Requirements

142. Paragraph 15A.50 of the Listing Rules requires that issuers disclose to the Exchange any dealing (including any warrant, option or other similar instrument) relating to the securities underlying a derivative warrant issue:
- by the issuer or its subsidiaries and associates and any connected person of the issuer so far as is known to the issuer or its directors after making reasonable enquiries in the period commencing 6 weeks prior to the announcement of the issue and ending on the latest practicable date before the date of the listing document.
143. This information is also required to be disclosed in the listing document, in accordance with paragraph 32 of Appendix 1d to the Listing Rules.

Discussion

144. For the purposes of the Listing Rules connected persons will include directors of the issuer. Where, as is often the case, the issue of warrants is guaranteed by a guarantor, then the disclosure requirements will also apply in relation to the guarantor. It is therefore necessary for issuers to establish procedures to determine the dealings to be disclosed under this rule. Where the guarantor is based overseas, these requirements may be burdensome for the issuer.
145. The information that these disclosures provide to potential warrant investors may also be of limited value. It is not considered that an issuer would enter into the transactions to hedge a warrant issue as much as six weeks in advance of the launch date of a warrant issue. Many of the dealings disclosed may have been entered into for purposes other than the issue of the warrant (for example to hedge existing warrants or options or other proprietary positions not related to the warrant issue). In certain cases dealings by directors will also not be related to the issue of derivative warrants. Indeed, it may also be the case that dealings are by directors who are not responsible for the issuance of derivative warrants.

146. Overseas exchanges do not require disclosure of dealings by issuers in the shares underlying warrant issues. It is also noted that that this rule was introduced in 1992 when controlling shareholders of listed companies were permitted to issue warrants over shares of the companies they controlled. The issue of warrants by controlling shareholders is now prohibited by rule 15A.26²⁹

Proposals

147. *The Exchange proposes to repeal the requirement to disclose details of dealings in the six weeks prior to the announcement of the issue. The Exchange seeks comment on this proposal.*

148. *The Exchange also seeks comments on whether, as an alternative, the period of dealings to be disclosed should be reduced and if so, to what period. In these circumstances the Exchange also invites comments on whether the entities and persons subject to this disclosure should be limited to those involved in issuing and managing the warrant issue.*

²⁹ “Derivative warrants will not be considered suitable for listing if they are issued directly or indirectly by a controlling shareholder of or a person who, in the opinion of the Exchange, has effective management control of the company or any of the companies whose securities underlie the derivative warrants.” (Listing Rule 15A.26)

Research Reports

Listing Rule Requirements

149. The Listing Rules (in paragraph 15A.27) prohibit issuers from issuing warrants over assets or securities where they (or companies associated with them³⁰) have either issued or updated an analyst's research report on the underlying one week before the launch of the warrant.

Discussion

150. The above rule was first introduced in August 1996, although in a slightly modified form. At that time warrant issuance was not permitted if the issuer (or companies associated with the issuer) had issued a full analyst's research report with an indicative target price or strike level in the four weeks before the launch of a warrant. Issuance was also prohibited if within two weeks of a launch an issuer had updated an analyst's report with a target or strike price.
151. Most issuers of warrants are members of large groups which produce research reports on companies listed on the Hong Kong market and markets overseas. These issuers maintain that because of "Chinese Walls" within their organisations they are not privy to the contents of research reports until they are published. However, once the report is published or updated issuance is prohibited. Issuers also note that the restriction applies irrespective of whether the recommendation in the report "supports" the warrant issue. It is also noted that other exchanges do not have a similar restriction on warrant issuance.

Proposal

152. *The Exchange proposes to repeal the rule restricting warrant issuance where an issuer has issued or updated an analyst's research report on the security or asset underlying a warrant issue. Issuers will be required to state in the Listing Document whether they or companies associated with them have published research on the securities or assets underlying a warrant issue.*

³⁰ Rule 15A.27 defines this as the issuer "...or any of its holding companies, subsidiaries or fellow subsidiaries; or any associated companies of any of them..."

Contents of Listing Documents

153. Where derivative warrants are listed on the Exchange, a listing document is required to be prepared and distributed before the listing date. The required contents of that document are set out in part D of Appendix 1 to the Listing Rules. The information required by Appendix 1, part D may be included in either a document that is specific to each warrant issue or alternatively in a “Base Document” – which can be used for many issues – and a “Supplemental Document” which is specific to each issue of warrants. Most issuers adopt the practice of preparing a “Base Document” together with supplemental documents.
154. The requirements in the Listing Rules are designed to ensure that information is included in relation to: the issuer, which in the case of guaranteed issues, will also include the guarantor; the securities underlying a warrant issue; and, certain general information. The Exchange has reviewed the required contents, as set out in Appendix 1, part D and is proposing a number of changes to ensure that the information presented in listing documents continues to be relevant for investors, whilst at the same time not imposing an unnecessary burden on warrant issuers.

Financial Information on the Warrant Issuer

Listing Rule Requirements

155. Listing documents in relation to the issue of derivative warrants are required, by paragraph 13 of Appendix 1, part D, to include the issuer’s published audited consolidated financial statements (including the accompanying notes) and the auditor’s report thereon, for the last two financial years. Where more than 10 months have elapsed since the date to which the latest published audited consolidated financial statements of the issuer were made up, paragraph 14 requires an interim financial report in respect of the first six months of the financial year be included. In addition, where published, the issuer’s latest quarterly interim financial report is to be included in the Listing document.
156. Issuers are required to make this information available for inspection by the public during the life of warrants which they have issued. These requirements, in the case of guaranteed issues, will also apply in relation to the guarantor.

Discussion

157. As stated earlier, derivative warrants issued by an issuer constitute unsecured credit obligations of that issuer. One of the risks that investors face when investing in warrants is credit risk on the issuer. To allow investors to assess that risk the Listing Rules have, for some time, required issuers' annual accounts to be included in the listing documents for warrant issues. Other exchanges also require financial information in respect of the issuer to be included in warrant listing documents.³¹
158. The published annual accounts of issuers are becoming increasingly complex and lengthy. The early eligibility requirements for issuers consisted primarily of an experience requirement and a net asset requirement. In these circumstances, it was felt that including the full accounts of issuers in listing documents would put potential investors in the warrants in a position where they could assess for themselves the creditworthiness of the issuer.
159. As discussed earlier in this consultation paper, the requirements for issuers have evolved to the extent that issuers are now required to meet a credit rating requirement or, be subject to regulation by the Hong Kong Monetary Authority, the SFC or another regulator acceptable to the Exchange. The credit ratings of the issuer, whether an issuer is regulated (and if so, by whom) are matters which are required to be disclosed in the listing document.
160. In addition, although there are timeliness requirements in relation to financial information the usefulness of that information is inevitably eroded with the passage of time. This limits the effectiveness of annual accounts as a tool for assessing the ability of issuers to honour the obligations created by the issue of warrants.
161. Derivative warrant issuers are under an obligation, set out in paragraph 2 of the Listing Agreement, to make timely disclosure of matters which would adversely affect their financial position and their ability to meet the obligations arising under warrants issued by them. It is also noted that credit ratings are subject to periodic review by rating agencies. When reviews are conducted by the agencies this is often publicised and an indication is given as to whether the review is a regularly scheduled one or one which is being conducted to assess the effect of current developments on an issuer's rating. In addition, the rating agencies will often indicate whether the likely outcome of the rating review will be an upgrade or a downgrade of the rating.

³¹ The Australian Stock Exchange requires the audited profit and loss statements and balance sheets of the issuer (and guarantor, if applicable) for the five years before the listing application to be included in the listing document. The audited financial statements for those five financial years and the current annual report are to be made available to warrant holders on request.

162. The Exchange also notes that a number of issuers make their financial information available on their web sites.
163. The Exchange considers that, where a guarantor guarantees an issue of warrants, financial information on the issuer – which will often be a special purpose derivatives issuing vehicle – is of less relevance to warrant holders and investors in warrants.

Proposals

164. In light of the above, the Exchange considers that the provision of full accounts, and interim results, by issuers in listing documents has ceased to be as relevant as was previously the case. In addition, it is also noted that the requirement to publish these accounts in full, in the listing document, will add considerably to the cost of publishing the document. The Exchange considers that an appropriate approach would be to allow issuers to present summary financial information (balance sheet, profit and loss account, cash flow statement and statement of changes in equity) in Listing documents whilst at the same time obliging issuers to make full financial information available to those investors which want it.
165. *The Exchange therefore proposes to amend the Listing Rules to clarify that, in the case of an issue of warrants guaranteed by a guarantor, financial information on the issuer is not required to be included in the listing document. The existing requirement, that this information be made available for inspection will continue.*
166. *The Exchange also proposes to amend the requirement to disclose the full published accounts, and the full published interim results of issuers. The Exchange proposes to amend the Listing Rules to permit issuers or, in the case of guaranteed issues, guarantors, to publish summarised annual accounts and summarised interim results in listing documents, provided that the full accounts and full interim report will be submitted to the Exchange for publication on HKEx's web site. The summarised annual accounts to be included in listing documents shall comprise the balance sheet, profit and loss account, cashflow statement, and, where it is included in the accounts, a statement of changes in equity. Issuers will continue to be required to make their full annual accounts and interim reports available for inspection throughout the life of a warrant issue. A statement that the accounts and interim reports will be available for inspection throughout the life of the warrant issue will also be required to be included in the Listing Document*
167. *The Exchange invites comments on the above proposals.*

Financial Information on Underlying Securities

Listing Rule Requirements

168. Where a derivative warrant relates to securities of a company or companies which are listed on the Exchange, the issuer is required to include a summary of that company's published audited consolidated financial statement in respect of the two financial years immediately prior to the date of the listing document. In addition, where available, interim financial statements of that company are also to be included in the listing document. The listing document must include an undertaking by the issuer to make complete copies of the published audited consolidated financial statements and the interim financial statements available for inspection, at a place in Hong Kong acceptable to the Exchange, by the public during the life of the derivative warrants.
169. Where a company whose shares underlie a derivative warrant issue is listed on another exchange, the listing document is required to include the published audited consolidated financial statements (including the accompanying notes thereto) and the auditors' report thereon, for the last two financial years immediately prior to the date of the listing document. Where available, interim financial statements are also to be included in the document.

Discussion

170. For companies listed on the Exchange, it is considered that there is considerable public information available in relation to these companies such that a requirement to provide a summary of financial information may no longer be appropriate. Companies listed on the Exchange are also required to publish financial and other information in respect of themselves in accordance with the terms of their listing agreement with the Exchange. In addition, the Exchange would note that, ordinary investors, may buy or sell the underlying securities in the "cash market" without first having reference to the financial information.
171. Investors, particularly retail investors, may not be familiar with financial performance of overseas-listed companies. The Exchange considers that, in relation to companies which are listed overseas, there is still a requirement for investors to be provided with some financial information in relation to the underlying company. However, the Exchange considers that it may not be necessary for the full financial statements of an underlying company to be included in the listing document. Summary financial information (for example the balance sheet, profit and loss account, cash flow statement and statement of change in equity) may be sufficient for investors' purposes, provided that a means is available for those investors who want them, to obtain the full published financial accounts.

Proposals

172. *The Exchange proposes that for warrants on companies listed on the Exchange the requirement to include a summary of the published audited consolidated financial statements in the listing document should be repealed. The existing requirement, for issuers to undertake to make the annual accounts available for inspection in Hong Kong throughout the life of the warrant will continue.*
173. *The Exchange also proposes that for warrants on companies listed overseas the existing requirement to publish the overseas' company's full annual accounts should be replaced with a requirement to provide a summary of the financial statements. (That summary would comprise the balance sheet, profit and loss account, cash flow statement, and, where published, the statement of changes in equity.) A similar summary of an underlying company's interim reports is also to be included in the listing document. The current obligation on issuers to make the full annual accounts and interim reports available for inspection throughout the life of the warrant will continue.*
174. *The Exchange seeks comments on the above proposals. The Exchange also seeks comments on whether in addition to making financial information of overseas companies available for inspection issuers should also be required to make this information available to warrant holders on request. The Exchange also seeks comments on whether issuer's should be obliged to supply the Exchange with overseas companies' financial information in a form suitable for publication on HKEx's web site.*

Other Information on Underlying Companies

Listing Rule Requirements

175. The Listing Rules require the following information in respect of a company underlying a warrant to be included in the listing document:
- a description of the principal activities of the company and its subsidiaries;
 - details of the authorised and issued share capital; and
 - details of the underlying company's directors' and substantial shareholders' interests in the company.

These requirements apply irrespective of whether the underlying company's listing is on the Exchange or another exchange.

Discussion

176. The eligibility criteria for issuance over Hong Kong-listed companies are such that larger capitalisation stocks will be regarded as eligible. Such companies may have a wider following among investors and background information about them – such as that above – will be widely disseminated in the Hong Kong market. Those companies will be under an obligation – in accordance with the Listing Rules – to disseminate price sensitive information to the market. The companies are also required to publish details of certain transactions and to publish annual and interim results announcements. Against this background it might be felt that imposing a requirement on issuers to publish the above information in listing documents would add little to investors’ knowledge of the companies.
177. Where companies underlying a warrant issue are listed on overseas exchanges then information such as that above will be less widely disseminated in Hong Kong. The provision of this information may assist investors in determining whether to purchase a particular warrant.
178. As set out earlier warrant prices are principally affected by the price of the underlying asset or security. Against this background it might be felt that the disclosure of the above information, which is largely historic, provides little information of relevance to investors

Proposals

179. *The Exchange accepts that disclosure of company activities, share capital and directors’ interests serves little purpose where the company is listed on the Exchange. It is therefore proposed to remove the requirement to provide:*
- *a description of the principal activities of the underlying company and its subsidiaries;*
 - *details of the underlying company’s authorised and issued share capital; and*
 - *details of the underlying company’s directors’ and substantial shareholders’ interests in the company*

where the company underlying a warrant issue is listed on the Exchange.

180. *The Exchange considers that issuers should provide information on overseas-listed companies where these are the subject of warrant issuance. The provision of this information is seen as a means of familiarizing Hong Kong investors with such companies. Warrant issuers will therefore continue to be required to provide this information in relation to companies which are not listed on the Exchange*
181. *The Exchange invites comments on these proposals.*

Warrants over Indices

Listing Rule Requirements

182. In the case of derivative warrants relating to indices, the following information is to be included in the listing document:–
- a description of the index;
 - a description of the constituent stocks (if applicable);
 - the identity of the party which sponsors and / or calculates the index;
 - a description of the method of calculation;
 - the arrangements for calculation if the index is not published by the normal party;
 - the historic highs or lows for the last five years; and
 - the closing spot level at the latest most practicable date.
183. These requirements apply irrespective of whether the index is based on Hong Kong securities or is based on securities listed on an overseas market.

Discussion

184. The principal index over which warrants have been issued in Hong Kong is the Hang Seng Index of 33 stocks. As this index is widely reported in Hong Kong it might be felt that there was little need to include details of historic highs and lows and most recent spot levels. Details of most recent spot levels would in any event quickly become out of date after the listing document was published – and since this would also apply to overseas indices, it might be felt that for such indices there was also little cause to include such information in the listing document. An alternative would be to require closing spot prices to be published in the launch announcement.
185. Information on the constituents of the HSI, changes in its composition and information on the index compiler are widely available in Hong Kong.³² Information in relation to overseas indices is less readily available and it might therefore be felt that information in relation to the index should be provided to investors. Many overseas exchanges also require “background” information to be included in listing documents relating to warrants on indices, irrespective of whether that index is based on locally listed shares.³³

³² Details of changes in HSI constituents, background and other statistical information is available from the web site of HSI Services Limited, <http://www.hsi.com.hk/>

³³ The rules of the London Stock Exchange require a description of the index, name of the publisher of the index, how the index is compiled, and the frequency of publication. The Rules of the ASX require ‘a description of the underlying [Index]’. The Swiss Exchange requires similar information to the London Stock Exchange together with details of index movements for the past five years.

186. Information in relation to the arrangements if any index is not published by the normal party are clearly matters which warrant holders and other investors would be interested in as they would potentially affect the calculation of amounts due to warrant holders on exercise of the warrant. The Exchange notes that warrant issuers deal with this matter in the detailed terms and conditions for the warrants.

Proposals

187. *For derivative warrants over indices the Exchange proposes to repeal the requirement to disclose historic highs and lows and most recent closing prices of underlying indices in the listing document. A requirement to publish the most recent closing level of the index in the launch announcement will be introduced.*
188. *The Exchange proposes to exempt warrants over the Hang Seng Index from the requirement to disclose a description of the index; description of the constituent stocks (if applicable); the identity of the party which sponsors and / or calculates the index; and a description of the method of calculation.*
189. *The Exchange also proposes to modify its existing requirement to disclose details of the arrangements where the index is not published by the normal party by making it clearer that this is a matter which must be addressed in the terms and conditions for a warrant.*
190. *The Exchange seeks comments on the above proposals. The Exchange particularly seeks comments on whether other indices, in addition to the HSI, should be exempted from the requirement to disclose a description of the index; a description of the constituent stocks; the identity of the party which sponsors and / or calculates the index; and a description of the method of calculation.*

Details of Other Warrant Issues

Listing Rule Requirements

191. In accordance with paragraph 25 of Appendix 1d to the Listing Rules listing documents are required to include a “statement of the amount and brief details of any outstanding issues of derivative warrants made by the issuer”.

Discussion

192. The above requirement is intended to provide investors with an indication of an issuer’s experience in issuing derivative warrants. In practice this rule is satisfied by including a list of an issuer’s outstanding warrants and brief details of each of those issues (e.g. issue date, underlying asset or security, number of warrants, place of listing and expiry date) in the listing document. Providing a summary of an issuer’s outstanding warrants rather than a list of warrants could convey this.

Proposal

193. *It is proposed to amend paragraph 25 of Appendix 1d to require:*

“A statement of the number of outstanding issues of derivative warrants made by the issuer analysed into those issues listed on the Exchange, those issues listed on another exchange and those issues which are unlisted”

194. *The Exchange invites comments on this proposal.*

Issuer’s Guarantee

Listing Rules Requirement

195. In the case of guaranteed issues, the full text of the guarantee is to be included in the listing document.

Discussion

196. It has been suggested that the full text of the guarantee is a matter which investors would only seek access to in circumstances where they were contemplating making a claim under the guarantee. In view of this there may be merit in replacing the current rule with a requirement to include a summary of the guarantee in the listing document together with obligations to make the guarantee available on request. The Exchange is also mindful that certain investors may wish to continue to have access to the guarantee at the time a warrant is launched or may not wish to request copies of the guarantee from the issuer as this might indicate that they proposed to take legal action under the guarantee. The Exchange notes that other exchanges have adopted different requirements in relation to guarantees.³⁴

Proposal

197. *The Exchange considers that it is appropriate to include the full text of the guarantee in the Listing Document and therefore proposes no changes to the existing requirement. The Exchange invites comments on whether the existing rule should be replaced with a requirement to include a summary of the guarantee in the Listing Document and obligations to make the guarantee available for inspection and to make copies available on request.*

³⁴ The ASX requires the listing document to include: “clear and comprehensive information about...guarantees” (ASX rule 8.7.10(n)). The Swiss Exchange requires the full text of the guarantee to be included in the listing document.

Warrant Terms & Conditions

Market Capitalisation

Listing Rule Requirements

198. Paragraph 15A.38 of the Listing Rules requires that at launch the expected capitalisation of a derivative warrant shall be no less than HK\$50 million. This requirement does not apply in the case of Further Issues

Discussion

199. The capitalisation of a warrant at launch is a function of the number of warrants issued multiplied by the issue price. If, as discussed in paragraphs 71 to 84, issue sizes are restricted by reference to the average daily volume of an underlying security this will limit the number of warrants over a stock that can be issued. This may result in cases where issuers are unable to comply with the minimum market capitalisation requirement.

200. It is noted that the Listing Rules allow company warrants (i.e. those issued by the underlying company) to be issued where the expected market capitalisation of the issue at launch is HK\$10 million or more. The Swiss Exchange has a requirement that the minimum market capitalisation should be CHF10 million. The Frankfurt Exchange has adopted a requirement for issue sizes, which combines a minimum number of warrants with a minimum nominal value. The minimum size for an issue is 100,000 warrants and the issue must have a total nominal value of DM500,000.

201. It is considered that the size of an issue is more in the nature of a commercial decision and that therefore issuers should be provided with additional flexibility in relation to issue sizes. This might allow issuers to launch warrants targeted at “niche markets” where demand may be relatively low. An approach of allowing a lower initial market capitalisation might be felt to be preferable to one where a larger issue was launched (solely because of the minimum capitalisation requirement) and a substantial proportion of the issue was retained by the issuer. Allowing smaller issues would possibly utilise less of an underlying company’s “quota” thereby leaving “room” for other issuers to launch warrants. The existing fee levels for derivative warrants would provide an appropriate disincentive for issuers to issue small warrants, which were not economically worthwhile

Proposal

202. *It is proposed to reduce the minimum market capitalisation of a derivative warrant on launch from HK\$50 million to HK\$10 million. There will continue to be no minimum market capitalisation for Further Issues of derivative warrants. The Exchange invites comments on this proposal. Comments are also invited as to whether the Exchange should impose a limit on the minimum number of warrants that may comprise a warrant issue.*

Board Lots

Listing Rule Requirements

203. Paragraph 15A.40 of the Listing Rules provides that where the securities underlying a derivative warrant (excluding a basket warrant) trade in board lots then the board lot of the warrant at the time of listing must be such that it is exercisable into a whole number of board lots of the underlying securities.

Discussion

204. The intention behind paragraph 15A.40 is to avoid a position whereby exercising warrant holders receive an odd lot of the underlying security, which will generally trade at a discount to a whole board lot. In the case of cash settled warrants, as no shares are delivered to warrant holders on exercise, it might be felt that there should be less concern to ensure that a board lot of the warrant represents a board lot of the underlying security. If an issuer were to offer cash-settled warrants which did not represent a whole board lot of the underlying once those warrants were in-the-money the issuer might not be able to fully match its exposure under the warrants by holding physical securities (as a board lot of underlying shares might be equivalent to one or more board lots of warrants.) In these circumstances it would be a commercial decision for the issuer to determine whether it was prepared to offer warrants in board lot sizes that did not correspond with board lot sizes of the underlying.

205. As warrants are at present always required to be offered in board lot sizes that represent a whole number of board lots this fact has become well known in the market. This, combined with the fact that practically all warrants are offered at an entitlement ratio of 10 to 1 generally means that the board lot of a warrant over a particular security is generally ten times greater than the board lot for that security. The Exchange considers that there are advantages in maintaining a clear relationship between the board lot of warrants and the board lot of underlying securities.

Proposals

206. *The Exchange proposes to modify the requirement that a board lot of derivative warrants shall represent a whole number of board lots of the underlying security. In the case of cash settled warrants only, the Exchange proposes that a board lot of warrants shall represent either a whole number of board lots of the underlying or one-tenth of a board lot of the underlying security.*

207. *The Exchange invites comments on the above proposal*

Warrant Lives

Listing Rule Requirements

208. The Listing Rules provide that derivative warrants must normally expire not less than six months and not more than two years from the date of listing.³⁵

Discussion

209. The minimum and maximum periods have been established to allow a reasonable time period for investors to obtain a return on their investment. As derivative warrants are credit obligations of issuers, the Exchange has also sought to limit the maximum maturity period for warrants as over a shorter period of time there is less likely to be a significant change in an issuer's financial position.

210. Other exchanges also impose limits. The Italian Stock Exchange requires warrants to have a maturity of not less than one year where the exchange has introduced a derivative contract on the same underlying asset. The maximum maturity for warrants on the Italian Stock Exchange is five years.³⁶

211. The Exchange has received no requests to extend the maximum life of warrants on launch and a very limited number of requests to reduce the minimum life of warrants on launch. There have been a number of requests to reduce the minimum life of Further Issues and the Exchange's proposals in this respect are set out in paragraphs 85 to 96.

Proposal

212. *The Exchange proposes no changes to the minimum and maximum life of derivative warrants on initial launch and invites comment on this.*

³⁵ Listing Rule 15A.37

³⁶ Italian Stock Exchange Article 2.2.17. The Rules of the Italian Stock Exchange permit warrants with maturities of more than five years to be listed but in these circumstances the exchange has the right to impose additional conditions on issuers.

Announcements

Listing Rule Requirements

213. Paragraph 15A.61 of the Listing Rules requires an issuer to publish an announcement, containing specified information, on the business day after the launch of a warrant. Paragraph 15A.84 requires an issuer to publish an announcement not less than 15 business days prior to the expiry date of a warrant an announcement containing certain specified information. These announcements are to be published in the newspapers.³⁷

Discussion

214. Last year the Exchange issued a consultation paper³⁸ in relation to paid announcements by listed companies. In relation to paid announcements the consultation paper observed:

- That there were substantial costs involved in making paid announcements;
- That as local newspapers are not widely circulated outside Hong Kong paid advertisements may not benefit international investors;
- That the popularity of the internet as a means of communication had increased;
- That the stock exchanges of New York, London, Tokyo, Australia and Singapore required dissemination of listed company announcements electronically or by press release rather than by paid announcements; and
- That the disclosure of information by companies listed on the Growth Enterprise Market (“GEM”) through the GEM website alone appeared to have been well received by the market.

215. The consultation paper included a proposal to have all announcements of listed issuers released through HKEx’s website in place of the existing requirement for them to be published in the newspaper. This proposal would bring the Exchange into line with other international exchanges in the dissemination of information to the public. In addition, it would reduce the costs of information dissemination to listed companies and the information on the web site would be easily accessible by the investing public locally and internationally.

³⁷ “...published as a paid advertisement in at least one English language newspaper and in Chinese in at least one Chinese language newspaper, being in each case a newspaper published daily and circulating generally in Hong Kong and specified in the list of newspapers issued and published in the Gazette for the purposes of section 71A of the Companies Ordinance...” (Listing Rules, paragraph 1.01)

³⁸ *Consultation Paper on Dissemination of All Listed Issuers’ Announcements Through the Exchange’s Website in Place of Publication as Paid Announcements in Newspapers, published April 2000.*

216. The comments in relation to the publication of paid announcements by the listed companies apply equally in the case of announcements by issuers of derivative warrants. The benefits identified in the consultation paper would also apply if derivative warrant issuers were required to publish announcements on HKEx's web site.
217. The Exchange notes that where an issuer launches more than one issue of derivative warrants on the same day, the issuer will generally publish two separate announcements. The Exchange considers that an equal level of dissemination would be achieved if issuers published information about their warrant launches in one announcement rather than several announcements.
218. The Exchange notes that the requirement to publish an expiry notice is drafted in such a way that a separate announcement is required for each warrant expiry. The Exchange considers that dissemination of warrant expiries can be provided in announcements dealing with more than one issue of derivative warrants.

Proposals

219. *The Exchange proposes to replace the existing requirement for announcements to be published in the newspaper with a requirement to release announcements through HKEx's web site.*
220. *The Exchange proposes to amend the launch announcement requirements. Where more than one warrant is launched by an issuer on the same day, one announcement (containing the required information for the issues launched on that date) may be issued rather than the current practice, of issuing two or more separate announcements.*
221. *The Exchange proposes to allow announcements which set out expiry details for more than one warrant issue provided that all the warrant issues in that announcement expire at least 10 business days after the publication date and not more than 20 business days after the publication date.*
222. *The Exchange invites comments on the above proposals.*

Warrants on Overseas Markets

Indices

223. The Exchange Listing Rules permit the listing of derivative warrants over the shares of companies listed on overseas exchanges. These warrants may be either single stock or basket warrants. In addition, the rules also allow for the issue of derivative warrants over overseas indices.
224. For single stock and basket warrants on overseas companies, the Listing Rules indicate that, the overseas exchange must be one which is regarded as regulated, regularly operating, and open and must be recognised as such by the Exchange. By implication – although this is not explicitly referred to in the Listing Rules – it follows that, as indices are based on share prices, that the market on which the shares underlying the index are listed, must also be recognised by the Exchange.
225. A list of exchanges which the Exchange has recognised as fulfilling the “regulated, regularly operating, open” criteria is set out in Appendix I. The Exchange has listed warrants on the following indexes:–
- The Dow Jones Industrial Average Index
 - The Standard and Poor’s 500 Index;
 - The Nasdaq 100 Index;
 - The Nikkei 225 Index;
 - The Morgan Stanley Taiwan Index
 - The Dow Jones Taiwan Index
226. *The Exchange invites comments on whether it should seek to recognise other indices as being suitable for derivative warrant issuance.*

Single Stocks

Eligibility for Warrant Issuance

227. For stocks listed on overseas markets (“Overseas Companies”) to be eligible for warrant issuance in Hong Kong a number of criteria are to be met. Where the Overseas Company is listed on an exchange which requires a minimum percentage of shares to be held by “the public” then the value of those shares must be not less than HK\$4 billion. Where the overseas exchange does not impose a requirement for a minimum number shares to be held by “the public”, the Exchange may allow the listing of the derivative warrants if the market capitalization of such shares is not less than HK\$10 billion and the Exchange is satisfied with the liquidity of the market in the shares.

228. It is also generally the practice of the Division to consider whether the Overseas Company is a member of a leading index of securities for the market where that company is listed.

Proposal

229. *The Exchange proposes to add membership of a leading index in respect of its home market as a criteria which the Exchange will consider in determining whether an Overseas Company is eligible for warrant issuance.*

230. *The Exchange invites comment on this proposal.*

Availability of Price Sensitive Information

231. Where it is intended to list a derivative warrant on an Overseas Company it is necessary for the Exchange to consider "... the quality of the reporting requirements such as the timely reporting of adequate financial information and the price and volume of transactions whether on or off exchange, timely dissemination of price-sensitive information and the availability of the foregoing to investors in Hong Kong..."³⁹

232. In considering applications to list warrants on Overseas Companies, it has been the practice of the Division to require issuers to undertake to make available for inspection by warrant holders all the information that the Overseas Company is required by the rules and legislation of its home market to make available to the public. Many issuers have indicated to the Exchange that this is an onerous requirement. Some issuers have pointed to this as one of the reasons that they have not issued warrants on Overseas Companies.

233. The Exchange acknowledges that it may be burdensome for issuers to agree to make information publicly available for inspection to investors in relation to Overseas Companies. However, the Exchange also considers that it is important for investors to be provided with a means whereby they may obtain information on companies underlying warrants. In the case of warrants over the shares of companies listed on the Hong Kong market, the underlying company is, under the terms of its Listing Agreement with the Exchange, required to make information publicly available. That information is available to warrant investors and shareholders of the issuer alike.

³⁹ Listing Rules, Chapter 15A, paragraph 15A.29(4)

234. Many companies, in particular those with an international name and a following of international investors – which might be regarded as the companies most likely to be attractive for warrant issuance in Hong Kong – have developed extensive investor relations web sites. Through these web sites, investors are able to obtain information which has been made available to shareholders of that particular company. These web sites might provide a means by which information can be made available to investors.

Proposal

235. *The Exchange therefore proposes that where an Overseas Company has an investor relations web site then issuers of warrants over the shares of that company might be relieved from the obligation to make that information available for inspection. In such a case it would be necessary for issuers to include the address of the Overseas Company's web site in the Listing Document for the warrant issue. Warrant Issuers would be required to confirm to the Exchange that the investor relations web site contained all the information that the overseas company was required by the rules and legislation of its home market to make available to shareholders and the public.*

236. *The Exchange invites comment on this proposal. The Exchange invites comments on whether links to such investor relations web sites should be included on HKEx's web site.*

Other Matters

Standardisation of Warrant Terms & Conditions

237. There is a substantial level of uniformity in the terms and conditions of derivative warrants adopted by issuers. However, the requirement to include those terms in issuers' listing documents adds to the length of those documents thereby adding to the costs of those documents.
238. The Exchange considers that there might be merit in publishing some of the more generally accepted terms and conditions for warrants in an appendix to the Listing Rules. Issuers could then, if they wished, refer to these terms in their issue documentation rather than printing them in full in Listing Documents.
239. The Exchange will therefore, in conjunction with issuers, consider including certain standard terms in the Listing Rules which might then be used as outlined by the Exchange.
240. *The Exchange invites comment on this proposal*

Prospectus Registration Requirement for Warrant Issuance

241. At present, as noted earlier, the offering of derivative warrants is conducted by way of placing to professional investors by an overseas company. Accordingly the listing document prepared in connection with the issue of a derivative warrant can be exempted from the prospectus requirements pursuant to section 343 of the Companies Ordinance.
242. The revised process for issuing derivative warrants envisaged in this paper may result in the issuer selling derivative warrants directly to the public. Thus it would be necessary for the listing document to be a prospectus for the purpose of the Companies Ordinance and would be registered under the Companies Ordinance. In light of the requirements of the Companies Ordinance as to the contents of a prospectus, the Exchange has discussed with the Securities & Futures Commission (the "SFC") the extent to which such prospectuses would be able to follow the disclosure currently made in the listing document amended to reflect the proposals in this paper. To achieve this it would be necessary for the SFC to grant issuers a substantial number of waivers from the requirements of the Companies Ordinance.
243. The SFC has indicated its willingness to work with the Exchange to design an appropriate system that allows issuers to prepare and register a "base document" (updated for significant changes and no less than each half year) similar to current Base Documents. On the issue of a derivative warrant the issuer would prepare and register a supplemental prospectus which would be similar to current Supplemental Documents as amended for the proposals in this consultation paper.

244. *The Exchange invites comments on this proposal. In particular the Exchange would welcome suggestions on the specific waivers from the requirements of the Companies Ordinance which would be necessary to give full effect to this proposal.*

Overseas Stock Exchanges Recognised for the Purposes of Issuing Derivative Warrants

- The London Stock Exchange;
- The New York Stock Exchange;
- Nasdaq;
- Australian Stock Exchange;
- Jakarta Stock Exchange;
- Korea Stock Exchange;
- The Kuala Lumpur Stock Exchange;
- The Stock Exchange, Mumbai;
- National Stock Exchange of India;
- New Zealand Stock Exchange;
- Osaka Securities Exchange;
- Philippine Stock Exchange Inc;
- Shanghai Stock Exchange;
- Shenzhen Stock Exchange;
- Singapore Exchange;
- The Stock Exchange, Thailand;
- Taiwan Stock Exchange;
- Tokyo Stock Exchange;
- Wiener Borse;
- Brussels Stock Exchange;
- The Copenhagen Stock Exchange;
- Helsinki Stock Exchange;
- The Paris Bourse;
- The Deutsche Borse;
- Athens Stock Exchange;
- The Irish Stock Exchange;
- Italian Exchange;
- Amsterdam Exchanges;
- Oslo Stock Exchange;
- Bolsa de Valores de Lisboa;
- Madrid Stock Exchange;
- Stockholm Stock Exchange;
- SWX Swiss Exchange.

Chapter 15A

DERIVATIVE WARRANTS

Preliminary

- 15A.01 This Chapter sets out the requirements for the listing of derivative warrants on the Exchange. Derivative warrants may be listed by the methods, where applicable, set out in Chapter 7.
- 15A.02 The provisions of this Chapter are not exhaustive. The Exchange may, whenever it considers it appropriate, impose additional requirements, make listing subject to special conditions or allow waivers from or modifications to the requirements of this Chapter. Compliance with the relevant conditions may not of itself ensure the suitability of an issuer, a guarantor, the share, or shares or assets underlying a derivative warrant or of a derivative warrant issue and the Exchange retains an absolute discretion to accept or reject applications for listing.
- 15A.03 Prospective issuers should consult the Exchange at the earliest opportunity to seek confidential guidance as to their suitability, the suitability of a guarantor and, approved issuers, as to the suitability for listing of a proposed derivative warrant issue.
- 15A.04 A derivative warrant gives its holders (“warrantholders”) the right (but not the obligation) either to:–
- (1) purchase from (“derivative call warrant”) or sell to (“derivative put warrant”) the issuer at a predetermined exercise price or strike price:–
 - (a) a specified number of securities issued by a company other than the issuer or any of its subsidiaries (or to receive a cash payment calculated by reference thereto); or
 - (b) any asset (or to receive a cash payment calculated by reference thereto); or
 - (2) receive from the issuer a cash payment equal to the excess (if any) of:–
 - (a) in the case of a derivative call warrant, the value of an index relating to securities or assets (or other index) on the date of exercise of the derivative warrant over the exercise price or strike price; or

- (b) in the case of a derivative put warrant, the exercise price or strike price over the value of an index relating to securities or assets (or other index) on the date of exercise of the derivative warrant

during a predetermined exercise period or on a predetermined date or dates, or any other similar type of instrument.

- 15A.05 Derivative warrants which, upon exercise, entitle warrant holders to purchase from or sell to the issuer two or more securities of a different class, indices or other assets in such proportions as may be specified in the terms and conditions of such derivative warrant, or to receive a cash settlement by reference to the value of such securities, indices or other assets are referred to as “basket warrants”.
- 15A.06 Derivative warrants listed or to be listed on the Exchange may either be “collateralised warrants” or “non-collateralised warrants”.
- 15A.07 “Collateralised warrants” are derivative warrants where the issuer owns all of the underlying securities or other assets to which the collateralised warrant relates and grants a charge over such securities or assets in favour of an independent trustee which acts for the benefit of the warrant holders.
- 15A.08 “Non-collateralised warrants” are derivative warrants where the obligations of the issuer are provided for in a form other than by way of a charge over the underlying securities or assets. Non-collateralised warrants are usually issued by financial institutions which will adopt hedging strategies to provide for their obligations during the life of the non-collateralised warrants.
- 15A.09 In the Exchange Listing Rules, “derivative warrants” (which includes basket warrants) shall where the context so admits refer to derivative call warrants, derivative put warrants, which may be either collateralised warrants or non-collateralised warrants.

Issuers

- 15A.10 An issuer must be duly incorporated or otherwise established under the laws of the place in which it is incorporated or otherwise established and must be in conformity with those laws and its memorandum and articles of association or equivalent documents.
- 15A.11 An issuer (except in the case of a guaranteed issue) must not be a private company within the meaning of section 29 of the Companies Ordinance or equivalent legislation of the jurisdiction in which it is incorporated or established.

15A.12 An issuer must be suitable to handle or capable of issuing and managing a derivative warrant issue and listing. In assessing the suitability or capability of an issuer the Exchange will have regard to, inter alia, its previous experience in issuing and managing the issue of other similar instruments and whether it has satisfactory experience to manage the potential obligations under the derivative warrants. Where listing of non-collateralised warrants is sought the Exchange will consider the issuer's risk management systems and procedures.

15A.13 An issuer of non-collateralised warrants must have a net asset value (i.e. the aggregate of share capital and reserves) of not less than HK\$2 billion as set out in its latest published audited financial statements and interim financial report which an issuer is required to submit to the Exchange in accordance with rule 15A.22. An issuer shall maintain a net asset value of HK\$2 billion whilst any non-collateralised warrant issued by it is listed on the Exchange. An issuer shall inform the Exchange immediately if its net asset value falls below HK\$2 billion.

15A.14 An issuer of non-collateralised warrants must also:–

- (1) have a credit rating which is one of the top three investment grades awarded by a credit rating agency recognized by the Exchange. A credit rating which is presently of such grade but which is under review for possible downgrading to less than such grade will not be regarded as fulfilling this criteria; or
- (2) be regulated by the Hong Kong Monetary Authority or an overseas regulatory authority acceptable to the Exchange, or
- (3) be regulated by the Commission as a registered dealer under the Securities Ordinance (Note), or

Note: Dealers registered under the Securities Ordinance are required to notify the Intermediaries Supervision Department of the Commission as soon as possible of their intention to issue any derivative warrants and to give to the Commission as much detail of the proposed issue as is available at the time of notification. A copy of such notification must be given to the Exchange before the Exchange will consider any application for listing derivative warrants.

- (4) be a government or state, or a body which is backed by the full faith and credit of a government or state.

15A.15 Where an issuer fails to satisfy the criteria in rules 15A.13 or 15A.14 the Exchange may accept an arrangement whereby the issuer's obligations arising under the non-collateralised warrants are unconditionally and irrevocably guaranteed or otherwise secured ("guaranteed") to the satisfaction of the Exchange by another legal person (the "guarantor") which meets the criteria in rules 15A.13 and 15A.14.

15A.16 The issuer will be required to sign a Listing Agreement in a form prescribed and provided by the Exchange before the launch of its first derivative warrant to be listed on the Exchange.

Guarantors

15A.17 Where listing is sought for derivative warrants which are guaranteed:–

- (1) the guarantor must not be a private company within the meaning of section 29 of the Companies Ordinance or equivalent legislation of the jurisdiction in which it is incorporated or established;
- (2) the guarantor will normally be required to be the issuer's ultimate holding company of the group to which the issuer belongs;
- (3) the guarantor will be required to comply with the Exchange Listing Rules to the same extent as if it was the issuer of the derivative warrants;
- (4) the listing document must contain the same information in respect of the guarantor as it does in respect of the issuer; and
- (5) the guarantor will be required to sign a Listing Agreement in a form prescribed and provided by the Exchange before the launch of any guaranteed derivative warrant to be listed on the Exchange.

15A.18 The guarantee or other security must be issued in conformity with the laws of the place in which the guarantor is incorporated or otherwise established and in conformity with the guarantor's memorandum and articles of association or equivalent documents and all authorisations needed for its issue under such laws or documents must have been duly given.

Legal Opinions on Guarantee

15A.19 In the case of a guaranteed issue, the issuer and/or the guarantor must submit to the Exchange legal opinions from competent legal advisers from such jurisdictions as the Exchange shall require. Such opinions, which must be acceptable to the Exchange, shall confirm that:–

- (1) the guarantee or other security constitute legal, valid and binding obligations of the guarantor in accordance with its terms;
- (2) the guarantor is, under the guarantee or other security, unconditionally and irrevocably liable for the due and punctual performance of the obligations of the issuer arising under the derivative warrants as primary obligor in accordance with the terms and conditions of the derivative warrants;

- (3) (1) and (2) above will not be affected in the event of the liquidation of the issuer, irrespective of the validity, regularity or enforceability of the derivative warrants, any waiver or consent by a warrant holder, any consolidation, merger, conveyance or transfer by the issuer or other event which would afford to a guarantor relief, legal or equitable, from its obligations under the guarantee or other security, and
- (4) such other matter as the Exchange shall require depending on the circumstances of the issuer.

15A.20 Where a guarantee is issued in relation to a specific derivative warrant issue, the legal opinions must be submitted to the Exchange in draft form at the time of submission to the Exchange of the first proof of the listing document and a copy in its final form must be submitted to the Exchange at the closing of the issue.

15A.21 Where a guarantee is intended to cover more than one issue of derivative warrants issued pursuant to a base listing document of the issuer, the conditions in rule 15A.20 will apply to the first derivative warrant issue under the guarantee. For subsequent issues under the same guarantee the issuer must submit a confirmation from competent legal advisers from such jurisdictions as the Exchange shall require, that the guarantee will apply to the proposed warrant issue. The Exchange will not accept a guarantee intended to cover warrant issues issued one year or more from the date of the guarantee.

Continuing Obligations

15A.22 In addition to the continuing obligations as set out in the Listing Agreement in Part H of Appendix 7 (subject to such modifications as shall be agreed to by the Exchange in accordance with rule 15A.24) an issuer shall, whilst any derivative warrants issued by it are listed on the Exchange:–

- (1) deliver to the Exchange:–
 - (a) as soon as practicable after the date of its publication but, in any event, not later than four months after the date to which they relate, ten copies of its annual report including its annual accounts and, where group accounts are prepared, its group accounts, together with the auditor's report thereon,
 - (b) at the date of submission of its annual report to the Exchange, a summary of the notional value and replacement costs of its off-balance sheet financial instruments (to include derivative warrants, options, futures, swaps and other similar instruments) as at the date of the audited balance sheet. The methods used to value the notional value and replacement costs of the issuer's off-balance sheet instruments should be stated,

- (c) as soon as practicable after the date of its publication or preparation but, in any event, not later than four months after the period to which it relates ten copies of its interim financial report in respect of the first six months of its financial year,
 - (d) where published, as soon as practicable after the date of its publication ten copies of its quarterly interim financial report, and
 - (e) as soon as practicable after the date of its publication, full details of any other financial information which the issuer may provide to any other exchange or market;
- (2) include either in the interim financial report referred to in rule 15A.22(1)(c) above or in a separate statement delivered at the same time to the Exchange as such interim financial report:–
- (a) profits or losses before taxation,
 - (b) taxation on profits,
 - (c) profits or losses attributable to minority shareholders,
 - (d) profits or losses attributable to shareholders,
 - (e) the balance at the end of the period of share capital and reserves, and
 - (f) comparative figures for the matters specified in (a) to (e) inclusive for the previous corresponding period;
- (3) prepare the interim financial reports and statement referred to in rule 15A.22(1)(c) and (d) and 15A.22(2) in accordance with the issuer’s usual accounting policies and procedures; and
- (4) make the financial information referred to in rule 15A.22(1) and (2) above available for inspection by the public at the issuer’s registered office or principal place of business in Hong Kong or such other place in Hong Kong as shall be acceptable to the Exchange.

15A.23 The text of the Listing Agreement applicable to derivative warrants is reproduced as Part H of Appendix 7 together with notes on its interpretation and application.

15A.24 The Exchange may agree modifications to or impose additional requirements in the Listing Agreement as it considers appropriate in a particular case.

Derivative Warrants

- 15A.25 The derivative warrants for which listing is sought must be issued in conformity with the laws of the place in which they are issued and in which the issuer is incorporated or otherwise established and in conformity with the issuer's memorandum and articles of association or equivalent documents. All authorisations needed for their creation and issue under such laws or documents must have been duly given.
- 15A.26 Derivative warrants will not be considered suitable for listing if they are issued directly or indirectly by a controlling shareholder or a person who, in the opinion of the Exchange, has effective management control of the company or any of the companies whose securities underlie the derivative warrants.
- 15A.27 An issuer is prohibited from listing derivative warrants where it; or any of its holding companies, subsidiaries or fellow subsidiaries; or any associated companies of any of them has:
- (1) at any time within a period of one week prior to the date of launch of an issue or further issue of derivative warrants, issued a full analyst's research report upon the securities, indices or assets underlying the derivative warrants; or
 - (2) at any time within a period of one week prior to the date of launch of an issue or further issue of derivative warrants, issued an update to a full analyst's research report or other short commentary upon the securities, indices or assets underlying the derivative warrants; or
 - (3) been retained by a company whose securities will underlie the derivative warrant (or by any of its holding, subsidiary, fellow subsidiary or associated companies) to give advice in relation to a transaction. Where the company whose securities will underlie the derivative warrant is listed on the Exchange, transaction refers to matters which would be discloseable to shareholders of the underlying company and the public in accordance with paragraph 2 of the Listing Agreement set out in Appendix 7 parts A, B and I to the Exchange Listing Rules, Chapter 14 of the Exchange Listing Rules, Rule 3 of the Hong Kong Code on Takeovers and Mergers, or Rule 10 of the Hong Kong Code on Share Repurchases. Where the company is listed on an overseas exchange, transactions refers to matters which would be discloseable under regulations equivalent to those in paragraph 2 of the Listing Agreement, Chapter 14 of the Listing Rules, Rule 3 of the Hong Kong Code on Takeovers and Mergers, or Rule 10 of the Hong Kong Code on Share Repurchases. The prohibition ceases to apply where the transaction is abandoned or announced.

Single Stock Warrant

15A.28 Where the derivative warrants relate to a single class of shares, the derivative warrants may only be listed if at the time of issue of the derivative warrants such class of shares is or will become at the same time:–

- (1) listed on the Exchange and in respect of which, subject to the qualifying period in rule 15A.33, the capitalisation of such shares in the hands of the public (“public float capitalisation”) is at least HK\$4 billion (Note); or

Note: Rules 8.08(1) and 8.24 provide guidance on calculating the number of shares “in the hands of the public.” Shares which are subject to lock up arrangement will not be considered as being in the hands of the public until the lock up arrangements expire.

- (2) listed or dealt in on another regulated, regularly operating, open stock market recognised for this purpose by the Exchange, and
 - (a) is required by the laws, regulations or rules of that market to have a minimum number or percentage of shares in the hands of the public and the public float capitalisation of such shares is not less than HK\$4 billion, or
 - (b) if such market does not impose a requirement to have a minimum number or percentage of shares in the hands of the public, the Exchange may allow the listing of the derivative warrants if the market capitalisation of such shares is not less than HK\$10 billion and the Exchange is satisfied with the liquidity of the market in the shares.

15A.29 Factors which the Exchange will consider in determining the suitability of derivative warrants which relate to shares listed or dealt in on another regulated, regularly operating, open stock market include, but are not limited to, the following:–

- (1) whether the market is regulated on a fair and orderly basis by a body of laws, regulations or rules which are enforced by government or a body having governmental authority particularly, its trading regulations including timely price and volume dissemination;
- (2) whether the market has adequate and pre-determined trading hours and days the suspension of which is provided for only by the laws, regulations or rules regulating it;
- (3) whether the jurisdiction in which the market is situated restricts foreign investors in the trading of securities listed or dealt in on that market or the

remittance of any proceeds from a disposal through e.g., foreign exchange controls or foreign ownership restrictions;

- (4) the quality of the reporting requirements such as the timely reporting of adequate financial information and the price and volume of transactions whether on or off exchange, timely dissemination of price-sensitive information and the availability of the foregoing to investors in Hong Kong;
- (5) the availability of price information in Hong Kong particularly on a real-time basis; and
- (6) the arrangements by the issuer for requesting suspension of trading in the derivative warrants whenever trading in the underlying securities or assets are suspended in the market on which such securities or assets are listed or dealt in.

Basket Warrants

15A.30 Where the basket warrants relate to shares listed on the Exchange:

- (1) subject to the qualifying period in 15A.33, the public float capitalisation of each class of shares shall not be less than HK\$1 billion, and
- (2) the minimum weighting for each constituent share in a basket warrant shall be as follows:

Number of underlying securities comprised in a basket warrant	Minimum weighting of each constituent share
Two	25.0%
Three	12.5%
Four or more	10.0%, and

Note: Weightings for constituent shares in a basket are calculated in accordance with rule 15A.30(3)(b) below.

- (3) where any share in the basket warrant is of a class of shares having a public float capitalisation of less than HK\$4 billion:
- (a) the weighting of shares of that class per basket warrant (calculated and expressed as a percentage in accordance with the formula below) shall not exceed the public float capitalisation of that class expressed as a percentage of HK\$8 billion.

(b)
$$\text{Weighting} = \frac{N \times M}{P} \times 100$$

where:

- N: is the number of shares (whether a whole or a fraction) of that class per basket warrant,
- M: is the closing price of one share of the class in N, and
- P: is the total market value of all of the shares of each class per basket warrant obtained by multiplying the number of shares (whether a whole or a fraction) of each class therein by their respective closing prices.
- (c) The closing price referred to in M and P above shall be the closing price as derived from the Daily Quotation Sheet of the Exchange on the business day prior to the date of launch of the basket warrant.

15A.31 Where the basket warrant is comprised of:-

- (1) shares which are not listed on the Exchange, or
- (2) other securities, indices or assets

the weighting of each of the securities, indices or assets in the basket warrant must first be approved by the Exchange.

15A.32 The underlying shares of a basket warrant must be such that it allows the holders to gain exposure to a sector, industry, market or other theme recognizable by investors.

Qualifying Period

15A.33 The public float capitalisation requirements of HK\$4 billion and HK\$1 billion for shares underlying a derivative warrant must be maintained for a qualifying period. A qualifying period ends on the day immediately preceding the intended date of launch of the relative derivative warrant and is either:

- (1) a period of 60 consecutive business days during which dealing in the shares in the company underlying the derivative warrant have not been suspended; or
- (2) a period of no more than 70 consecutive business days comprising 60 business days during which dealings in the shares of the company underlying the warrant have not been suspended and no more than 10 business days during which dealings in the shares underlying the warrant have been suspended.

Warrant Issuance Limits

15A.34 A derivative warrant relating to shares shall not be considered suitable for listing if the shares to which the derivative warrant relates are listed on the Exchange and the number of such shares would, when aggregated with the number of shares of the same class underlying existing derivative warrants listed on the Exchange, exceed the lower of:–

- (1) 20% of the aggregate number of issued shares of that class; and
- (2) 30% of the aggregate number of issued shares of that class which are in the hands of the public.

Note: A ballot or other equitable method shall be used by the Exchange to determine the allocation of shares where the number available for derivative warrant issues is insufficient to allow all interested issuers to issue derivative warrants on such shares.

Terms and Conditions

15A.35 Derivative warrants listed or to be listed on the Exchange shall be subject to the terms and conditions approved by the Exchange. Modification to terms and conditions must be approved by the Exchange. The terms and conditions set out herein are not exhaustive.

15A.36 The derivative warrants for which listing is sought must be freely transferable.

15A.37 Derivative warrants must normally expire not less than 6 months and not more than two years from the date of listing.

(Note: for derivative warrants relating to the same underlying securities listed on the Exchange, normally no more than one such derivative warrant may expire on any one day)

15A.38 The expected market capitalization of a derivative warrant issue must normally be at least HK\$50 million.

15A.39 Derivative warrants relating to shares (or other securities) shall normally be issued in the ratio of either one derivative warrant for one share (or other security) or ten derivative warrants for one share (or other security).

15A.40 When the underlying securities of a derivative warrant (excluding basket warrants) are normally traded in board lots, the board lots of the derivative warrants at the time of listing shall be such that on exercise of one board lot of derivative warrants the warrant holder is entitled to a whole number of board lots of the underlying securities.

15A.41 The trading board lot of derivative warrants relating to index, currency or a basket of shares must be 10,000.

15A.42 The minimum issue price of a derivative warrant must not be less than HK\$0.25 per warrant. In exceptional circumstances, the Exchange may apply a minimum issue price to an issue of Further Warrants (as defined in Practice Note 14).

15A.43 The issuer must, at the time of launch, specify the settlement method of the derivative warrant upon exercise. Options for the issuer or warrant holder to elect for settlement either in shares or cash, upon exercise of the derivative warrant will not be acceptable. *(Note)*

Note: The terms and conditions of the warrant may provide that the warrant holder, upon exercise of the warrant, shall be entitled to receive a cash amount from the issuer in relation to the number of underlying shares which is less than a board lot. The cash amount shall be delivered as soon as practicable.

15A.44 A derivative warrant relating to a basket of securities or to securities not listed on the Exchange must be settled wholly in cash. Where the derivative warrant is traded on the Exchange in Hong Kong dollars, settlement shall be in Hong Kong dollars.

15A.45 In relation to derivative warrants which are settled by delivery of the underlying securities or assets the terms and conditions must:–

- (1) in the case of a derivative call warrant, treat the warrant holder as the beneficial owner of the underlying securities or assets and entitled to all rights, enjoyment, entitlement and benefit in respect thereof which exists as at or which arises as from the date such warrant holder pays to the issuer the exercise price; and
- (2) in the case of a derivative put warrant,
 - (a) treat the issuer as the beneficial owner of the underlying securities or assets and entitled to all rights, enjoyment, entitlement and benefit in respect thereof which exists as at or arises as from the date the issuer pays to a warrant holder the cash settlement amount;
 - (b) require the warrant holder to beneficially own and deliver on the date of exercise such underlying securities or assets; and
- (3) provide for either settlement by physical delivery of documents of title (including certificates in the name of the warrant holder or its nominee) to the warrant holder (or its nominee) or settlement by way of electronic transfer through CCASS within such period following a valid exercise as shall be agreed to by the Exchange.

15A.46 In relation to derivative warrants over securities or assets which are to be settled wholly in cash,

- (1) the valuation method for determining the amount of the cash settlement shall be:–
 - (a) where the derivative warrant relates to securities listed on the Exchange, the average of the closing prices of the underlying securities (as derived from the Daily Quotation Sheet of the Exchange, subject to any adjustments as may be necessary to such closing prices to reflect any capitalisation, rights issue, distribution or the like) for the 5 business days prior to and up to and including the business day before the exercise date;
 - (b) where the derivative warrant relates to securities which are not listed on the Exchange or to other assets, such formula as shall be permitted by the Exchange; and

- (2) the net cash settlement to be paid to the warrant holder within such period following a valid exercise as shall be agreed to by the Exchange. An exercising warrant holder shall not be required to deliver the exercise money at the time of exercise; and.
- (3) the terms and conditions must provide for automatic settlement on expiry (i.e., so that warrant holders are not required to serve a notice of exercise) if the derivative warrants are “in the money” at expiry.

Collateralised Warrants

15A.47 In addition to the other requirements which apply generally to derivative warrants, an issuer of collateralised warrants must:–

- (1) satisfy the Exchange that the proposed security arrangements are for the benefit of and adequately protect the interests of warrant holders. In particular, the underlying securities or assets (or rights to acquire the underlying securities or assets) must normally be held as security for the performance of the issuer’s obligations under the collateralised warrants by an independent trustee, custodian or depositary for the benefit of warrant holders;
- (2) grant a charge over such securities or assets in favour of an independent trustee, custodian or depositary on behalf of warrant holders to secure the issuer’s obligations to deliver such securities or assets upon valid exercise of the collateralised warrants;
- (3) deposit such securities or assets with the trustee, custodian or depositary in order to secure performance by the issuer of such obligations and authorise the trustee, custodian or depositary to deliver the underlying securities or assets to warrant holders upon valid exercise of the collateralised warrants in the event that the issuer is unable to discharge its obligations under the collateralised warrants; and
- (4) provide a warranty to the trustee, custodian or depositary for the benefit of warrant holders that the underlying securities or assets are unencumbered, that the securities or assets are being held by the trustee, custodian or depositary for the benefit of warrant holders and that the issuer will, upon a valid exercise, be able to convey to warrant holders good title to the underlying securities or assets free from all claims, charges, encumbrances, liens, equities and other third party rights whatsoever.

15A.48 For the purposes of rule 15A.47 the Exchange will normally require the trustee, custodian or depositary to be:–

- (1) a bank licensed under section 16 of the Banking Ordinance;
- (2) a trust company which is a subsidiary of such a bank;
- (3) a trust company registered under Part VIII of the Trustee Ordinance; or
- (4) a banking institution or trust company incorporated outside Hong Kong which is acceptable to the Exchange.

However, the Exchange may in exceptional cases accept an alternative person to be trustee, custodian or depositary.

15A.49 In the case of an issue of collateralised warrants, the issuer must submit to the Exchange legal opinions upon the legally binding effect and enforceability of the proposed trust or other security arrangements.

Disclosure of Securities Dealings

15A.50 In the case of derivative warrants relating to securities, the issuer must disclose to the Exchange any dealings (including any warrant, option or other similar instrument) relating to the underlying securities:–

- (1) by the issuer or its subsidiaries and associates and any connected person of the issuer so far as is known to the issuer or its directors after making reasonable enquiries;
- (2) where the issue of the derivative warrants is managed and/or underwritten by persons other than the issuer, by the manager(s) and the underwriter(s), or any of their respective subsidiaries or associates; and
- (3) by any person who deals in the underlying securities by arrangement with, or pursuant to an understanding with, the issuer, or any of its subsidiaries or associates or any connected person of the issuer

in the period commencing six weeks prior to the announcement of the issue and ending on the latest practicable date before the date of the listing document.

Note: For issuers whose business involves the buying and selling of securities, the dealings referred to above relate to dealings on the issuer's own behalf or on behalf of a person or company associated with him or it.

- 15A.51 An issuer must disclose to the Exchange any agreement, arrangement or understanding (direct or indirect) in place at the date of issue between the issuer and, if any, its holding company, subsidiaries or associated companies and any substantial shareholder of the company whose securities underlie the derivative warrant.

Increase in Size/Further Issue

- 15A.52 An issuer may with the consent of the Exchange increase the size of a derivative warrant issue already launched. The increase must be on the same terms and conditions as the original tranche as announced in the launch announcement. An increase in size may be made after publication of the launch announcement but before the Listing Committee hearing for the listing application of the derivative warrant.
- 15A.53 An issuer may make a further issue or issues of derivative warrants to form a single series with a derivative warrant which has been approved for listing by the Listing Committee. The issuer must comply with the requirements set out in Practice Note 14 for a further issue.

Marketing of Derivative Warrants

- 15A.54 Subject as stated below, an issuer shall not, prior to or during the launch of an issue of derivative warrants, release, issue or distribute any publicity material relating to such derivative warrants.
- 15A.55 An issuer may, prior to or during the launch of an issue of derivative warrants and subject to compliance with all relevant laws, regulations and rules, release publicity material in relation to such derivative warrants in the form of comparative data i.e., material which compares the derivative warrant in terms of its premium, gearing, issue price, exercise price, exercise period, etc., with that of other derivative warrants on the same securities, assets or indices.
- 15A.56 Where an issuer releases or distributes publicity material allowed under rule 15A.55 such material shall also be included in the listing document.
- 15A.57 Issuers are reminded that securities legislation may apply to the marketing of derivative warrants to the public in Hong Kong.

Application Procedures and Requirements

- 15A.58 An applicant must obtain the Exchange's clearance as to its suitability and the suitability of the derivative warrant for which listing is sought prior to the launch of a derivative warrant.

15A.59 An issuer shall not launch an issue of derivative warrants relating to securities listed on the Exchange or make any announcement relating thereto until trading on the Exchange on the day of launch has ceased.

15A.60 A formal announcement stating the information set out in rule 15A.61 must be published in the newspaper (as defined in Chapter 1) once the Exchange has confirmed it has no comments thereon on the first business day following the day upon which the derivative warrants are launched.

15A.61 A formal announcement must not be less than 12 centimetres by 16 centimetres (4 inches by 6 inches approximately) in size and must include at least the following:

- (1) the full name and country of incorporation or other establishment of the issuer and/or the guarantor;
- (2) the nature, amount and title of the derivative warrants for which listing is sought (*Note*);

Note: The description of the derivative warrants must indicate the nature of the warrant including whether it is,:

- (a) call or put
- (b) single or basket
- (c) American or European
- (d) stock, index, currency or commodity
- (e) cash or physical settlement.

- (3) the date of publication of the announcement;
- (4) a statement that the formal announcement appears for information purposes only and does not constitute an invitation or offer to acquire, purchase or subscribe for the derivative warrants;
- (5) a disclaimer statement as follows (“prescribed form”):

“The Stock Exchange of Hong Kong Limited takes no responsibility for the contents of this announcement, makes no representation as to its accuracy or completeness and expressly disclaims any liability whatsoever for any loss howsoever arising from or in reliance upon the whole or any part of the contents of this announcement.”;

- (6) where the derivative warrants are to be settled wholly in cash,:-
 - (a) details of the formula for calculating the cash settlement amount; and

- (b) a statement that such warrants will be automatically settled on the expiry date without the need for warrant holders to deliver a notice of exercise;
- (7) a summary of the terms of the derivative warrants including the issue price, the strike price or level, the exercise period or date and the expiry date;
- (8) the volatility, gearing and premium of the warrant with a note indicating that these values may not be comparable to similar information provided by other issuers;
- (9) a statement whether the issuer and/or guarantor is regulated by a body specified in rule 15A.14(2), (3) or (4);
- (10) in the case of a guaranteed issue, a statement that the obligations of the issuer are unconditionally and irrevocably guaranteed by the guarantor;
- (11) where applicable, a statement that the derivative warrants constitute general unsecured obligations of the issuer and/or the guarantor;
- (12) a statement that application has been made to the Exchange for listing of and permission to deal in the derivative warrants and the expected date of commencement of dealings in the derivative warrants;
- (13) the address(es) at which and the date on which copies of the listing document will be available to the public;
- (14) the name of the sponsor/manager and, if applicable, any distributor(s) or placing agent(s);
- (15) the credit rating of the issuer and/or the guarantor;
- (16) in the case of a further issue, the following additional information:
 - (a) the number of the Further Warrants (as defined in Practice Note 14) to be issued;
 - (b) the issue price of the Further Warrants;
 - (c) the closing price of the Existing Warrants on the day on which the Further Warrants are launched;
 - (d) a statement that the Further Warrants form a single series with the Existing Warrants (as defined in Practice Note 14); and

- (17) such other information as the Exchange shall require.
- 15A.62 A formal announcement containing the information in rule 15A.61 must be made in respect of any increase in size or further issue of existing warrants.
- 15A.63 Seven copies of any published launch announcement (for both English and Chinese version) under rules 15A.60 and 15A.62 must be submitted to the Exchange as soon as possible after publication.
- 15A.64 An issuer is not required to submit an advance booking form in accordance with rule 9.03.
- 15A.65 The items referred to below must be lodged with the Exchange for review as soon as practicable following the day on which the derivative warrant is launched to allow sufficient time for review and clearance by the Exchange before the proposed listing date:
- (1) two drafts or proofs of the listing document in reasonably advanced form, with full details of the terms and conditions of the derivative warrants, marked in the margin to indicate compliance with the requirements of this Chapter and Part D of Appendix 1;
 - (2) a completed checklist (obtainable from the Exchange) which specifies the information required by this Chapter and Part D of Appendix 1 regarding the issuer and the issue;
 - (3) a list of placees including the names, addresses and ID/Passport numbers for individuals; the names, addresses, registered office and, if not the same, place of business for corporate placees together with the names and addresses of the beneficial owners for any nominee company; and the number of derivative warrants taken up by each placee. Such lists may be supplied directly to the Exchange by each manager, placing agent, distributor appointed by the issuer in order to maintain confidentiality; and
 - (4) a copy of the placing letters and a separate marketing statement in the form set out in Form D in Appendix 5 signed by each manager, placing agent, distributor appointed by the issuer.
- 15A.66 The following documents must be supplied to the Exchange as soon as practicable after the hearing of the application by the Listing Committee but before the listing of the derivative warrant:–
- (1) completed Form C1 in the form set out in Appendix 5;

- (2) a remittance in respect of the listing fee and transaction levy as determined pursuant to Appendix 8;
- (3) ten copies of the listing document, one of which must be dated and signed by a duly authorised officer of the issuer;
- (4) where any document referred to in (3) above is signed by an agent or attorney, a certified copy of the authorisation for such signature;
- (5) 300 copies of the listing document to be supplied to the Trading Floor of the Exchange;
- (6) two specimen copies of the definitive derivative warrant certificate in compliance with the requirement of Appendix 2;
- (7) in the case of a guaranteed or collateralised warrant issue, legal opinions or confirmation from competent legal advisers of the continued validity of the previously submitted legal opinions required pursuant to rules 15A.20, 15A.21 and 15A.49 respectively;
- (8) a copy of the warrant instrument, registrar's agreement, warrant agency agreement, placing agreement and all other material agreements relating to the issue and management or administration of the derivative warrants;
- (9) if any, a certified copy of the resolution(s) of the issuer in general meeting authorising respectively the issue of all derivative warrants for which listing is sought together with one copy of the notice of meeting of shareholders referred to in the listing document;
- (10) if any, a certified copy of the resolution(s) of the issuer's board of directors or other governing body or any other person to whom it has properly delegated these powers (together, in such case, with a certified copy of the power of attorney or resolution delegating the powers) authorising the issue and allotment of such derivative warrants, the making of the application for listing in the form set out in Form C1 in Appendix 5, the signing of the Listing Agreement and approving and authorising the issue of the warrant;
- (11) in the case of a guaranteed issue, a certified copy of the resolution(s) of the board of directors or other governing body of the guarantor approving and authorising the signing and the giving of the guarantee, the signing of the Listing Agreement and approving and authorising the issue of the listing document;

- (12) a certified copy of every letter, report, financial statement, statement of adjustments, valuation, contract, agreement, resolution or other document any part of which is extracted or referred to in the listing document;
- (13) a certified copy of the written consent by an expert to the issue of the listing document with the inclusion therein, in the context in which it is included, of a statement purporting to be a copy of or extract from or summary of or reference to a report or valuation or other statement by such expert in the form and context in which they are included; and
- (14) a declaration substantially in the form set out in Form F of Appendix 5 duly signed by the issuer.

Placing

15A.67 Where derivative warrants are listed on the Exchange by way of a placing, the placing of derivative warrants shall be conducted in accordance with the guidelines set out in Appendix 6A.

Listing Documents

15A.68 A listing of derivative warrants pursuant to this Chapter must be supported by a listing document. Listing documents must contain all of the specific items of information which are set out in this Chapter and Part D of Appendix 1 and must, as an overriding principle, contain such particulars and information necessary to enable an investor to make an informed assessment of the assets and liabilities and financial position of the issuer and of the derivative warrants. The Exchange may require the inclusion in the listing document of such additional or alternative items of information as it considers appropriate. Conversely, the Exchange may be prepared to permit the omission or modification of certain items of information if, in its absolute discretion, it considers it appropriate. Issuers who wish to omit any of the prescribed information should consult the Exchange at the earliest opportunity.

15A.69 An issuer may use a “base listing document” containing the information required by this Chapter and Part D of Appendix 1 in relation to the issuer and the derivative warrants and which the issuer considers will apply generally in respect of all derivative warrants or in relation to a particular type of derivative warrant in respect of which listing is sought on the Exchange during such period in which the base listing document is valid.

15A.70 If an issuer uses a base listing document, it shall be supported by a “supplemental listing document” containing the information required by this Chapter and Part D of Appendix 1 and which the issuer considers is specific to the derivative warrant in respect of which listing is sought.

- 15A.71 The base listing document and the supplemental listing document must together contain all the information required by this Chapter and Part D of Appendix 1 in relation to the issuer and the derivative warrants. The supplemental listing document must contain a declaration by the issuer that the information contained in the base listing document is up-to-date and is true and accurate as at the date of the supplemental listing document or include details of any changes to the information contained in the base listing document.
- 15A.72 A base listing document shall be valid for a period of 12 months from the date on which it is published or (if earlier) until such date as the issuer submits its annual accounts to the Exchange in accordance with rule 15A.22 whereupon an issuer must file a further base listing document. A base listing document may not be amended without the prior approval of the Exchange.
- 15A.73 If, at any time after the issue of the listing document (including any base listing document or supplemental listing document) and before the commencement of dealings in the derivative warrants for which listing is sought, the issuer becomes aware that:–
- (1) there has been a significant change affecting any matter contained in the listing document; or
 - (2) a significant new matter has arisen, the inclusion of information in respect of which would have been required to be included in such listing document if it had arisen before such listing document was issued,
- the issuer (unless the Exchange agrees otherwise) shall, as soon as practicable, submit to the Exchange for its review a supplementary listing document giving details of the change or new matters. For this purpose “significant” means significant for the purpose of making an informed assessment of the matters mentioned in rule 15A.68.
- 15A.74 No amendment to the final proof of the listing document (including any base listing document, supplemental listing document or supplementary listing document) shall be made without the prior consent of the Exchange.
- 15A.75 A listing document (including any base listing document, supplemental listing or supplementary listing document) shall not be issued until the Exchange has confirmed to the issuer that it has no comments thereon.
- 15A.76 Except where expressly provided, every director of an issuer is required to accept responsibility for the information contained in a listing document (including any base listing document, supplemental listing document or supplementary listing document). Where listing of the derivative warrants is sought by way of a placing to professional investors and securities dealers, this statement may be given on a corporate basis.

15A.77 A listing document may include illustrations of a pictorial or graphic nature provided that such illustrations are not misleading or likely to mislead in the form and context in which they are included.

15A.78 If the derivative warrants are marketed in Hong Kong to “professional persons” the listing document need not contain a Chinese translation, unless required to do so by applicable securities legislation but, must be in the English language or contain a English translation certified by a person acceptable to the Exchange. A Chinese translation of the listing document must be available upon request.

Documents of Title and Admission into CCASS

15A.79 Subject to rule 15A.83, derivative warrants shall be represented by definitive documents of title.

15A.80 Subject to rule 15A.81 and rule 15A.83, derivative warrants must be Eligible Securities from the date on which dealings in the derivative warrants are to commence.

15A.81 An issuer shall ensure that all necessary arrangements are made in order to comply with sub-paragraph rule 15A.80 above. The Exchange may, in its absolute discretion, waive compliance with this rule.

15A.82 An issuer shall ensure, so far as it is able, that its derivative warrants remain Eligible Securities.

15A.83 Alternative forms of documents of title and alternative settlement arrangements may be used by agreement with the Exchange. The Exchange should be consulted at the earliest opportunity if alternative forms of documents of title or alternative arrangements are proposed.

Expiry of Derivative Warrants

15A.84 An issuer shall, not less than 15 business days prior to the expiry day in relation to any of its derivative warrants, publish in the newspapers a notice containing, inter alia, the following:–

- (1) the date of expiry, the last expected date of dealings and the date of withdrawal from listing of the derivative warrants;
- (2) the exercise price;
- (3) if applicable, the method of calculation of the cash payment;
- (4) the expected date of payment or delivery (as the case may be);

- (5) moneyness (being the extent to which a derivative warrant is in-the-money or out-of-the-money expressed as a percentage of the exercise price) of the derivative warrant as of the latest closing price before the publication of the announcement; and
- (6) such other information as the Exchange shall require.

Withdrawal of Listing

- 15A.85 An issuer may apply to withdraw the listing of a derivative warrant prior to its expiry if the derivative warrant is held entirely by the issuer or members of the issuer's group.
- 15A.86 Where a derivative warrant has been fully exercised prior to expiry, an issuer is required to notify the Exchange of the full exercise as soon as practicable so that the Exchange may delist the derivative warrant accordingly.

Suspension of Trading

- 15A.87 In addition to the provisions of rules 6.02 and 6.03 of the Exchange Listing Rules, where the securities or assets underlying derivative warrants listed on the Exchange are suspended from trading for whatever reason on the market on which they are listed or dealt in (including the Exchange), trading on the Exchange in derivative warrants relating to such securities or assets shall also be suspended.
- 15A.88 The Exchange shall, save in exceptional circumstances, suspend from trading on the Exchange basket warrants which have one or more of their underlying securities suspended from trading in the market or exchanges on which such suspended security or securities are listed and the value or aggregate value of such suspended security or securities represents 30 per cent ("Specified Percentage") or more of the total value of all securities comprised in the basket, or such other Specified Percentage as announced by the Exchange from time to time. The value of the suspended security or securities shall be determined by reference to the price of such securities immediately prior to their suspension on the market or exchanges in which they are listed.

Registrar

- 15A.89 The issuer must be an approved share registrar or employ an approved share registrar to maintain in Hong Kong its register of warrant holders.

Listing Fees

15A.90 Details of the listing fee are set out in Appendix 8.

Authorised Representatives

15A.91 Every issuer is required to appoint two authorised representatives in accordance with rules 3.05 to 3.07 save that one of the two authorised representatives must be a senior officer of the compliance department of the issuer and/or the guarantor.

Appendix 6A

Placing Guidelines for Derivative Warrants

1. The guidelines set out in this Appendix are not exhaustive and each case must be considered in the light of its own particular circumstances. In addition, the criteria set out below may in consultation with the Exchange be amended or extended from time to time. Each placing will be reviewed upon its completion to ensure that the guidelines have been or will be satisfied.

Note: In the case of a guaranteed issue, references in this Appendix to the “issuer” should be read as applying equally to the guarantor.

2. An issuer may retain up to but not more than 15 per cent. of a derivative warrant issue. In calculating the proportion of the total issue retained by an issuer, derivative warrants held by the issuer’s holding company, its subsidiaries and associates for the account of the issuer or for their own respective accounts shall be counted as belonging to the issuer.
3. The issuer must ensure that adequate distribution facilities are available, manage the application list and determine a fair basis for allocating derivative warrants when an issue is oversubscribed.
4. The derivative warrants to be placed must have an adequate spread of holders. An issue of derivative warrants will satisfy this guideline if, upon listing,
 - (i) there are at least 100 holders; or
 - (ii) there are at least 50 holders who each take up not less than HK\$100,000 worth of derivative warrants.
5. The respective holdings of each of the top 5 placees must be disclosed to the Exchange on the business day immediately preceding the day of listing of the derivative warrant. The Exchange will release this information to the market through its news dissemination system. The same information must also be included in the listing document of the derivative warrants.
6. Not more than 20 per cent. of a derivative warrant issue shall be placed with any person or persons who are connected persons of the company whose securities are the underlying securities to an issue of derivative warrants or any associate or associates of such connected persons.

7. Save as expressly provided in this Appendix no allocations will be permitted to:–
 - (1) “connected clients” (as defined in paragraph 14),
 - (2) connected persons of the issuer or any associates of such persons or their nominees, and
 - (3) subject to (2) above nominee companies unless the name of the ultimate beneficiary is disclosedwithout the prior written consent of the Exchange.
8. Not more than 25 per cent. of a derivative warrant issue may be allocated to “discretionary managed portfolios” (as defined in paragraph 14).
9. Not more than 10 per cent. of a derivative warrant issue may be offered to employees of the issuer or individuals who were employed by the issuer within the 6 months before the date of launch of the derivative warrant.
10. These guidelines apply equally to every member of the Exchange with whom or through whom the derivative warrants are placed by the parties referred to in paragraph 14(2)(a).
11. Separate Marketing Statements in the form set out in Form D in Appendix 5 signed by each of the parties referred to in paragraph 14(2)(a) and any member of the Exchange referred to in paragraph 10 must be lodged with the Exchange before dealings commence.
12. Dealings in the derivative warrants cannot commence until the Exchange has been supplied with and approved a list setting out the names, addresses and identity card or passport numbers (where individuals) and the names, addresses and registration numbers (where companies) of all placees, the names and addresses of the beneficial owners (in the case of nominee companies) and the amount taken up by each placee. Such lists may be supplied directly to the Exchange by the parties referred to in paragraph 14(2)(a) and any member of the Exchange referred to in paragraph 10 to maintain confidentiality.
13. The parties referred to in paragraph 14(2)(a) and any member of the Exchange referred to in paragraph 10 must keep a record of their placees for at least three years following the placing.

14. The following definitions shall apply this Appendix:–

- (1) A connected client is any client of a relevant party who is:
 - (a) a partner of the relevant party;
 - (b) an employee of the relevant party;
 - (c) where a relevant party is a company, a connected person or associate of such relevant party;
 - (d) a close relative of any person in (a) to (c) above whose account is managed in pursuance of a discretionary managed portfolio agreement by such relevant party; or
 - (e) a company which is a member of the same group of companies as such relevant party.
- (2) A relevant party is:
 - (a) the lead manager, the co-managers, any distributors or placing agents, or any party involved in the management, distribution or placing of the derivative warrants; or
 - (b) any member of the Exchange with whom or through whom the derivative warrants are placed by the parties in 14(2)(a) above.
- (3) “discretionary managed portfolio” means a fund of investments, the contents of which are kept under review by a relevant party or any member of its group which has authority to effect or arrange for the effecting of transactions for a fund at its discretion.

Questionnaire

Comments

Please complete this questionnaire and return it to:

Head – Listing, Regulation & Risk Management
Hong Kong Exchanges and Clearing Limited
11th Floor, One International Finance Centre
1 Harbour View Street
Central

Fax: (852) 2971 0170

E-mail: warrants@hkex.com.hk

Responses should arrive no later than the close of business on 30th June, 2001.

Background Information

Please advise whether you are:

Current Warrant Issuer (see note)

Former Warrant Issuer (see note)

Listed Issuer

Institutional Investor

Retail Investor

Other, please specify _____

Note: A current warrant issuer is one who has listed warrants on the Exchange in the past twelve months. A former warrant issuer is one that has listed warrants on the Exchange but not in the past twelve months.

The following information is not mandatory:

Name _____

Organisation _____

Address _____

Telephone _____

E-mail _____

Consultation Issues:

The Placing Guidelines

The Exchange proposes to abolish the current placing requirement (under which issuers are required to place warrants to a minimum of 100 places or to 50 places each of whom takes HK\$100,000 of warrants) and the current 15% limit on the percentage of an issue which an issuer may retain at launch. Thus, an issuer could launch a warrant and retain the entire issue.

1. Do you support the proposal to abolish the placing requirement?
 - Yes
 - No, please explain and (if appropriate) specify number of places

2. Do you support the proposal to remove the current 15% limit on the percentage of an issue which an issuer may retain on launch?
 - Yes
 - No, please explain and (if appropriate) specify a percentage limit

3. Other comments _____

Market Making

The Exchange seeks comments on the type of market making system it should introduce.

4. Should the Exchange introduce
 - a buyback obligation for warrant issuers
 - an obligation for warrant issuers to respond to quote request
 - an obligation to respond to quote requests as a transitional measure before introducing a requirement for continuous market making
 - a continuous market making requirement

It is proposed at this stage to introduce an obligation for warrant issuers to respond to quote requests submitted via the AMS/3 trading system.

5. Do you support this proposal
 Yes
 No
6. Do you support the proposed spread obligation of 5 spreads?
 Yes
 No, please specify a spread obligation _____
7. Do you support the proposed volume obligation of ten board lots?
 Yes
 No, please specify a volume obligation _____
8. Do you support the proposed permitted response time of 3 minutes?
 Yes
 No, please specify a response time _____
9. Should issuers be required to respond to quote requests in the five trading days before the expiry of warrant issue?
 Yes
 No
10. Are there any circumstances, in addition to those in paragraph 61 of the consultation paper under which an issuer should not be obliged to respond to quote requests?
 Yes, please specify _____
 No
11. Do you believe the Exchange should keep the quote request system under review and may subsequently introduce a requirement for continuous market making?
 Yes
 No, please explain _____
12. Other comments _____

It is proposed to require an additional risk factor to be included in listing documents, to emphasize to investors that there may be a liquidity risk in buying warrants.

13. Do you support this proposal?
 Yes
 No

14. Other comments _____

Issuer's Retention Level

The Exchange proposes to require issuers to disclose in the launch announcement the percentage of a warrant issue that they have retained.

15. Do you support this proposal?

- Yes
- No

16. Other comments _____

Issue Sizes & Quota

The Exchange seeks comment on whether there should be any issue limit over warrants relating to a particular underlying share.

17. Do you agree the Exchange should remove all issue limits?

- Yes
- No, please explain why and specify the level for the market as a whole
 - the current 20% limit
 - other limits, please specify _____

The Exchange proposes to limit the maximum size of new individual issues and Further Issues of warrants. The limit could take the form of a maximum market capitalisation level. Alternatively, the number of shares of an underlying company that an issue was exerciseable could be restricted.

18. Should a quote system apply to individual warrant issues or to the market as a whole

- Individual issue (see question 19)
- Market as a whole, how could this work _____

19. Do you support the proposal to limit individual issue sizes?

- Yes, see below
- No, please explain and suggest alternatives to ensure that “quota limits” are not utilised unduly quickly _____

If you answered “yes” should the limit be based on:

- initial market capitalisation of the warrant issue, please specify limit _____
- multiple of average trading volume of the underlying share, see below.

Should that multiple be:

- three days average trading volume
- five days average trading volume
- ten days average trading volume
- other (please specify) _____

Should that average be calculated over

- sixty trading days
- ninety trading days
- other period (please specify) _____

20. Other comments _____

Further Issues of Warrants

The Exchange proposes to repeal the existing limitation on the aggregate market capitalisation of Further Issues of derivative warrants.

21. Do you support this proposal?

- Yes
- No, please explain _____

The Exchange proposes to permit issuers to launch Further Issues where they hold up to a specified percentage of the warrant issue (including any previous Further Issues).

22. Do you support this proposal?

- Yes, see below
- No, please explain _____

If you answered “yes” please indicate whether the specified percentage should be:

- 15%
- 20%
- 25%
- 30%
- other (please specify) _____

The Exchange proposes to shorten the minimum period to expiry permitted at the time a Further Issue is launched.

23. Do you support this proposal?

Yes, see below

No, please explain _____

If you answered “yes” please indicate whether the minimum life should be:

one month

two months

three months

other period (please specify) _____

24. Other comments _____

Issuer Eligibility

No changes are proposed to the existing issuer eligibility requirements.

25. Do you support this proposal?

Yes

No, see below

Should changes be made to:

the net asset requirement, please specify _____

the credit rating requirement, please _____

other requirements, please _____

26. Other comments _____

Stock Eligibility

The Exchange proposes that stocks which are constituents of the Hang Seng Index (“HSI”) should be eligible for single stock warrant issuance. Other stocks will continue to be required to meet the existing public float capitalisation criteria.

27. Do you support this proposal?

Yes

No, please explain _____

The Exchange intends to continue to regard shares held by persons holding 5% to less than 10% of the issued share capital of a company as being part of the public float of that company for the purposes determining whether it is eligible for warrant issuance.

28. Do you support this proposal?

Yes

No, please explain _____

29. Other comments _____

Cash Settlement Formula

The Exchange proposes to permit the cash settlement amount paid to warrant holders who exercise American style warrants prior to the expiry of those warrants to be based on the closing price of the underlying security on the day of exercise.

30. Do you support this proposal?

Yes

No, please indicate how cash settlement amount should be calculated

31. Should there be a limit on the number of warrants in a warrant issue that may be exercised each day?

Yes, see below

No, please explain _____

If you answered "Yes" should that limit be:

a fixed number of warrants (please specify) _____

a fixed percentage of the warrant issue (please specify) _____

other limit (please specify) _____

No changes are proposed to the existing cash settlement formula that applies for the automatic exercise of warrants on their expiry.

32. Do you support this proposal?

Yes

No, see below

If you answered "no" please indicate how the cash settlement amount should be calculated _____

33. Other comments _____

Disclosure of Securities Dealings

Exchange proposes to repeal the requirement to disclose details of dealings in the security underlying a warrant issue six weeks prior to the announcement of the issue.

34. Do you support this proposal?
 Yes
 No, please explain _____

35. Other comments _____

Research Reports

The Exchange proposes to remove the restriction on warrant issuance where an issuer has issued or updated an analyst's research report on the security or asset underlying a warrant issue. Issuers will be required to state in the Listing Document whether they or companies associated with them have published research on the securities or assets underlying a warrant issue.

36. Do you support this proposal?
 Yes
 No

37. Other comments _____

Contents of Listing Documents

The Exchange proposes that financial information on an issuer shall not be required in a listing document where the warrant issue is guaranteed by a guarantor. The requirement for this information to be made available for inspection will continue.

38. Do you support this proposal?
 Yes
 No, please explain _____

The Exchange proposes to permit issuers or, in the case of guaranteed issues, guarantors, to publish summarised annual accounts and summarised interim results in listing documents. Full accounts and interim reports will be submitted to the Exchange for publication on HKEx's web site and will continue to be available for inspection throughout the life of a warrant issue.

39. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes to repeal the requirement to include a summary of the published audited consolidated financial statements in the listing document for warrants on companies listed on the Exchange. Issuers will continue to be required to make the annual accounts available for inspection in Hong Kong until the warrant expires.

40. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes that for warrants on companies listed overseas the existing requirement to publish the overseas' company's full annual accounts should be replaced with a requirement to provide a summary of the financial statements. A similar summary of an underlying company's interim reports is also to be included in the listing document. The current obligation on issuers to make the full annual accounts and interim reports available for inspection throughout the life of the warrant will continue.

41. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes to remove the requirement to provide:

- a description of the principal activities of the underlying company and its subsidiaries;*
- details of the underlying company’s authorised and issued share capital; and*
- details of the underlying company’s directors’ and substantial shareholders’ interests in the company*

for inclusion in the listing document where the company underlying a warrant issue is listed on the Exchange. Warrant issuers will continue to be required to provide this information in relation to companies which are not listed on the Exchange

42. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes for warrants over indices to repeal the requirement to disclose historic highs and lows and most recent closing prices of underlying indices in the listing document. A requirement to publish the most recent closing level of the index in the launch announcement will be introduced.

43. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes to exempt warrants over the Hang Seng Index from the requirement to disclose a description of the index; description of the constituent stocks (if applicable); the identity of the party which sponsors and/or calculates the index; and a description of the method of calculation.

44. Do you support this proposal?

Yes

No, please explain _____

45. Should other indices be exempted from this requirement?

Yes, specify other indexes _____

No

The Exchange proposes to modify its existing requirement to disclose details of the arrangements where an index is not published by the normal party by making it clearer that this is a matter which must be addressed in the terms and conditions for a warrant.

46. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes to amend paragraph 25 of Appendix 1d to require:

“A statement of the number of outstanding issues of derivative warrants made by the issuer analysed into those issues listed on the Exchange, those issues listed on another exchange and those issues which are unlisted”

47. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes no changes to the requirement to include the full text of the guarantee in the Listing Document.

48. Do you support this proposal?

Yes

No, see below

If you answered “no” should the Exchange replace the above rule with a requirement to include a summary of the guarantee in the Listing Document and obligations to make the guarantee available for inspection and to make copies available on request?

Yes

No

49. Other comments _____

Warrant Terms & Conditions

The Exchange proposes to reduce the minimum market capitalisation of a derivative warrant on launch from HK\$50 million to HK\$10 million. There will continue to be no minimum market capitalisation for Further Issues of derivative warrants.

50. Do you agree the Exchange should retain a minimum issue size on launch?

Yes

No, please explain _____

51. Do you support the Exchange’s proposal to reduce the minimum market capitalisation on launch from HK\$50 million to HK\$10 million?

Yes

No, specify minimum market capitalisation _____

52. Do you agree that there should continue to be no minimum issue size on Further Issue?
- Yes
 - No, specify minimum market capitalisation _____

The Exchange proposes in the case of cash settled warrants only, that a board lot of warrants shall represent either a whole number of board lots of the underlying or one-tenth of a board lot of the underlying security.

53. Do you support this proposal?
- Yes
 - No, please explain _____

The Exchange proposes no changes to the minimum and maximum life of derivative warrants on initial launch.

54. Do you support this proposal?
- Yes
 - No, see below

If you answered “no” please explain and specify:

A minimum life _____

A maximum life _____

55. Other comments _____

Announcements

The Exchange proposes to replace the existing requirement for announcements to be published in the newspaper with a requirement to release announcements through HKEx’s web site.

56. Do you support this proposal?
- Yes
 - No, please explain _____

The Exchange proposes to amend the launch announcement requirements. Where more than one warrant is launched by an issuer on the same day, one announcement (containing the required information for the issues launched on that date) may be issued rather than the current practice, of issuing two or more separate announcements.

57. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes to allow announcements which set out expiry details for more than one warrant issue provided that all the warrant issues in that announcement expire at least 10 business days after the publication date and not more than 20 business days after the publication date.

58. Do you support this proposal?

Yes

No, please explain _____

59. Other comments _____

Warrants on Overseas Markets

The Exchange has listed derivative warrants on the following indexes: the Dow Jones Industrial Average Index; the Standard and Poor's 500 Index; the Nasdaq 100 Index; the Nikkei 225 Index; the Morgan Stanley Taiwan Index; and the Dow Jones Taiwan Index.

60. Should the Exchange recognise other overseas indexes as being suitable for warrant issuance?

Yes, please specify indexes _____

No

The Exchange proposes to add membership of a leading index in respect of its home market as a criteria which the Exchange will consider in determining whether an Overseas Company is eligible for warrant issuance.

61. Do you support this proposal?

Yes

No, please explain _____

The Exchange proposes that where an overseas company has an investor relations web site containing information that it is required by the rules and regulations of its home market to make available to the public issuers of warrants over that company will be relieved of the obligation to undertake to make this information available for inspection. In such a case it would be necessary for issuers to include the address of the Overseas Company's web site in the Listing Document for the warrant issue. Warrant Issuers would be required to confirm to the Exchange that the investor relations web site contained all the information that the overseas company was required by the rules and legislation of its home market to make available to shareholders and the public.

62. Do you support this proposal?

- Yes, see below
- No

If you answered "yes" should the Exchange include links to these web sites on its web site?

- Yes
- No

63. Other comments _____

Standardisation of Warrant Terms & Conditions

The Exchange is considering including standard terms and conditions in relation to warrant issues in an appendix to the Listing Rules. Issuers could then refer to these terms in listing documents rather than printing them in full.

64. Do you support this suggestion?

- Yes, see below
- No, please explain _____

If you answered "yes" please suggest specific terms and conditions to be included in such an appendix _____

65. Other comments _____

Prospectus Registration Requirement for Warrant Issuance

The Exchange proposes to require the Listing document issued in respect of warrants to be registered as a prospectus under the Companies Ordinance.

66. Do you support this proposal?
 Yes
 No, please explain _____
67. Please suggest specific waivers from the requirements of the Companies Ordinance that would be necessary to give effect to this proposal _____
68. Other comments _____

Any Other Comments

69. Are there any other comments you wish to make in respect of the proposals in the consultation paper or any other aspect of the Listing Rules in relation to derivative warrants?

Please specify _____