

HONG KONG EXCHANGES AND CLEARING LIMITED

GUIDE ON ENHANCING REGULATION OF THE LISTED STRUCTURED PRODUCTS MARKET

27 July 2012

Purpose of the Guide

1. The purpose of this guidance material is to enhance regulation of the listed structured products market and it applies to all approved structured products issuers in Hong Kong.

Introduction

2. The Exchange invited structured products issuers in September 2011 to discuss a range of issues to enhance regulation of the structured products market.
3. A working group, representing active structured products issuers, the Securities and Futures Commission (the “**SFC**”) and the Exchange have deliberated on various issues aimed at developing high standards across the listed structured products market and promoting investor confidence. The Exchange has taken into account the views from various parties and made refinements leading to the publication of this Guide. This Guide covers the following areas:
 - Streamlining listing documentation
 - Introducing new active quote standards as industry best practices
 - Tightening liquidity providing obligations for quote requests
 - Monitoring liquidity provision performance
 - Enhancing internal controls and systems
 - Loss of issuer eligibility upon occurrence of a credit rating downgrade
 - Investor communication strategy
 - Issuers’ conduct and personal account dealing rules
 - Marketing materials

Failure to follow this Guide will reflect adversely on the capability and suitability of an issuer to issue and manage listed structured products.

4. The working group has also formulated industry principles on liquidity provision (the “**Industry Principles**”) to enhance service levels to investors. The new active quote standard is a significant improvement on service levels currently set out in the listing documents. The Industry Principles is attached as the Appendix.

Streamlining listing documentation

5. Listing documents should adopt consistent presentation formats, common definitions and standard terms to make the documents more user-friendly, facilitate clear

comparison of competing product offerings and avoid market confusion caused by different market practices. Plain language should be used to enhance readability.

6. Standardized templates for supplemental listing documents will be published and updated by the Exchange from time to time. Issuers should adopt the standardized templates for new issuance involving local equity and index as underlying not later than 31 October 2012.

Introducing new active quote standards as industry best practices

7. All issuers currently adopt quote requests as the means of liquidity provision in the listing documents. The attached Industry Principles introduces new active quote standards under which liquidity providers will provide liquidity for products with an active underlying under certain market conditions as elaborated in the Industry Principles. All issuers should follow the Industry Principles on active quote standards not later than 31 December 2012.
8. The maximum bid-ask spread should be:
 - (a) warrant on local index underlying : 5 spreads
 - (b) CBBC on local index underlying : 10 spreads
 - (c) warrant on actively traded stock underlying : 10 spreads
 - (d) CBBC on actively traded stock underlying : 15 spreads
9. While the Exchange considers issuers should strive to provide quotes all the time when the prescribed criteria for active quotes are met, we recognize that issuers may temporarily cease quoting for a short period of time to adjust quotes in response to market conditions or other operational needs. The Exchange will monitor the duration of time during which active quotes are provided by issuers for each product and may require an issuer to explain if (i) it fails to provide active quotes for at least 90% of the Qualified Period (as defined in the Industry Principles) of a trading day; or (ii) any temporary cessation of active quotes exceeds 10 minutes in the Qualified Period. The Exchange may review and adjust the monitoring thresholds from time to time.
10. These principles, developed by the industry, are intended to encourage improved market conduct and the development of consistently high standards across the listed structured products' industry. While issuers should comply with these principles, the principles are not intended to be binding commitments nor should they give rise to enforceable obligations or duties. Occasional failure to comply with the Industry Principles will not in itself render an issuer or its liquidity agent liable to any sanction or enforcement action. However, compliance with the Industry Principles is relevant to the Exchange's assessment of an issuer's suitability to list structured products.
11. The Industry Principles are a significant first step to enhance service levels of liquidity provision. The Exchange will monitor the results of implementation and consider the effectiveness of these best practices. The Exchange together with the industry may also review the Industry Principles and make suitable adjustments from time to time where appropriate.

Tightening liquidity providing obligations for quote requests

12. Issuers should incorporate the following service levels in their listing documents not later than 31 October 2012:
 - (a) maximum quote response time : 10 minutes
 - (b) maximum bid-ask spread : 20 spreads
 - (c) minimum quote size : 20 board lots

The Exchange may not approve listing applications for structured products if these service standards are not incorporated in the relevant listing documents.

13. Issuers should introduce a minimum holding time of 5 minutes. If the price of the underlying or prevailing market circumstance changes, issuers can refresh the quote by posting a new pair of quotes. A quotation lapses if any investor has proceeded with a trade during the five minutes holding period.

Monitoring liquidity provision performance

14. Issuers should have internal systems and procedures to monitor whether actual performance meets committed obligations. Issuers should keep records of actual liquidity provision performance which enable them to demonstrate when a particular quote request was received and how it was dealt with. Issuers should report the content of such records to the Exchange upon request.
15. Issuers should provide a report to the Exchange reviewed and signed by their compliance officers when there are material breaches of liquidity provision obligations.
16. Issuers must record complaints made with respect to their structured products as required by their internal policies and the SFC's Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct"). The complaint log should be readily available to the Exchange upon request.
17. Issuers should inform the Exchange immediately upon becoming aware of any events which affect their ability to provide liquidity and publish announcements to inform the market as soon as possible.
18. The Exchange may publish from time to time information about an issuer's failure to provide liquidity in accordance with this Guide or the listing documents, including technical failure and mispricing.

Enhancing internal controls and systems

19. Issuers should put in place adequate internal control systems to ensure accuracy of documentation and enable error detection. Frequent errors, irrespective of materiality, may indicate internal control weaknesses on documentation and may affect the structured products issuers' status. Past experience indicates that incidents and errors

could have been avoided if there are:

- (a) adequate resources and sufficient time for the documentation process;
- (b) sufficient communication and coordination among different departments and external counsel;
- (c) robust review by staff with adequate technical competency;
- (d) robust and regular review of documentation controls; and
- (e) regular staff training to ensure they understand and adhere to the stated controls.

The above list is not exhaustive. Issuers are recommended to devise their internal controls and systems based on their specific circumstances.

- 20. Issuers should also conduct periodic reviews or drills testing the adequacy and effectiveness of their risk management and technical systems relating to structured products. Procedures should be put in place to monitor unusual price and volume movements of structured products. Contingency handling procedures including backup arrangements to minimize disruption time should be devised to handle unanticipated situations.
- 21. Issuers should follow the following protocol:
 - (a) inform the Exchange immediately of (i) errors that affect terms and conditions; (ii) errors that relate to disclosure required by the Listing Rules; (iii) matters which may cause unusual trading price or volume or an establishment of a false market; or (iv) the occurrence of a fast market, operational or technical problem or other matters that affect its ability to provide liquidity as set out in this Guide or the listing documents;
 - (b) provide a preliminary impact assessment and the basis on whether suspension is needed or not needed as soon as possible;
 - (c) publish an announcement about the incident as soon as possible;
 - (d) where the error involves terms and conditions set out in the listing documents, provide a legal opinion whether the error affects the validity of the intended terms and conditions as soon as possible; and
 - (e) where appropriate, provide a preliminary incident report on the cause of the incident and proposed remedial measures as soon as possible.
- 22. Consideration will be given to the cause of the incident, materiality, market impact, frequency of errors and prior compliance records. The Exchange may take the following actions as appropriate:
 - (a) suspend new issuance until satisfactory remedial measures are taken;

- (b) request issuers to appoint an independent professional party to review the adequacy of internal control procedures; and/or
- (c) take disciplinary action including assessment of an issuer's suitability to manage structured products issuance.

Loss of issuer eligibility upon occurrence of a credit rating downgrade

- 23. An issuer of non-collateralized structured products can meet the eligibility requirement through it or its guarantor (a) having a credit rating of one of the top three investment grades awarded by Moody's or Standard & Poor's or (b) being regulated by the Hong Kong Monetary Authority ("HKMA") or the SFC.
- 24. In light of market concern about the risks associated with non-collateralized structured products, the Exchange invited issuers (which are not regulated by the HKMA or the SFC) to provide concrete proposals on collateralization including the value and form of collateral and possible ways to mitigate credit risk on outstanding structured products position. The working group expressed concerns on practical and legal difficulties relating to collateralization. Nevertheless, the Exchange continues to encourage issuers to provide proposals on this subject.
- 25. Issuers not regulated by the HKMA or the SFC must follow the following measures in the event that they no longer fulfill the relevant requirement of the Listing Rules due to a credit rating downgrade:
 - (a) the issuer must publish an announcement regarding the credit rating downgrade and its continuing obligation to provide liquidity and perform settlement obligation upon expiry;
 - (b) the issuer must not launch new issues or further issues; and
 - (c) the issuer must apply for withdrawal of (i) products launched but not yet listed and (ii) products with no outstanding position in the market.
- 26. Issuers must prominently display the non-collateralized nature of structured products and highlight the associated risks in their listing documents and marketing materials.

Investor communication strategy

- 27. The past experience of the Exchange in handling investor complaints indicated that some complaints were caused by investors' misunderstanding of liquidity provider obligations, nature of structured products and how pricing may be affected. Issuers should therefore allocate adequate resources for investor education. This should include, among other things:
 - (a) publishing on issuers' websites an agreed industry response to the questions most frequently asked by investors no later than 31 October 2012;

- (b) setting up a dedicated or user friendly hotline to answer enquiries and complaints. Complaints must be handled in a timely and appropriate manner. This involves an immediate investigation with possible remedial action and a prompt response to the complainant;
 - (c) organizing regular investor seminars; and
 - (d) conducting regular assessment on sufficiency and effectiveness of investor education programs for future planning.
28. Issuers should lay down procedures on how to communicate with investors, regulators and media, particularly in response to unanticipated events. The communication should be timely and transparent.

Issuers' conduct and personal account dealing rules

29. Issuers should act in the best interests of the integrity of the structured products' market and not bring that market or the Exchange into disrepute. The Exchange may suspend new issuance of listed structured products for issuers failing to comply with this Guide and commence a review of their suitability to act as listed structured product issuers.
30. Issuers, whether or not they are licensed or authorized by the SFC, should observe the relevant sections in the Code of Conduct including the general principles, employee dealings, complaints handling and responsibility of senior management.
31. Issuers should formulate best practices on staff personal account dealings for products issued by their own firms or by other issuers.

Marketing materials

32. Issuers should adopt the principles for disclosure and presentation of advertisements set out in the *Guidelines on Marketing Materials for Listed Structured Products* published by the SFC. Any such marketing materials should also prominently display the non-collateralized nature of structured products and highlight the associated risks.

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

July 2012

1. Introduction

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

2. What is liquidity and why is it required?

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

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

3. Quote Request

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

3.2 Minimum service levels for Quote Request are:

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

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

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

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

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

4. Active Quotes

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

Criteria for Active Quotes

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

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

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

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

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

4.3 An active underlying means:

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

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

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

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

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

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

Period for Active Quotes

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

Minimum service levels for Active Quotes

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

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

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

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

Active Quotes may not be continuous

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

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

Voluntary provision of Active Quotes

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

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