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Please reply to : Mr. Anthony Lam

The Commission Secretariat  
Securities and Futures Commission  
8/F Chater House  
8 Connaught Road Central  
Hong Kong**BY HAND & FAX (2523-4825)****Attn.: Mr. Martin Wheatley**

Dear Sirs,

**Re: A Healthy Market for Informed Investors -  
A Report on the Derivative Warrants Market in Hong Kong ("the Report")**

We act for a client who is a market participant in Stock Exchange of Hong Kong.

We refer to the press release of your reputable Commission dated 25<sup>th</sup> November 2005 and the Report wherein you welcomed interested parties in expressing their views, comments and concerns about the proposals before the end of January 2006. In this respect, we are therefore instructed to herein put on record our client's views, comments and concerns for your consideration.**Liquidity Providers**

We appreciate that your reputable Commission very much concerns the market conduct and quality of information provided to investors and have committed yourself to make the market more efficient, fair and competitive.

**I. Supervision of in-house liquidity providers**

While it is your believe the liquidity provider system is necessary to provide a distribution mechanism for issuers to sell their derivative warrants, and an exit mechanism for investors who wish to pull out from an investment in a derivative warrant (c.f. paragraph 24), our client failed to reckon the basis of your believe that

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there is more likelihood of an issuer properly supervising the liquidity provider if they are part of the same group. And our client is unable to find any subjective data or example which could demonstrate the view that external LP is any worse than in-house LP.

**II. Deter healthy competition**

We trust you must appreciate that many issuers and potential issuers may not have a brokerage house within its group to act as liquidity providers (e.g. international banking institutions). By instituting regulations compelling issuers to set up its own brokerage house to act as liquidity providers would imply additional cost centre to those issuers and potential issuers that do not currently have a brokerage house. The cost implication would deter issuers and potential issuers and further created a barrier for potential issuer to enter into the market. Besides, additional costs for setting up in-house brokerage services are likely to be reflected in the price of the derivative warrants. Such are in clear conflict with your reputable Commission's objective to make the market more efficient, fair and competitive. More importantly, it would run into the pit-fall whereby over-regulating would undermine Hong Kong's status as an international financial centre and the market for derivative warrants would be dominated by those selected few issuers that have established its in-house liquidity providers.

In addition, based on your observation that trading in derivative warrants and equity-linked instruments do have an opposite hedging effect (c.f. paragraphs 125-128) it necessary implies the existence of both derivative warrants and equity-linked instruments are essential to stabilize both markets. Any attempts to reduce competition in derivative warrant market are not only superfluous but undesirable.

**III. Wastage of capital and resources of brokerage firms**

As per paragraph 45 of the Report and the table showing the growth in derivative warrant issues since 2000, it is noted that the number of listed derivative warrants and newly listed derivative warrants contracted substantially in 2001 over 2000. With the implementation of 2002 reform, market sentiment for derivative warrants slowly recoup. One the one hand, you reckon that issuers had put a lot of resources into promoting their derivative warrants and enhancing their brand name at the retail level (c.f. paragraph 38), it is likewise on the other hand that many brokerage firms had invested substantial capital and resources in concert with your implementation of the liquidity provider system (including but without limitation to investing in efficient information and technology system and platform). The heavy investments of these brokerages in both capital and resources would turn futile. We believe that many brokerage houses plan their investment base on 5 or even 10 years time horizon. The 2002 warrant market reform was in place for less than 4 years. It is extremely

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difficult for the industry to cope with the sudden change in policy within such a short period of time. We believe changing policy frequently suffocates long term investment of the industry. The frequent changing environment only encourages short term investment and we believe it will lead to poor quality of compliance and service. Eventually, the investing public will suffer.

Acting as liquidity providers for issuers had now become the bread and butter for many exchange participants. By banning non-in-house liquidity providers is equivalent to imposing death sentences to many brokerages. Besides, those brokerages that are non-in-house liquidity providers are deprived of the opportunity or otherwise forbidden to serve the service sector of an issuer.

**IV. Use of external liquidity providers**

Without concrete evidence and statistics, our client disagree that an issuer will have less control over the activities of the external liquidity providers and that they have less incentive to closely monitor them as there is less reputational risk to the issuer (c.f. paragraph 159). Whereas issuers are keen in promoting their derivative warrants and enhancing their brand name at the retail level, exchange participants are also conscious on their goodwill bearing in mind there are over 400 exchange participants in the market and business remains highly competitive.

Some LP are acting purely as an execution brokers and they are not responsible to determine the price of those warrants. It is unfair and unnecessary to deprive those brokers to receive buy/sell instruction from their clients (issuers).

**V. Suggestion for prohibition of external liquidity providers from some issuers**

It is our client's believe that such suggestions are from mega-size issuers who have their in-house liquidity providers. Such suggestions are, to a certain extent, in the view of our client, malice in nature with a view to dominate the derivative warrant market by driving out the smaller issuers. We trust your reputable Commission would carefully consider such proposal when it ultimately reduce the number of issuers in the market and thus competitiveness.

In the event that the proposal for prohibition of external liquidity providers be adopted, existing external liquidity providers will be driven out of the market. Therefore, despite that your reputable Commission will consider transitional arrangements for issuers who do not have a local brokerage arm in Hong Kong, it is unlikely that any external liquidity providers will be available to such issuer. Even if in the unlikely event that such external liquidity providers are available, it is foreseeable that that such issuers have to pay additional premium for such external liquidity

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providers and we run into the dilemma that costs be transferred to the investing public or otherwise a reduction in competition of available issuers.

**VI. Maximize Economy**

To achieve maximum economy, it is the world trend for industry segmentation with each segment specializing in particular process of work. Such industry segmentation would not only reduce operating costs but also improve efficiency. Likewise, it is our client's view that industry segmentation can be achieved via the engagement of external liquidity providers in the derivative warrant industry. More importantly, perhaps a check-and-balance protocol could be struck between the issuer and liquidity provider as separate individual entity.

**VII. Queries and suggestions**

Should there be any market mis-behaviour, your reputable Commission should take such disciplinary actions as you deem fit rather than undermining the privileges of other well-behaved exchange participants in providing services as external liquidity providers. "Drawing conclusions from a part" is therefore inappropriate under all circumstances.

Perhaps, your reputable Commission shall consider the following:-

- (a) To implement mandatory undertaking system - requiring those exchange participants that act as liquidity providers to undertake certain responsibilities; and
- (b) To implement rules and regulations - prescribing the rights, obligations and responsibilities of both internal and/or external liquidity providers.

**Data and Statistics – The Foundation**

We noted that you have on numerous occasions stressed that from January to October 2005, issuers were involved – as either purchaser or seller – in about 73% of the total transactions by value (i.e. 73% of the total turnover). We are instructed that such statement is biased and misleading. Any issuer of a particular derivative warrant must have one and only one liquidity provider and a liquidity provider are not permitted to transact with itself. There are circumstances where sellers and/or buyers are in the market and an investor can complete a transaction with the willing seller or buyer without invoking the liquidity provider. However, if there are no sellers and/or buyers, liquidity providers are obliged to respond to investor's requests for quotes (c.f. paragraph 81(3)).

More importantly, It is our client's understanding if not of the industry that the "total transaction by value" or "total turnover" is derived when a matching sale transaction merges

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with a purchase transaction (i.e. total transaction by value or total turnover = sale transactions + purchase transactions / 2). Your said 73% is therefore an inflated or exaggerated figure when it might more appropriately be 36.5% after taking into consideration of the dual directional nature of "total transaction by value" or "total turnover".

In view of the inflated or exaggerated statistics, the public might be misconceived, and in particular by the following statements in the Report:-

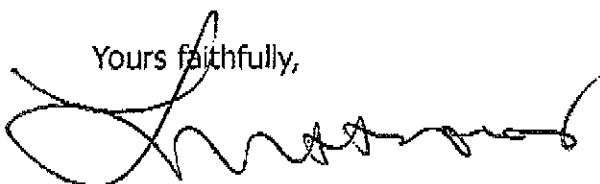
- Para.18 "There is a significant growth in issuers' trading activities"
- Para.38 "This indicates that trading in derivative warrants relies heavily on the participation of derivative warrant issuers."
- Para.95 "Derivative warrant issuers dominate trading activities in their own derivative warrants (see paragraph 38 above). The readiness of the liquidity provider to participate to such a large extent attracts investors as they then see the market as being full of liquidity and trading opportunities. This in turn further increases liquidity in the market."
- Para.186 "The supply of derivative warrants is largely controlled by the issuer of them. Issuers are also typically involved in over 70% of all trades in their warrants (see paragraph 38 above). As a result, issuers set the prices for their derivative warrants."

**CONCLUSIONS**

We conclude by stressing herein that it is our client's view that prohibition against the engagement of external liquidity providers are contrary to your reputable Commission's objective to provide an efficient, fair and competitive market environment. Not only the livelihood of exchange participants be severely affected but general investors will also have limited access to derivative warrants offered by the selected or privileged few that have their own in-house liquidity providers. The derivative warrant market will thereby easily be controlled by the mega-size issuers. We are instructed to herein sincerely urge your Commission to reconsider the proposal in prohibiting external liquidity providers when it ultimately reduce the number of issuers in the market and thus competitiveness in general.

Thank you for your kind attention to the matter.

Yours faithfully,



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