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## Frozen warrants in Hong Kong

# A \$45m typo

## Goldman Sachs gets burned by, er, Goldman Sachs

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FOR Hong Kong's population, trading in complex financial products rivals a day at the track. Despite the territory's tiny size, its market for "exchange-traded warrants" is the most active in the world. Last year's turnover of \$534 billion put it far ahead of South Korea and Germany, the next biggest. The instruments give investors the right to buy a security at a fixed price, allowing them to bet on which way a market will move or to arbitrage differences between the warrant and its components.

Almost 14,400 such products were issued in Hong Kong last year by a dozen or so big banks, each with a prospectus the size of a phone book that must be approved by the exchange's listing committee and incurs a registration fee of HK\$100,000 (\$13,000). Given the warrants' complexity, problems can emerge. Few cases will excite more *Schadenfreude* than that involving Goldman Sachs.

On February 11th Goldman issued four warrants tied to Japan's Nikkei index which were described in three separate filings amounting to several hundred pages. Buried in the instructions to determine the settlement price was a formula that read "(Closing Level – Strike Level) x Index Currency Amount x Exchange Rate". It is Goldman's contention that rather than multiplying the currency amount by the exchange rate, it should have divided by the exchange rate. Oops.

The mistake meant that the warrant should have had a much higher price than that quoted by Goldman. According to a report compiled for Hong Kong's legislature, the exchange was notified at 9.10am on March 31st by a lawyer for Goldman that an error had been made and quotes would be suspended. At 9.40am, just after the opening of trading, the exchange began receiving complaints from traders who wanted to buy in. By 10.52am, with prices spiking and after a request from Goldman, the exchange suspended trading. The notes have been frozen ever since.

Goldman has made an offer to buy back the warrants from holders for a 10% premium on their purchase price, plus a fixed payment to cover broker fees. In resisting a settlement tied to the published formula, Goldman cites a clause in the prospectus that lets an issuer change terms "of a formal, minor or technical nature, which is made to correct an obvious error".

This argument has not won over the 124 warrant-holders. Based on the formula provided in the prospectus, says one of them, Goldman could be on the hook for HK\$350m, as opposed to the estimated HK\$10m being offered. The bank's offer has already been extended once because of lacklustre response. Holders also allege that after it notified the exchange of the problem but before trading was frozen, Goldman continued to bid to buy back the warrants while ceasing sell offers that would have meant disclosing the real price based on the prospectus. Goldman merely says it made offers at the "correct" price.

There are wider issues at stake. Warrant-holders slam the Hong Kong exchange, not just for approving the prospectus but for trading softly around an important, and profitable, client.

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Frozen warrants in Hong Kong: A \$45m ...

(The exchange has launched an investigation of its own.) Politicians are taking an interest. "If it was possible to renege even on what was written down in black and white, how can we possibly be an international financial centre any more?" asked James To, a member of the Legislative Council (Legco), at a hearing in April; another Legco hearing was held this week and a further one is due in June. Perhaps the biggest question of all concerns the complexity of these instruments. What other risks might be lurking in the market undergrowth?

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