



Hong Kong

March 2016

HONG KONG SFC PUBLISHES CIRCULAR ON REQUIREMENTS FOR AUTHORISATION OF LEVERAGED AND INVERSE PRODUCTS STRUCTURED AS ETFs

The Securities and Futures Commission of Hong Kong (the **SFC**) has published a Circular on Leveraged and Inverse Products¹ (the **Circular**) setting out the requirements for SFC authorisation of leveraged and inverse products which are structured as exchange traded funds (**ETFs**) for public offering in Hong Kong (**Leveraged and Inverse Products**).

Background

Leveraged and Inverse Products are regarded as a new type of collective investment scheme, although in overseas markets, they are more commonly known as Leveraged ETFs and/or Inverse ETFs. They are becoming increasingly popular in overseas markets, predominantly in Asia, and the SFC thinks that there might be a demand for these products in Hong Kong.

Leveraged Products typically aim to deliver a daily return equivalent to a multiple of the underlying index return that they track, while Inverse Products typically aim to deliver the opposite of the daily return of the tracked underlying index.

To be authorised for public offering in Hong Kong, Leveraged and Inverse Products are required to meet the relevant requirements of the Overarching Principles Section and the Code on Unit Trusts and Mutual Funds (**UT Code**) in the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products. In view of the complexity and novelty

of Leveraged and Inverse Products, the SFC has set out additional requirements in the Circular that Leveraged and Inverse Products must meet in order to be authorised by the SFC under sections 104 and 105 of the Securities and Futures Ordinance.

Requirements

Product Structure

Leveraged and Inverse Products seeking SFC approval are required to have a swap-based synthetic replication structure or a futures-based replication structure.

The SFC has imposed the following limits on the leverage factor (subject to reviews going forward):

- i) Leveraged products must be subject to a maximum leverage factor of two times (2x); and
- ii) Inverse Products must be subject to a maximum leverage factor of one time (-1x). This means that Inverse Products cannot be leveraged.

Further, to allow Hong Kong investors to become familiar with Leveraged and Inverse Products and to allow the SFC to monitor their potential impact on investors, the SFC proposes that:

¹ SFC. Circular on Leveraged and Inverse Products. 5 February 2016 at <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC6>.

- i) in the first stage, the SFC will only accept applications for authorisation for Leveraged and Inverse Products tracking liquid and broadly based non-Hong Kong, non-Mainland foreign equity indices;
- ii) a review to consider extending eligible indices to include liquid and broadly based Hong Kong equity indices will be conducted by the SFC 6 months after the launch of the initial batch of Leveraged and Inverse Products; and
- iii) the eligible indices for Leveraged and Inverse Products will be kept under review. However, the SFC does not currently plan to accept applications for products tracking Mainland indices.

Product Naming

In order to deliver their specified leveraged or inverse return, Leveraged and Inverse Products have to rebalance their portfolios, typically on a daily basis. Due to this daily trading characteristic, Leveraged and Inverse Products that have been authorised by the SFC should not be called “ETFs”. Instead, they should be called “Leveraged Products” or “Inverse Products” and the product name must include the leverage or inverse factor and the word “daily” to highlight the daily rebalancing aspect of these products. For example:

- i) A two-time Leverage Product: “[Issuer] [Index] Daily (2x) Leverage Product”; and
- ii) A one-time Inverse Product: “[Issuer] [Index] Daily (-1x) Inverse Product”.

The Hong Kong Exchanges and Clearing Limited (**HKEx**) and the SFC have created a segregated category for these products on their respective websites. They will also be assigned distinctive stock codes and distinctive stock short names, beginning with an “L” for Leveraged Products, and an “I” for Inverse Products. Further details regarding the stock short name and stock code can be found on the HKEx webpage.

Experience of Management Company of Leveraged and Inverse Products

The management company of a futures-based Leveraged and Inverse Product must meet the specialist expertise requirement under 8.4A(i) of the UT Code.²

Offering Document Disclosure

On top of the disclosure requirements under 8.6 and Appendix C of the UT Code, the offering documents for Leveraged and Inverse Products are required to contain the following upfront disclosures in the product key facts statement so that investors understand that Leveraged and Inverse Products do not have the buy-to-hold characteristics of conventional ETFs:

- a) a warning against holding Leveraged and Inverse Products for longer than the rebalancing interval, typically one day;
- b) Leveraged and Inverse Products are not intended for long term investment but are rather designed as a trading tool for short-term market timing or hedging purposes;
- c) Leveraged and Inverse Products are only suitable for sophisticated trading-oriented investors who constantly monitor the performance of their holdings on a daily basis; and
- d) the performance of Leveraged and Inverse Products may deviate from the underlying indices if they are held longer than the rebalancing interval (i.e. held overnight).

Clear disclosure of the costs of entering into the swap with the counterparty is required for Leveraged and Inverse Products using swap-based synthetic replication structures. These should include, but are not limited to, all costs which are not captured by the ongoing charges figure under the 16 December 2014 supplemental circular to management companies of SFC-authorized Funds on “Disclosure of the ongoing charges figure and past performance information in the Product Key Facts Statements”. Clear disclosure of the maximum amount of the redemption fee is also required.

² When determining the acceptability of the management company, the SFC (i) considers its specific experience in the field of futures and options, (ii) may also consider the qualifications and experience of persons employed by the management company. An applicant must provide details of the performance of all futures funds under its management or the management of the employees responsible for the applicant scheme for the preceding five years.

Market Making Arrangements

There must be at least one market maker for a Leveraged and Inverse Product at the commencement of trading and on an ongoing basis. To be eligible, an exchange participant must possess at least 1 year's prior Leveraged and Inverse Products official market making experience. In particular:

1. the exchange participant must have at least 1 trading person in Hong Kong who has participated in market making of Leveraged and Inverse Products in overseas markets and/or in Hong Kong for at least 1 year; or
2. where a group entity is providing technical assistance to the exchange participant, the relevant group entity must have at least 1 trading person who has participated in market making of Leveraged and Inverse Products in overseas markets and/or in Hong Kong for at least 1 year.

The HKEx may permit a market maker for ETFs to make markets for Leveraged and Inverse Products after becoming a participating dealer for Leveraged and Inverse Products in Hong Kong for a period of at least 1 year. The HKEx considers that market makers and their performance are especially important for Leveraged and Inverse Products given their investment purpose as a short term trading instrument. As a result, the HKEx will:

1. monitor the performance of market makers on an ongoing basis. Those who fail to meet the required performance levels may have their market maker permits revoked and/or be banned from applying for market maker permits for other Leveraged and Inverse Products for a period specified by the HKEx; and
2. require the termination of Leveraged and Inverse Products in the event of resignations of all market makers. The Leveraged and Inverse Products provider and market maker should provide a sufficiently long resignation notice period to enable an orderly unwinding and termination of the products. The termination should be implemented at approximately the same time as the last market maker's termination becomes effective.

Performance Simulator

Providers of Leveraged and Inverse Products are required to provide a performance simulator, which will allow investors to select a historical time period and simulate the performance of the Leveraged and Inverse Product during that period

based on historical data. To demonstrate the performance of the Leveraged and Inverse Product under different market conditions, it is expected that:

- a) the historical period available should cover the period since the launch of the Leveraged and Inverse Product;
- b) the interface of the performance simulator should be constructed in a way that is user-friendly and easy to navigate and understand, using diagrams and tables if appropriate; and
- c) the website of the Leveraged and Inverse Product should include explanations of the results of the performance simulator which should set out key assumptions, parameters and formulae used in the calculation.

The Leveraged and Inverse Products section on the HKEx website will have links to the performance simulator of each Leveraged and Inverse Product authorised by the SFC.

Providers of Leveraged and Inverse Products are expected to provide comprehensive investor education prior to launching Leveraged and Inverse Products in Hong Kong.

Distribution

Leveraged and Inverse Products are derivatives products. Intermediaries who provide services in relation to Leveraged and Inverse Products are therefore subject to the applicable requirements of the Code of Conduct for Persons Licensed or Registered with the SFC, in particular the requirements of paragraphs 5.1A to 5.3 which are relevant to the provision of services to clients with respect to derivative products.³

Margin Financing

Generally, margin financing is permitted for Leveraged and Inverse Products subject to an individual exchange participant's risk management policy. However, the HKEx has advised exchange participants not to grant margin financing to investors for trading Leveraged and Inverse Products due to their leveraged and/or inverse features and the additional leverage impact from margin financing.

³ Refer to Circular on Providing Services to Clients with respect to Leveraged and Inverse Products for guidance to intermediaries on the applicable requirements.

Application

The SFC has advised that if clarification is required of any aspects of the Circular, inquiries should be directed to the team supervisor or case officer of the Investment Products Division who is responsible for overseeing the SFC-authorized funds of the relevant fund group or client.

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