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5 February 2016

Circular on Leveraged and Inverse Products

1. This circular sets out the requirements under which the SFC would consider authorising leveraged and inverse products structured as exchange traded funds (ETFs) for public offering in Hong Kong under sections 104 and 105 of the Securities and Futures Ordinance. Hereafter, leveraged and inverse products structured as ETFs are referred to as “Leveraged Products” and “Inverse Products” respectively, and “L&I Products” collectively.

Background

2. L&I Products have become increasingly popular in overseas markets, particularly in Asia, and there may be 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. On the other hand, Inverse Products typically aim to deliver the opposite of the daily return of the underlying index that they track. To produce the specified leveraged or inverse return, these products have to rebalance their portfolios, typically on a daily basis.
3. L&I Products seeking SFC authorization for public offering in Hong Kong must meet the applicable requirements in the Overarching Principles Section (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 (SFC Handbook).
4. In view of their novelty and the technical complexity, to protect the interests of the investing public of Hong Kong and to maintain the integrity of the Hong Kong market, L&I Products that are seeking SFC authorization for public offering in Hong Kong should meet the additional requirements set out in this circular.

Requirements

Product naming

5. In view of the day trading nature of L&I Products as opposed to the investment nature of conventional ETFs, L&I Products that have been authorized by the SFC should not be named “ETFs”. Instead, these products must be named “Leveraged Products” or “Inverse Products”, as the case may be. In addition, the product name should always



include the leverage or inverse factor and the word “daily” to emphasise the daily rebalancing aspect of these products. To illustrate, as examples:

- a) a two-time Leveraged Product should be called “[Issuer] [Index] Daily (2x) Leveraged Product”¹; and
 - b) a one-time Inverse Product should be called “[Issuer] [Index] Daily (-1x) Inverse Product”².
6. In addition, L&I Products will be put under a new, standalone product category in the websites of the SFC and Hong Kong Exchanges and Clearing Limited (HKEX). They will have their own distinctive stock short names, beginning with an “L” for Leveraged Products, and an “I” for Inverse Products. Distinct stock code ranges will also be designated for L&I Products.
7. Further details regarding the stock short name and stock code arrangements can be found in the HKEX webpage³.

Product Structure

8. Both swap-based synthetic replication and futures-based replication structures are allowed for L&I Products seeking SFC authorization.
9. The following caps on the leverage factor are set at the initial stage, subject to review going forward:
- a) Leveraged Products shall be subject to a maximum leverage factor of two times (2x); and
 - b) Inverse Products shall be subject to a maximum leverage factor of one time (-1x). (i.e. Inverse Products cannot be leveraged)
10. As with conventional ETFs, we expect L&I Products to track indices with constituent securities which are sufficiently liquid and broadly based. Given the novelty of these products in the Hong Kong market, we would like to give Hong Kong investors time to familiarise themselves with L&I Products while allowing the SFC to monitor the potential investor impact. As such,
- a) at the initial stage, the SFC will only accept applications for L&I Products tracking liquid and broadly based non-Hong Kong, non-Mainland foreign equity indices;
 - b) the SFC will conduct a review 6 months after the launch of the initial batch of L&I Products, to consider extending eligible indices to include liquid and broadly based Hong Kong equity indices;

¹ The Chinese name of a two-time Leveraged Product is expected to be [發行人][指數]每日槓桿(2x)產品

² The Chinese name of a one-time Inverse Product is expected to be [發行人][指數]每日反向(-1x)產品

³ Please refer to the HKEX website at <http://www.hkex.com.hk/eng/prod/secprod/lip/LIProduct.htm>



- c) we will continue to keep in view the eligible indices of L&I Products but, at this stage, the SFC has no plan to accept applications for L&I Products tracking Mainland indices.

Experience of management company of L&I Products

- 11. The management company of futures-based L&I Products should meet the specialist expertise requirement as set out in 8.4A(i) in the UT Code.

Offering documents disclosure

- 12. In addition to the requirements under 8.6 and Appendix C of the UT Code, the offering documents of L&I Products shall contain upfront disclosure of the following in the product key facts statement (Product KFS) so that investors will not mistakenly assume L&I Products share the buy-to-hold characteristics of conventional ETFs:
 - a) A warning against holding L&I Products for longer than the rebalancing interval, typically one day;
 - b) L&I Products are designed as a trading tool for short-term market timing or hedging purposes, and are not intended for long term investment;
 - c) L&I 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 L&I Products, when held overnight, may deviate from the underlying indices.
- 13. For L&I Products using swap-based synthetic replication structures, we expect clear disclosure of the costs of entering into the swap with the counterparty. These should include, without limitation, 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*”. We also expect clear disclosure of the maximum amount of redemption fee.

Market making arrangements

- 14. The L&I Product provider shall ensure that there is at least one market maker for the L&I Product at the commencement of trading and on an ongoing basis.
- 15. As required by the HKEX, to be eligible as market makers of L&I Products, an exchange participant must possess at least 1 year prior L&I Products official market making experience, specifically:



- a) the exchange participant must have at least 1 trading person in Hong Kong who has participated in market making of L&I Products in Hong Kong and/or overseas markets for at least 1 year; or
 - b) where a group entity will provide technical assistance to the exchange participant, the relevant group entity must have at least 1 trading person who has participated in market making of L&I Products in Hong Kong and/or overseas markets for at least 1 year.
16. The HKEX may allow a market maker for ETFs in Hong Kong to make markets for L&I Products after it has become a participating dealer for L&I Products in Hong Kong for a period of at least 1 year. Please refer to the HKEX website⁴ and consult with HKEX if in doubt.
17. To enable an L&I Product to meet its investment objectives as a short term trading tool, it is important that investors are able to enter into and exit their investments. As such, the presence of market makers as well as their performance is particularly important for L&I Products. In view of this,
- a) we require that an L&I Product must be terminated in the event of resignations of all market makers. The termination should take place at about the same time as the resignation of the last market maker becoming effective. The L&I Product provider and market maker should provide for a sufficiently long resignation notice period to allow for an orderly unwinding and termination of the product. In addition, advance notices of termination must be issued to investors pursuant to 11.5 of the UT Code; and
 - b) the performance of market makers will be monitored by the HKEX on an ongoing basis. Those who fail to meet the performance requirements set by the HKEX may have their market maker permits revoked and/or be banned from applying for market maker permits for other L&I Products for a period of time. Please refer to the HKEX website for details of the relevant HKEX requirements.

Performance simulator

18. The provider of an L&I Product is required to make available a “performance simulator”, which allows investors to select a historical time period and simulate the performance of the L&I Product during that period based on historical data. To demonstrate the performance of the L&I Product under different market conditions, it is expected that:
- a) The historical period available in the performance simulator should cover the period since the launch of the L&I Product.
 - b) The interface of the performance simulator should be designed in a way that is user-friendly and easy to navigate and understand, using diagrams and tables where appropriate.

⁴ Please refer to the HKEX website at <http://www.hkex.com.hk/eng/prod/secprod/lip/LIPProduct.htm>



- c) The website of the L&I Product should include narratives to help investors understand the results of the “performance simulator” and should set out the key assumptions, parameters and formulae used in the calculation.
19. The designated section for L&I Products on the HKEX website will contain hyperlinks to the performance simulator of each L&I Product authorized by the SFC.
20. In addition to the above, providers of L&I Products are expected to carry out extensive investor education before launching L&I Products in Hong Kong.

Distribution

21. As L&I Products are derivatives products, intermediaries are subject to the applicable requirements under the Code of Conduct when they provide services to clients with respect to L&I Products. Please refer to the Circular on Providing Services to Clients with respect to Leveraged and Inverse Products⁵ for guidance to intermediaries on the applicable requirements.

Margin Financing

22. Please refer to the circular issued by HKEX to exchange participants advising them not to provide margin financing to investors for trading of L&I Products⁶.

Application

23. The SFC understands that this is the first time that L&I Products may seek authorization from the SFC. If you wish to seek clarification of any aspects of this circular, please contact the team supervisor or case officer of the Investment Products Division who is responsible for overseeing the SFC-authorized funds of your fund group or client.

Investment Products Division Securities and Futures Commission

⁵ Available via: <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=16EC7>

⁶ Available via: <http://www.hkex.com.hk/eng/market/partcir/sehk/2016/Documents/MKDCMS00116E.pdf>