



Hong Kong

June 2017

SFC REQUIREMENTS FOR AUTHORISING LEVERAGED AND INVERSE PRODUCTS FOR PUBLIC OFFERING

Introduction to Leveraged and Inverse Products

Leveraged and inverse products structured as Exchange Traded Funds (ETFs) (**Leveraged Products** and **Inverse Products** respectively, and **L&I Products** collectively) are authorised by the Securities and Futures Commission (SFC) as Collective Investment Schemes (CIS). L&I Products are listed and traded on the Hong Kong Stock Exchange's (HKEx) securities market, and may be traded, cleared and settled in HKD, RMB and/or USD. Overseas, they are generally known as Leveraged and/or Inverse ETFs.

L&I Products are financial derivatives. Leveraged Products seek to deliver a daily return equivalent to a multiple of the underlying index return that they track, e.g. if the underlying index increases by 10% in one day, a two-time (2x) leveraged product aims to deliver a 20% return on the same day. Inverse Products seek to deliver the opposite of the daily return of the underlying index that they track, e.g. if the underlying index increases by 10% in one day, an inverse product aims to incur a 10% loss on the same day.

Under the Securities and Futures Ordinance (Cap 571) (SFO), SFC authorisation is required for all L&I Products listed in Hong Kong. For SFC authorisation, applicants must satisfy the relevant CIS requirements in the Code on Unit Trusts and Mutual Funds in the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (SFC Handbook), as well as additional requirements under the SFC's "Circular

on Leveraged and Inverse Products"¹ dated 5 February 2016, which was supplemented by the "Supplemental Circular on Leveraged and Inverse Products"² dated 23 December 2016.

L&I Product provider applicants should obtain the SFC's authorisation prior to applying for listing on the HKEx. L&I Products' listing is governed by Chapter 20 (Authorized Collective Investment Schemes) of the HKEx's Main Board Listing Rules.

In February 2016, the SFC issued a circular which specified the requirements under which it would consider authorising L&I Products for public offering in Hong Kong under SFO sections 104 (SFC may authorise collective investment schemes) and 105 (SFC may authorise issue of advertisements, invitations or documents). The circular required that the L&I Products' underlying indices be liquid and broadly based non-Hong Kong, non-Mainland foreign equity indices. This was followed by a six-month review to consider whether to extend such indices to include liquid and broadly based Hong Kong equity indices. Following the review, the SFC issued a supplemental circular in December 2016, and agreed to accept (i) liquid and broadly based Hong Kong and non-Mainland foreign equity indices; and (ii) on a case by case basis, non-equity indices, where the indices meet the relevant requirements in the Code on Unit Trusts and Mutual Funds, and subject to the full implementation of the measures specified in the circulars on leveraged and inverse products. The SFC decided not to

- ¹ <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=16EC6>
- ² <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=16EC70>

extend authorisation to products tracking other indices due to the novelty of the products in Hong Kong as well as their technical complexity.

On 9 January 2017, the SFC commenced accepting applications for L&I Products tracking Hong Kong equity indices and non-equity indices.

Supplemental Circular on Leveraged and Inverse Products

The “Supplemental Circular on Leveraged and Inverse Products” dated 23 December 2016 details the requirements under which the SFC would consider authorising L&I Products for public offering in Hong Kong under sections 104 and 105 of the SFO.

Background

Leveraged Products are financial products which seek to deliver a daily return equivalent to a multiple of the underlying index return that they track. Inverse Products are financial products which seek to deliver the opposite of the daily return of the underlying index that they track. In order to deliver the stipulated leveraged or inverse return, L&I Products must rebalance their portfolios, generally on a daily basis.

L&I Products seeking SFC authorisation for public offering in Hong Kong must satisfy the relevant requirements in the Overarching Principles Section and the Code on Unit Trusts and Mutual Funds in the SFC Handbook. Additional requirements as specified in the circular are set out below.

Requirements

Product Naming

L&I Products should not be named “ETFs” given their day trading nature, which is in contrast to conventional ETFs’ investment nature. These products are required to be named “Leveraged Products” or “Inverse Products”, as applicable, and include the leverage/inverse factor and the word “daily” in their names. For example:

- a two-time Leveraged Product – “[Issuer] [Index] Daily (2x) Leveraged Product”; and
- a one-time Inverse Product – “[Issuer] [Index] Daily (-1x) inverse Product”.

L&I Products will be featured under a standalone product category on the SFC and HKEx websites.

L&I Products will have distinctive code ranges and stock short names, with Leveraged Products beginning with “L” and Inverse Products beginning with “I”.

Product Structure

L&I Products with swap-based synthetic replication or futures-based replication structures are eligible for SFC authorisation.

The initial caps on the leverage factor, which may be subject to future review, are:

- Leveraged Products – maximum leverage factor of two times (2x); and
- Inverse Products – maximum leverage factor of one time (-1x).

Currently, the SFC only accepts applications for L&I Products tracking (i) liquid and broadly based Hong Kong and non-Mainland foreign equity indices, and (ii) on a case-by-case basis, non-equity indices. The SFC will monitor the eligible indices of L&I Products, but currently has no intention to extend authorisation to L&I Products which track Mainland indices.

Experience of Management Company of L&I Products

The management company of futures-based L&I Products should satisfy the specialist expertise requirement of 8.4A(i) of the Code on Unit Trusts and Mutual Funds. The SFC must be satisfied that the applicant management company and the investment advisor (if applicable) have specific experience in futures and options. In assessing the acceptability of the management company, the SFC may also consider the qualifications and experience of employees of the management company or the investment adviser. The company is required to supply the SFC with details of the performance of all futures funds under its management or its employees’ management for the previous five years.

Offering Documents Disclosure

L&I Products’ offering documents are required to fulfil the requirements of 8.6 (Index Funds) and Appendix C (Information to be disclosed in the offering document) of the Code on Unit Trusts and Mutual Funds.

Additionally, in order to ensure that investors will not make the incorrect assumption that L&I Products share the buy-to-hold characteristics of conventional ETFs, L&I Products' offering documents are required to include the following upfront disclosures in the product key facts statement:

- a warning against holding L&I Products for longer than the rebalancing interval, typically one day;
- 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;
- L&I Products are only suitable for sophisticated trading-oriented investors who constantly monitor the performance of their holdings on a daily basis; and
- the performance of L&I Products, when held overnight, may deviate from the underlying indices.

In relation to L&I Products using swap-based synthetic replication structures, the SFC requires clear disclosure of the costs of entering into the swap with the counterparty. Costs disclosed should include, without limitation, all costs which are not captured by the ongoing charges figure under the 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" dated 16 December 2014. Clear disclosure of the maximum amount of redemption fee is also required.

Market Making Arrangements

L&I Product providers must ensure that there is at least one market maker for the product at the commencement of trading and on an ongoing basis.

The HKEx requires that market makers of L&I Products must have at least one year experience in L&I Products official market making. In particular, the exchange participant or the group entity (in cases of group entities providing technical assistance to the exchange participant) must have a minimum of one trading person in Hong Kong who has participated in market making of L&I Products in Hong Kong and/or overseas markets for a minimum of one year.

The HKEx may permit market makers for ETFs in Hong Kong to become market makers for L&I Products after becoming a participating dealer for L&I Products in Hong Kong for a minimum of one year.

An L&I Product is required to be terminated where all market makers resign. Termination should occur around the same time as the last resignation becomes effective. The L&I Product provider and market maker should allow a sufficiently long resignation notice period to ensure an orderly unwinding and termination of the L&I Product. Further, advance notices of termination are required to be issued to investors in accordance with the requirements of the Code on Unit Trusts and Mutual Funds. Paragraph 11.5 of the code provides that where a scheme is to be terminated, in addition to following any procedures in the scheme's constitutive documents or governing law, notice is required to be given to investors as determined by the SFC. Notice should be submitted to the SFC for its prior approval and include the reasons for termination, the relevant provisions under the constitutive documents enabling such termination, the consequences of the termination and its effects on existing investors, the alternatives available to investors (including, if possible, a right to switch without charge into another authorised scheme), and the estimated costs of the termination and who is expected to bear them.

L&I Product providers are subject to ongoing disclosure requirements, and in particular the provision of daily reports to the HKEx³. The HKEx will monitor market makers' performance on an ongoing basis. Failure to meet the HKEx's performance requirements for a continuous period of two months may result in the revocation of market maker permits and/or being banned from applying for market maker permits for other L&I Products for one year.⁴

Performance Simulator

L&I Product providers are required to make available a "performance simulator" through which investors are able to select a historical time period and simulate the L&I Products' performance during the selected period based on historical data. In order to demonstrate the L&I Product's performance under various market conditions, the SFC expects that:

- the historical time period should encompass the period since the product's launch;
- the interface should be user-friendly, and easy to navigate and understand, with diagrams and tables where appropriate; and

³ <https://www.hkex.com.hk/eng/prod/secprod/lip/LIPlaunch.htm> "On-going disclosure"

⁴ <https://www.hkex.com.hk/eng/prod/secprod/lip/LIPsmm.htm> "SMM performance for L&I Products"

- the L&I Products' website should contain narratives to facilitate investors' understanding of the performance simulator's results and should specify the key assumptions, parameters and formulae used in the calculation.
- participants not to provide margin financing to investors for trading of L&I Products, given the leveraged and/or inverse characteristics of L&I Products and the additional leverage impact from margin financing.

Performance simulators of SFC-authorized L&I Products will be accessible via a hyperlink on the L&I Products section of the HKEx website.

Further, the SFC expects L&I Product providers to carry out extensive investor education prior to launching L&I Products in Hong Kong.

Distribution

Intermediaries which provide L&I Products services to clients are subject to the relevant requirements under the Code of Conduct for Persons Licensed by or Registered with the SFC. Paragraphs 5.1A to 5.3 of the code contains 'know your client' obligations which apply to licensed or registered persons providing client services in relation to derivative products, such as L&I Products. The SFC further reminded intermediaries about these obligations in its Circular on "Providing Services to Clients with respect to Leveraged and Inverse Products"⁵ dated 5 February 2016.

In this February 2016 circular, the SFC also stated that intermediaries should establish appropriate measures, including the provision of staff training, so as to ensure that staff are familiar with the risks and features of investment products and comply with the relevant requirements when serving clients. Additional information can be found in the SFC's circular on "Code of Conduct Requirements with respect to Derivative Products"⁶ dated 31 August 2010. The SFC also reminded intermediaries to act in their customers' best interests, and, in particular, intermediaries must be aware that gearing to invest in a product compounds the underlying risk.

Margin Financing

The HKEx issued a circular entitled "Launch of Leveraged and Inverse Products"⁷ on 5 February 2016, advising exchange

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

6 <http://www.sfc.hk/edistributionWeb/gateway/EN/circular/openFile?refNo=H596>

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

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