HONG KONG MONETARY AUTHORITY
香港金融管理局

Banking Conduct Department 銀行操守部

Our Ref: B1/15C
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3 September 2010

The Chief Executive
All Registered Institutions

Dear Sir / Madam,

Synthetic Exchange-Traded Funds (ETFs) and Related Products

With the increasing popularity of ETFs and related products, I am writing to remind registered institutions (RIs) to put in place appropriate measures to ensure compliance with the relevant regulatory requirements when soliciting or making recommendations to clients to invest in such products, particularly those involving synthetic replication strategy.

The principal objective of an ETF is to track the performance of an underlying index[1]. Some ETFs gain exposure to the underlying index by investing in shares, bonds or other assets that make up the index. Nevertheless, an increasing number of ETFs adopt a different replication strategy by investing in derivative instruments designed to replicate the performance of the index. Investors of such synthetic ETFs are exposed to the credit risk of the counterparties who issued the derivatives, in addition to the risks of the index synthetically replicated by the ETFs. In turn, products with performance linked to synthetic ETFs also expose the investors to such risks.

It is therefore important that when soliciting or providing recommendations to clients to invest in synthetic ETFs and related products (collectively "Synthetic ETF Products"), RIs should ensure that the material features and risks of such products are adequately disclosed to customers and taken into account in the product due diligence process and the suitability assessment of customers.

Disclosure of product features and risks

RIs should disclose and explain to customers the key features and risks of a product. In the context of Synthetic ETF Products, this should include, among other things, the index that the synthetic ETF is tracking, the replication strategy, any embedded

[1] Some ETFs may track the performance of a group of assets such as commodities instead of an index.

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derivatives and collateral. The major risks associated with synthetic ETFs are highlighted below:

- Market risk – Customers are exposed to the political, economic, currency and other risks related to the synthetic ETF's underlying index.

- Counterparty risk – Where a synthetic ETF invests in derivatives to replicate the index performance, customers are exposed to the credit risk of the counterparties who issued the derivatives, in addition to the risks relating to the index. Further, potential contagion and concentration risks of the derivative issuers should be taken into account (e.g. since derivative issuers are predominantly international financial institutions, the failure of one derivative counterparty of a synthetic ETF may have a "knock-on" effect on other derivative counterparties of the synthetic ETF). Some synthetic ETFs have collateral to reduce the counterparty risk, but there may be a risk that the market value of the collateral has fallen substantially when the synthetic ETF seeks to realise the collateral.

- Liquidity risk – A higher liquidity risk is involved if a synthetic ETF involves derivatives which do not have an active secondary market. Wider bid-offer spreads in the price of the derivatives may result in losses.

- Tracking error – There may be disparity between the performance of the synthetic ETF and the performance of the underlying index due to, for instance, failure of the tracking strategy, currency differences, fees and expenses.

- Trading at a discount or premium – Where the index/market that the synthetic ETF tracks is subject to restricted access, the efficiency in unit creation or redemption to keep the price of the synthetic ETF in line with its net asset value (NAV) may be disrupted, causing the synthetic ETF to trade at a higher premium or discount to its NAV. Investors who buy a synthetic ETF at a premium may not be able to recover the premium in the event of termination.

Product due diligence and risk rating

RIs should ensure that the major features and risks highlighted above are taken into account in the product due diligence process, including the continuous review of product risk ratings. Where the review results in a higher risk rating being attributed to a Synthetic ETF Product, RIs should notify the customers concerned[2].

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[2] See circulars of 23 October 2008 and 25 March 2009 issued by the HKMA, and the Questions and Answers on Suitability Obligations issued by the Securities and Futures Commission.

Product and customer suitability

RIs should take into account the complexity of an investment product when assessing suitability of customers for the product, and assure themselves that customers have a reasonable understanding of the nature, structure (including the tracking strategy), and risks of the Synthetic ETF Products when making a recommendation or solicitation[3].

Other obligations regarding derivative products

Where derivatives or leverage is involved, RIs should also be sure that the customer has sufficient net worth to be able to assume the risks and bear the potential losses[4]. Pursuant to the recently added paragraph 5.1A of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission which will take effect in June 2011, where a client characterised as without knowledge of derivatives wishes to purchase a Synthetic ETF Product involving derivatives, even if no solicitation or recommendation is made, RIs should,

(a) where the product is traded on an exchange, explain to the client the risks associated with the product; and

(b) where the product is not traded on an exchange, warn the client about the transaction and provide appropriate advice as to whether the transaction is suitable for the client.

RIs should ensure compliance with all the relevant regulatory requirements regarding Synthetic ETF Products. The HKMA will assess the compliance of RIs in our supervisory process.

Yours faithfully,

Meena Datwani
Executive Director (Banking Conduct)

c.c. SFC (Attn: Mr Stephen Po, Senior Director of Intermediaries Supervision)

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[3] See the HKMA circular of 23 October 2008

[4] Paragraph 5.3 of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission