# Derivative Products Features and Risk Disclosures

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***This document is intended as a general guide to highlight some basic facts and characteristics of certain types of derivative products. Haitong International Securities Group of Companies endeavour to ensure the accuracy and reliability of the information provided, but do not guarantee its accuracy and reliability and accept no liability for any loss or damage arising from any inaccuracies or omissions. Trading in derivative products involve high risks. Investors are strongly advised to have a thorough understanding of the product as well as the terms and conditions of the product being offered and/or consult your brokers or other professional advisors prior to making any investment decision. Investors should also refer to the relevant information posted on the HKEx website.***

# 1 Warrants

Warrants are an instrument which gives investors the right - but not the obligation - to buy or sell the underlying asset at a pre-set price on or before a specified date. There are two main types of warrants: equity warrants and derivative warrants, which are subject to different provisions of the Listing Rules in Hong Kong.

## 1.1 Equity warrants

Issued by a listed company and give holders the right to subscribe for equity securities of the issuer. Equity warrants are often issued together with new shares in IPOs, or distributed together with the shares acquired for any dividend payment, bonus issue or rights issue. Equity warrants have a life of one to five years. Upon exercise, the listed company will issue new shares to their holders and collect extra capital. The issuer of a warrant must specify whether it is settled by cash or by physical delivery of the underlying assets.

## 1.2 Derivative warrants

Issued by a third party, generally an investment bank, independent of the issuer of the underlying assets. They have a life of six months to five years. The underlying assets of derivative warrants include ordinary shares, market indices, currencies and baskets of shares. The issuer of derivative warrants may not be the issuer of the underlying assets but should hold or have a right to hold the underlying assets. The right conferred by a derivative warrant may be the right to buy (call warrant) or the right to sell (put warrant).

Derivative warrants can be linked to a single security or a basket of securities, stock indices, currencies, commodities or futures contracts (like crude oil futures). Almost all derivative warrants currently traded in Hong Kong are cash-settled. When a physically settled call derivative warrant on a single stock is exercised, the warrant holder will receive the underlying stock from the issuer. Unlike equity warrants, no new shares will be issued. Furthermore, every derivative warrant has a designated liquidity provider to help improve the liquidity of the instrument in the market.

The price of a derivative warrant at expiry mainly rests with the price of the underlying assets. However, so long as a derivative warrant remains valid, its price will be affected by other factors in addition to the underlying assets' price. They include the volatility of the underlying assets' price, the exercise price, the time remaining to expiry, interest rates and expected dividend payments on the underlying assets, etc. Like other securities, the price of a derivative warrant may also be affected the supply of and demand for the derivative warrant itself.

Since derivative warrants can have great product variety, large warrant markets in the world are usually mainly derivative warrant markets. The equity warrant markets are usually of a much smaller scale.

## 1.3 Attributes

Warrants have following attributes which include:

1.3.1 Issuer
A warrant can be issued by a listed company (i.e. subscription warrant) or a third party such as a financial institution (i.e. derivative warrant).

1.3.2 Underlying asset
It can be a single stock, a basket of stocks, an index, a currency, a commodity, a futures contract (e.g. oil futures) etc.

1.3.3 Types of rights
Don't mix up a call warrant with a put warrant. A call warrant gives you the right to buy whereas a put warrant gives you the right to sell the underlying asset.

1.3.4 Exercise price
The price at which you buy or sell the underlying asset in exercising a warrant.

1.3.5 Conversion ratio
This refers to the number of units of the underlying asset exchanged when exercising a unit of a warrant. Normally, in Hong Kong a derivative warrant on shares has the ratio of 1 (i.e.one warrant for one share) or 10 (i.e.10 warrants for one share).

1.3.6 Expiry date

The date on which a warrant will expire and become worthless if the warrant is not exercised.

1.3.7 Exercise style
With an American warrant, you can exercise to buy/sell the underlying asset on or before the expiry date. Whereas a European warrant allows exercise on the expiry date only.

1.3.8 Settlement
A warrant can be settled by cash or physical delivery upon exercise.

### 1.4 Trading policy

Derivative warrants are traded on the Exchange during trading hours in board lot multiples settled on T+2 (T being the transaction day).

### 1.5 Risk disclosure

Derivative warrant trading involves high risks and is not suitable for every investor. Investor should understand and consider the following risks before trading in derivative warrants.

1.5.1 Issuer risk
Derivative warrant holders are unsecured creditors of the issuer and they have no preferential claim to any assets an issuer may hold.

1.5.2 Gearing risk
Although derivative warrants often cost less than the price of the underlying assets, a derivative warrant may change in value to a much greater extent than the underlying assets. Although potential return on derivative warrants may be higher than that on the underlying assets, it should be noted that in the worst case the value of derivative warrants may fall to zero and holders may lose their entire investment amount.

1.5.3 Limited life
Unlike stocks, derivative warrants have an expiry date and therefore a limited life. Unless the derivative warrants are in-the-money, they become worthless at expiration.

1.5.4 Time decay
So long as other factors remain unchanged, the value of derivative warrants will decrease over time. Therefore, derivative warrants should never be viewed as products that are bought and held as long term investments.

1.5.5 Market forces
In addition to the basic factors that determine the theoretical price of a derivative warrant, derivative warrant prices are also affected by the demand for and supply of the derivative warrants. This is particularly the case when a derivative warrant issue is almost sold out and when there are further issues of an existing derivative warrant.

1.5.6 Turnover
High turnover should not be regarded as an indication that a derivative warrant's price will go up. The price of a derivative warrant is affected by a number of factors in addition to market forces, such as the price of the underlying assets and its volatility, the time remaining to expiry, interest rates and the expected dividend on the underlying assets.

# 2 Callable Bull/Bear Contracts (CBBC)

A CBBC is a contract that you can buy and sell; and tracks the performance of an underlying asset without requiring investors to pay the full price required to own the actual asset. They are issued either as Bull or Bear contracts with a fixed expiry date, allowing investors to take bullish or bearish positions on the underlying asset.

Its value is determined, among other things, by the performance of an asset it is linked to. A HSI callable bull contract rises in value if the index rises and a HSI callable bear contract rises in value if it falls.

## 2.1 Attributes

### 2.1.1 Close price tracking

If the underlying asset increases in value, a Bull CBBC with entitlement ratio of 1 to 1 generally increases in value by approximately the same amount whereas a Bear CBBC with the same entitlement ratio generally decreases in value by approximately the same amount. It offers investors a product which tracks the price movement of the underlying asset more closely and with higher price transparency than some other structured products.

### 2.1.2 Call price and mandatory call

One of the features of CBBC is the mandatory call event (MCE). For Bull contracts, the Call Price must be either equal to or above the Strike Price. For Bear contracts, the Call Price must be equal to or below the Strike Price. If the underlying asset's price reaches the Call Price at any time prior to expiry, the CBBC will expire early. The CBBC will expire earlier and the trading of it will be terminated immediately.

### 2.1.3 Valuation at expiry

CBBC can be held until maturity (if not called before expiry) or sold on the Stock Exchange before expiry. In the case of a Bull contract, the cash settlement amount at normal expiry will be the positive amount of the underlying asset price as determined on the valuation day less the strike price. In the case of a Bear contract, the cash settlement amount at normal expiry will be the positive amount of the strike price less the underlying asset price on valuation day.

## 2.2 Risk disclosure

### 2.2.1 Mandatory call

A CBBC will be called by the issuer when the price of the underlying asset hits the Call Price. Payoff for Category N CBBC will be zero when they expire early. When Category R CBBC expire early the holder may receive a small amount of Residual Value payment, but there may be no Residual Value payment in adverse situations. Once the CBBC is called, even though the underlying asset may bounce back in the right direction, the CBBC which has been called will not be revived and investors will not be able to profit from the bounce-back.

### 2.2.2 Gearing effects

Since a CBBC is a leveraged product, the percentage change in the price of a CBBC is greater compared with that of the underlying asset. When the underlying asset price is closer to the CBBC Call price, the risk for the CBBC being called is higher. Theoretically, the CBBC gearing ratio will be higher, reflecting the risk of being called.

### 2.2.3 Limited life

A CBBC has a limited life, as denoted by the fixed expiry date. The life of a CBBC may be shorter if called before the fixed expiry date. The price of a CBBC fluctuates with the changes in the price of the underlying asset from time to time and may become worthless after expiry and in certain cases, even before the normal expiry if the CBBC has been called early.

### 2.2.4 Liquidity

Although CBBC have liquidity providers, there is no guarantee that investors will be able to buy/sell CBBC at their target prices any time they wish.

### 2.2.5 Funding costs

Different issuers adopt different formulas in calculating CBBC funding cost. When a CBBC is called, the CBBC holders (investors) will lose the funding cost for the full period since the funding cost is built into the CBBC price upfront at launch even though with the MCE, the actual period of funding for the CBBC turns out to be shorter.

2.2.6 Movement with underlying asset

The price of a CBBC tends to follow closely the price of its underlying asset, yet in some situations it may not. Prices of CBBC are affected by a number of factors, such as its own demand and supply, funding costs and time to expiry. And, the delta for a particular CBBC may not always be close to one, especially when the price of the underlying asset is close to the Call Price.

2.2.7 Trading close to Call Price

When the underlying asset is trading close to the Call Price, the price of a CBBC may be more volatile with wider spreads and uncertain liquidity. CBBC may be called at any time and trading will terminate as a result.

2.2.8 Overseas underlying assets

CBBC issued on overseas underlying assets may be called outside the Exchange’s trading hours. Besides, Investors trading CBBC with overseas underlying assets are exposed to an exchange rate risk as the price and cash settlement amount of the CBBC are converted from a foreign currency into Hong Kong dollars.

# 3 Exchange Traded Fund (ETF)

An index tracking exchange traded fund (ETF) is traded on an exchange. Its principal objective is to track, replicate or correspond to the performance of an underlying index. The index can be on a stock market, a specific segment of a stock market or a group of stock markets in a region or elsewhere in the world. It can also be on bonds or commodities.

Synthetic ETF is a kind of ETF, which fund managers adopt synthetic replication through investing in financial derivative instruments, such as swaps and performance-linked notes, to replicate the index performance.

## 3.1 Attributes

3.1.1 Exchange trading

An ETF is structured as a mutual fund or a unit trust but its units, like a stock, are also tradable on the Stock Exchange of Hong Kong.

3.1.2 Index tracking

Synthetic replication is sometimes used by an ETF to raise efficiency and reduce cost. It is also applicable when an ETF tracks a market (or an index in a market) that has restricted access, and then it has no other choice but to adopt synthetic replication through the use of financial derivative instruments.

3.1.3 Net Asset Value (NAV)

Each ETF has an NAV that is calculated with reference to the market value of the investments held by it. The trading price of an ETF may not therefore be equal to its NAV, and this disparity may give rise to arbitraging opportunities.

3.1.4 Dividend entitlement

An ETF may or may not distribute dividends, depending on its dividend policy.

3.1.5 Fees and charges

An ETF incurs certain fees and expenses such as management fees charged by the ETF manager and other administrative costs. Like stocks, trading ETFs on the SEHK incurs transaction costs such as stamp duty, transaction levy and brokerage commission.

3.1.6 Regulated fund

Like other authorized funds, an ETF has to comply with the relevant regulatory requirements imposed by the SFC. However, SFC authorization does not imply recommendation of the product.

## 3.2 Risk disclosure

3.2.1 Market risks

An ETF is exposed to the economic, political, currency, legal and other risks of a specific sector or market related to the index and the market that it is tracking.

3.2.2 Credit/Counterparty risk

Investors in an ETF that uses synthetic replication are also exposed to the credit risk of the counterparty that provides the fund with indirect access to the market or index. If the fund buys a structured note that replicates the index performance, it is subject to the credit risk of the note issuer.

Due to restricted market access and limited investment quotas, some ETFs using synthetic replication have limited scope to diversify their counterparty exposure and have to rely on buying structured notes from just one or a few counterparties.

Some ETFs adopting synthetic replication by buying structured notes use collateral and/or their own securities portfolio to reduce their exposure to the note counterparties. However, investors should also take notice of counterparty risk for collateral security that falls outside the scope.

3.2.3 Tracking error

The disparity between the performance of an ETF and performance of its underlying index. Tracking error may arise due to various factors. These include failure of the ETF's tracking strategy, the impact of fees and expenses, or corporate actions.

3.2.4 Trading at discount or premium

Since the trading price of an ETF is also determined by the supply and demand of the market, the ETF may trade at a price higher or lower than its NAV.

3.2.5 Liquidity risk

There is not guaranteed that a liquid market exists for an ETF. A higher liquidity risk is involved if an ETF uses financial derivative instruments, which are not actively traded in the secondary market and whose price transparency is not as easily accessible as securities. This may result in a bigger spread. And, they are also susceptible to more price fluctuations and have a higher volatility. Hence, they can be more difficult and costly to unwind early, when the instruments provide access to a restricted market where liquidity is limited.

# 4 Listed equity linked instruments (ELI/ELN)

ELI are structured products which can be listed on the Exchange under Chapter 15A of the Main Board Listing Rules. They are marketed to retail and institutional investors who want to earn a higher interest rate than the rate on an ordinary time deposit and accept the risk of repayment in the form of the underlying shares or losing some or all of their investment.

ELI are traded in board lots and the minimum trading unit is one board lot. One board lot of ELI equals one board lot of its underlying security or its multiples. The duration of an ELI ranges from 28 days to two years. ELI are traded scripless in Hong Kong dollars and odd lots are settled in cash. Investors should note that short selling of ELI is prohibited.

An ELI's investment returns are often linked to the performance of their underlying stock(s). But for the purpose of increasing the overall return from that of plain-vanilla ELIs, some issuers may include additional features, such as early call, knock-in and daily accrual coupon. These features may affect the return of the ELIs in different ways.

## 4.1 Types

To match their directional view on the underlying securities, investors may choose from three different types of ELI listed on the Stock Exchange: Bull, Bear and Range. Other types of ELI may be traded on the Exchange in future.

## 4.2 Attributes

### 4.2.1 Early Call

ELI with early call feature will be terminated early if the closing price of the underlying stock (or in the case of a basket, that of the worst performing stock) is at or above its call price on a call observation date.

### 4.2.2 Knock-in/ Knock-out Options

Typically a currency and commodity option, a knock-in and knock out options allow the option writer to set a limit with a view towards minimizing losses from volatile price movements. The higher the market volatility, the greater is the probability that a knock-in option is triggered.

If the closing price of the underlying stock is at or below the trigger price on any knock-in observation date, a knock-in event occurs. The observation dates can be set as certain dates or certain periodic dates (e.g. monthly, quarterly). It also can be each scheduled trading day from the issue date to the scheduled final valuation date.

A knock-out option expires worthless if the price of an underlying asset crosses the pre-determined threshold. As the profit opportunity is limited, barrier options such as these are sold cheaper than standard options. They are suitable only for investors with a strong directional understanding or premium constraints and in a relatively stable market environment with little price movements.

### 4.2.3 Daily Accrual Coupon

The daily accrual feature allows an investor to capture daily price movements of the underlying stock. The ELI with daily accrual features take into account the number of trading days on which the closing price of the underlying stock is at or above the accrual coupon price during an observation period.

More than one accrual coupon price may be available. Different coupons may accrue for each day when the closing price of the underlying stock is above the high accrual coupon price, between the high accrual coupon price and the low accrual coupon price, and below the low accrual coupon price. In such case, it is possible that no coupon will be accrued if the closing price of the underlying stock is below the accrual coupon price throughout the observation period.

## 4.3 Trading policy

When ELI are issued, issuers will indicate on the listing document and launch announcement whether the ELI is to be settled by a cash payment or physical delivery upon expiry. Once listed, neither the issuers nor the holders are allowed to opt for an alternative settlement method at expiry.

**4.4 Risk disclosure**

4.4.1 Exposure to equity market

Investors are exposed to price movements in the underlying security and the stock market, the impact of dividends and corporate actions and counterparty risks. Investors must also be prepared to accept the risk of receiving the underlying shares or a payment less than their original investment.

4.4.2 Possibilities of losing investment

Investors may lose part or all of their investment if the price of the underlying security moves against their investment view.

4.4.3 Price adjustment

Investors should note that any dividend payment on the underlying security may affect its price and the payback of the ELI at expiry due to ex-dividend pricing. Investors should also note that issuers may make adjustments to the ELI due to corporate actions on the underlying security.

4.4.4 Interest rates

While most ELI offer a yield that is potentially higher than the interest on fixed deposits and traditional bonds, the return on investment is limited to the potential yield of the ELI.

4.4.5 Potential yield

Investors should consult their brokers on fees and charges related to the purchase and sale of ELI and payment / delivery at expiry. The potential yields disseminated by HKEx have not taken fees and charges into consideration.

# 5 Bond

Bond is a debt instrument issued for a predetermined period of time with the purpose of raising capital by borrowing. A bond generally involves a promise to repay the principal and interest on specified dates.

## 5.1 Attributes

5.1.1 Issuer

The party who borrows the money. The bonds are classified by the nature of their issuers, for example, corporate bonds (by listed companies or their subsidiaries), government bonds (by governors or government authorities), and supranational bond (by supranational organization, for example, the World Bank).

5.1.2 Principal

This is amount repaid to bondholder when bond matures; it is also called par value or face value.

5.1.3 Coupon rate

The rate which issuer pays interest on the principal to bondholder in regular intervals, e.g. annually, semi-annually, quarterly. The coupon rate can be fixed which the rate will not change over the term of the bond. The rate can be floating which will adjust periodically according to the predetermined benchmark, e.g. HIBOR. The coupon rate can also be zero, e.g. zero-coupon bond sold at low price than principal but will be repaid in principal upon maturity.

5.1.4 Term

This is the tenor of the bond which issuer has promised to meet its obligations under the bond.

5.1.5 Special feature

"Callable" bond grants the issuer the right to replay the bond before matures. "Puttable" bond gives bondholder the right to sell bond back to issuer. "Convertible" bond gives you the right to convert bond into a specified number of unissued shares of the issuer or a related company. "Exchangeable" bond allows bondholder to exchange the bond for the shares of any organization which are already in issue and held by the issuer or a related company.

5.1.6 Guarantor

Some bonds are guaranteed by a third party called guarantor. In case of defaults of issuer, the guarantor agrees to repay the principal and/or interest to bondholder.

## 5.2 Risk disclosure

5.2.1 Default risk

This is a risk that issuer may fail to pay bondholder the interest or principal as scheduled.

5.2.2 Interest rate risk

The price of a fixed rate bond will drop when the interest rate rises. If the bond to be sold before matures, the bond price may be less than the purchase price.

5.2.3 Exchange rate risk

Exchange rate risk exists if the bond is dominated in foreign currency.

5.2.4 Liquidity risk

In case of emergency to sell bond before maturity, there is a risk of low liquidity of the secondary bond market.

5.2.5 Equity risk

If the bond is "convertible" and "exchangeable", equity risk associated with the stock will be existed.

# 6 Futures

Futures contracts are derivative instruments. A stock futures contract represents a commitment to buy or sell a predefined amount of the underlying stock at a predetermined price on a specified future date. Remember though that not all futures contracts are linked to a product that can be physically delivered. A stock index futures contract, for example, is generally settled for cash.

Futures are leveraged investments. Both market gains and losses are magnified. Futures trading is only for sophisticated and more disciplined investors who can afford potential losses should he find himself on the wrong side of a market.

## 6.1 Attributes

6.1.1 Underlying asset

Assets underlying futures contracts can be quite varied. They include stocks, indices, currencies, interest rates, commodities, such as oil, beans and gold. HKEx futures contracts are financial futures mainly based on interest rates, gold, stocks and stock indices such as the HSI, H-shares Index.

6.1.2 Contracted price

The price at which a futures contract is registered by the clearing house, i.e. the traded price.

6.1.3 Contract multiplier

The weight that is multiplied by the contracted price when calculating the contracted value. With HSI and H-Shares Index futures, the contract multiplier is $50 per index point, whereas in a mini-HSI futures contract, it is $10 per index point. For HKEx stock futures contracts, this is one board lot of the underlying stock.

6.1.4 Last trading day

The last day when a futures contract can be traded on an exchange.

6.1.5 Final settlement day

The day when the buyer and the seller must settle the futures contract.

6.1.6 Final settlement price

The fixed price determined by the clearing house and used to calculate the futures contract's final settlement value. Multiplying the final settlement price by the contract multiplier gives the final settlement value.

6.1.7 Settlement method

A futures contract can be settled by cash or by physical delivery of the underlying asset. All futures contracts traded on the HKEx (except for Three-year Exchange Fund Note futures) are settled in cash.

## 6.2 Risk disclosure

6.2.1 Risk of "Leverage" or "Gearing"

A relatively small market movement will have a proportionately larger impact on the funds you have deposited or will have to deposit; this may work against you as well as for you. You may sustain a total loss of initial margin funds and any additional funds deposited with the firm to maintain your position. If the market moves against your position or margin levels are increased, you may be called upon to pay substantial additional funds on short notice to maintain your position. If you fail to comply with a request for additional funds within the time prescribed, your position may be liquidated at a loss and you will be liable for any resulting deficit.

6.2.2 Risk-reducing orders or strategies

The placing of certain orders (e.g. "stop-loss" orders, or "stop-limit" orders) which are intended to limit losses to certain amounts may not be effective because market conditions may make it impossible to execute such orders. Strategies using combinations of positions, such as "spread" and "straddle" positions may be as risky as taking simple "long" or "short" positions.

6.2.3 Suspension or restriction of trading

Market conditions (e.g. illiquidity) and/or the operation of the rules of certain markets (e.g. the suspension of trading in any contract or contract month because of price limits or "circuit breakers") may increase the risk of loss by making it difficult or impossible to effect transactions or liquidate/offset positions. Further, normal pricing relationships between the underlying interest and the futures may not exist. The absence of an underlying reference price may make it difficult to judge "fair value.

# 7 Stock options

It is a contract that involves two parties, a buyer (or holder) and a seller (or writer). Option contracts are for an agreed quantity of an underlying asset, price, and future period. If the buyer exercises his right, the option's seller has to settle according to the contract's specifications.

## 7.1 Attributes

7.1.1 Underlying asset

The assets underlying options can be stocks, market indices, currencies, commodities, debt instruments, and so on. In Hong Kong, exchange-traded options' underlying assets are mainly stocks and market indices.

7.1.2 Exercise / Strike price

This is the predefined price at which the option's holder trades the underlying asset with the writer.

7.1.3 Expiry day

The last day on which a holder can exercise an option.

7.1.4 Exercise style

There are two types of exercise styles. An American-style option can be exercised during any trading day on or before the expiry date. European-style options can only be exercised on the expiry day.

7.1.5 Settlement method

This is the predetermined method in which the writer settles an option, and depends on what's stated in the contract. An option can be settled either by physical delivery of the underlying asset or in cash.

## 7.2 Risk disclosure

7.2.1 Risk of options buyers

The purchaser of options may offset or exercise the options or allow the options to expire. The exercise of an option results either in a cash settlement or in the purchaser acquiring or delivering the underlying interest. If the option is on a futures contract, the purchaser will acquire a futures position with associated liabilities for margin. If the purchased options expire worthless, you will suffer a total loss of your investment which will consist of the option premium plus transaction costs. If you are contemplating purchasing deep-out-of-the-money options, you should be aware that the chance of such options becoming profitable ordinarily is remote.

7.2.2 Risk of options sellers

Selling an option generally entails considerably greater risk than purchasing options. Although the premium received by the seller is fixed, the seller may sustain a loss well in excess of that amount. The seller will be liable for additional margin to maintain the position if the market moves unfavorably. The seller will also be exposed to the risk of the purchaser exercising the option and the seller will be obligated to either settle the option in cash or to acquire or deliver the underlying interest. If the option is on a futures contract, the seller will acquire a position in a futures contract with associated liabilities for margin. If the option is "covered" by the seller holding a corresponding position in the underlying interest or a futures contract or another option, the risk may be reduced. If the option is not covered, the risk of loss can be unlimited.

Certain exchanges in some jurisdictions permit deferred payment of the option premium, exposing the purchaser to liability for margin payments not exceeding the amount of the premium. The purchaser is still subject to the risk of losing the premium and transaction costs. When the option is exercised or expires, the purchaser is responsible for any unpaid premium outstanding at that time.

7.2.3 Suspension or restriction

Market conditions (e.g. illiquidity) and/or the operation of the rules of certain markets (e.g. the suspension of trading in any contract or contract month because of price limits or "circuit breakers") may increase the risk of loss by making it difficult or impossible to effect transactions or liquidate/offset positions. If you have sold options, this may increase the risk of loss.

7.2.4 Variable degree of risk

Transactions in options carry a high degree of risk. Purchasers and sellers of options should familiarize themselves with the type of option (i.e. put or call) which they contemplate trading and the associated risks. You should calculate the extent to which the value of the options must increase for your position to become profitable, taking into account the premium and all transaction costs.

# 8 Leveraged and Inverse Products (L&I Products)

Leveraged Products typically aim to deliver a daily return equivalent to a multiple of the underlying index return that they track. For example, if the underlying index rises by 10 per cent on a given day, a two-time (2x) Leveraged Product aims to deliver a 20 per cent return on that day.

Inverse Products typically aim to deliver the opposite of the daily return of the underlying index that they track. For example, if the underlying index rises by 10 per cent on a given day, an Inverse Product should incur a 10 per cent loss on that day.

To produce the specified leveraged or inverse return, these products have to rebalance their portfolios, typically on a daily basis.

L&I Products are derivative products. L&I Products structured as Exchange Traded Funds (ETFs) are authorised by the Securities and Futures Commission (SFC) as Collective Investment Schemes (CIS) and are listed and traded on the securities market of HKEX. It is different from conventional exchange traded funds as it typically seeks inverse investment results relative to the index and on a daily basis. In overseas markets, L&I Products are commonly known as Leveraged and/or Inverse ETFs.

## 8.1 Product Structure

Both swap-based synthetic replication and futures–based replication structures are allowed for L&I Products subject to SFC authorization. The caps on the leverage factor are provided on the website of the HKEX, subject to review going forward.

## 8.2 Attributes

8.2.1 Trading counters for L&I Products

L&I Products can be traded, cleared and settled in HKD, RMB and USD. Multiple counters of L&I Products are permissible, subject to the approval of the SFC and HKEX.

8.2.2 Short selling and tick rule exemption for L&I Products

Subject to approval by the SFC, an individual L&I Product may be designated for short selling with tick rule exemption from its listing day.

8.2.3 Settlement arrangements

T+2, similar to ETFs and other securities.

8.2.4 Fees and charges

A L&I Product incurs certain fees and expenses such as management fees charged by the product manager and other administrative costs. Like stocks, trading L&I Products on the SEHK incurs transaction costs such as trading fee, transaction levy and brokerage commission. For details, please refer to our company website.

8.2.5 Performance simulator

Performance simulators will be provided by L&I Product providers to facilitate the understanding of L&I Products to interested retail investors. The performance simulators should allow investors to select a historical time period and simulate the performance of the L&I Product during that time period based on historical data. The historical period available in the performance simulator should cover the period since the launch of the L&I Product. For detail, please refer to the hyperlinks to the performance simulator for each L&I Product posted on HKEX's L&I Product webpage.

8.2.6 Market making arrangements

At least one market maker for the L&I Products at the commencement of trading and on an ongoing basis.

## 8.3 Key risks disclosures

**Investment involves risks. The risks of investing in different L&I products vary due to the difference in product structure, investors are highly recommended to read the prospectus and key facts sheet carefully in order to understand the risks involved in a specific L&I product.**

8.3.1 Investment risk

The L&I product is a derivative product and is not suitable for all investors. There is no guarantee of the repayment of principal. Therefore your investment in the L&I product may suffer substantial/total losses.

8.3.2 Long term holding risk

The L&I product is not intended for holding longer than one day as the performance of the L&I product over a period longer than one day will very likely differ in amount and possibly direction from the leveraged performance of the index over that same period (e.g. the loss may be more than twice the fall in the index).

The effect of compounding becomes more pronounced on the L&I product's performance as the index experiences volatility. With higher index volatility, the deviation of the L&I product's performance from the leveraged performance of the index will increase, and the performance of the L&I product will generally be adversely affected.

As a result of daily rebalancing, the index's volatility and the effects of compounding of each day's return over time, it is even possible that the L&I product will lose money over time while the index's performance increases or is flat.

8.3.3 Leverage risk

Leveraged Products typically aim to deliver a daily return equivalent to a multiple of the underlying index return that they track. Inverse Products typically aim to deliver the opposite of the daily return of the underlying index that they track. Both gains and losses will be magnified. The risk of loss resulting from an investment in the L&I product in certain circumstances will be substantially more than a fund that does not employ leverage.

8.3.4 Inverse Product vs. short selling risk

Investing in the Inverse Product is different from taking a short position. Because of rebalancing, the return profile of the Inverse Product is not the same as that of a short position. In a volatile market with frequent directional swings, the performance of the Inverse Product may deviate from a short position.

8.3.5 Risk of rebalancing activities

There is no assurance that the L&I product can rebalance their portfolio on a daily basis to achieve their investment objectives. Market disruption, regulatory restrictions or extreme market volatility may adversely affect the L&I product's ability to rebalance its portfolio.

8.3.6 Liquidity risk

The rebalancing activities of the L&I product typically take place near the end of a trading day, shortly before the close of the underlying market, to minimise tracking difference. As a result, the L&I product may be more exposed to the market conditions during a shorter interval and maybe more subject to liquidity risk.

8.3.7 Intraday investment risk

The L&I product is normally rebalanced at day end. As such, return for investors that invest for period less than a full trading day will generally be differs from the leveraged investment exposure to the index, depending upon the movement of the index from the end of one trading day until the time of purchase.

8.3.8 Portfolio turnover risk

Daily rebalancing of L&I product's holdings causes a higher level of portfolio transactions than compared to the conventional ETFs. High levels of transactions increase brokerage and other transaction costs.

8.3.9 Futures contracts risk

If the L&I product is a futures based product, investment in futures contracts involves specific risks such as high volatility, leverage, rollover and margin risks. The leverage component of futures contracts can result in a loss significantly greater than the amount invested in the futures contracts by the L&I product. Exposures to futures contracts may lead to a high risk of significant loss by the L&I product.

A "roll" occurs when an existing futures contract is about to expire and is replaced with a futures contract representing the same underlying but with a later expiration date. The value of the L&I product's portfolio (and so the Net Asset Value per unit) may be adversely affected by the cost of rolling positions forward (due to the higher price of the futures contract with a later expiration date) as the futures contracts approach expiry.

There may be imperfect correlation between the value of the underlying reference assets and the futures contracts, which may prevent the L&I product from achieving its investment objective.

8.3.10 Foreign exchange risk

If the base currency of the L&I product is different from that of the underlying index, fluctuations in the exchange rates between currencies may have an adverse impact on the performance of the L&I product.

8.3.11 Distributions risk

Where distributions are distributed out of capital or effectively out of capital, this amounts to a return or withdrawal of an investor’s original investment or any capital gains attributable to that original investment and may result in an immediate reduction in the Net Asset Value per unit.

8.3.12 Passive investments risk

The L&I product is not “actively managed” and therefore the manager of the L&I product may not adopt any temporary defensive position when the index moves in an unfavourable direction. In such circumstances the L&I product will also decrease in value.

8.3.13 Trading risk

The trading price of the units on the exchange is driven by market factors such as the demand and supply of the units. Therefore, the units may trade at a substantial premium or discount to the Net Asset Value.

As investors will pay certain charges (e.g. trading fees and brokerage fees) to buy or sell units on the exchange, investors may pay more than the Net Asset Value per unit when buying units on the exchange, and may receive less than the Net Asset Value per unit when selling units on the exchange.

8.3.14 Trading differences risk

As the overseas exchange may be open when the units are not priced, the value of any underlying index futures contracts in the L&I product’s portfolio, and the value of the any constituents in the Index to which such futures contracts are linked, may change when investors may not be able to buy or sell units. Differences in trading hours between different markets may also increase the level of premium or discount of the unit price to its Net Asset Value.

8.3.15 Reliance on market maker risk

Although the L&I product manager is required to ensure that at least one market maker will maintain a market for the units and gives not less than 3 months’ notice prior to termination of the market making arrangement, liquidity in the market for the units may be adversely affected if there is only one market maker for the units. There is no guarantee that any market making activity will be effective.

8.3.16 Tracking error risk

Due to fees and expenses of the L&I Product, high portfolio turnover, liquidity of the market and the investment strategy adopted by the manager of the L&I product, the L&I product’s return may deviate from the daily leveraged performance of the index which the L&I product seeks to track. There can be no assurance of exact or identical replication at any time of the daily leveraged performance of the Index.

8.3.17 Termination risk

The L&I product may be terminated early under certain circumstances, for example, where there is no market maker, the index is no longer available for benchmarking or if the size of the L&I product falls below a specific value decided by the manager of L&I product. Any distribution received by a unitholder on termination of the L&I product may be less than the capital initially invested by the unitholder, resulting in a loss to the unitholder.