Press release

LCQ7: Exchange-traded funds

Wednesday, October 27, 2010

Following is a question by the Hon Frederick Fung and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (October 27):

Question:

It has been learnt that in recent years, exchange-traded funds (ETFs) have developed rapidly in the financial market in Hong Kong and the trading volumes involved have continued to rise. More than 60 ETFs are currently listed on the Hong Kong Stock Exchange, and a majority of ETFs seek to track the movements in indexes, commodities, bonds and currencies, etc. They adopt different replications and the risks incurred by them also vary. As ETFs, which adopt replication strategies, operate in the form of investments in derivative instruments, counterparty risks of issuers on derivative instruments and swap traders in respect of their ability to honour contracts are involved, and therefore relatively higher risks are entailed. It has been reported that extremely high risks exist in some ETFs, and earlier on the Securities and Futures Commission has also issued relevant risk warnings. In this connection, will the Government inform this Council:

(a) of the current mode and way of regulation on ETFs; whether the authorities have conducted studies, made references to relevant overseas experience and reviewed the current mode of regulation, including examining the adequacy of risk disclosure requirements on ETF issuers and risk awareness of investors, etc., as well as whether the authorities need to strengthen the regulation on such issuers in respect of their operation and collateral requirements; if they have not, of the reasons for that; and

(b) given that it has been reported that in the face of the increasing popularity of ETFs, more complex or leveraged ETFs with higher risks and much wider implications may evolve in future, whether the authorities have assessed the impact of short-term and medium-term ETFs on the overall stability of the financial market and the potential systemic risks in them; whether the authorities have formulated corresponding strategies to reduce the potential risks incurred by the trading of such funds, and avoid the recurrence of the situation similar to "the Lehman Brothers' Minibonds Incident"?

Reply:

President,

My reply to the two parts of the question is as follows:

(a) Before an exchange-traded fund (ETF) can be authorised for offering to the public in Hong Kong, it must comply with the disclosure and structural requirements as set out in the Securities and Futures Commission (SFC) Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products. The Handbook includes the Code on Unit Trusts and Mutual Funds (UT Code). A key requirement is that an ETF must be subject to the ongoing management of a manager regulated by the SFC. The manager must comply with the Fund Manager Code of Conduct, act in the best interest of unit holders and actively monitor the counterparty risk of the fund and the value of the collateral.

The UT Code also imposes a number of structural requirements with regard to the ETF. For instance, the collateral provided by a counterparty should be sufficiently liquid and must not include any structured products. In addition, the collateral provided has to be marked-to-market daily, appropriately diversified, and held and readily accessible/enforceable by the trustee/custodian of the ETF.

In terms of conduct requirements, an ETF intermediary is required to, among other things, know its clients and ensure the transaction is suitable for a client when making a recommendation or solicitation to the client. The SFC has issued circulars reminding licensed corporations to put in place appropriate measures to ensure that their staff be familiar with the risks and features of investment products, including ETFs that invest in derivative instruments designed to replicate the performance of an index (i.e. synthetic ETFs). The SFC is also working with the Stock Exchange of Hong Kong Limited (SEHK) and the industry on measures to help investors better differentiate traditional ETFs and synthetic ETFs.

The regulatory approach for ETFs in Hong Kong is in line with that in other leading international markets, such as the United States (US) and the European Union (EU). There are many synthetic ETFs in the US and the EU and their investor protection regimes primarily focus on disclosure requirements for ETFs and conduct regulation of intermediaries.

(b) The SFC has been closely monitoring the development of ETFs. As at the end of September 2010, there were 50 synthetic ETFs and 16 traditional ETFs listed on the SEHK. The average daily turnover of these 66 ETFs was HK$2.1 billion during January to September 2010. This represented about 3.3% of the total market turnover. The SFC considers that the ETFs market constitutes a relatively small part of the stock market at present, and does not seem to have a significant systemic impact on the stock market. Nevertheless, the SFC will continue to monitor the development and trading of ETFs in Hong Kong and in other major markets. It will also remain in close dialogue with relevant regulators for effective market surveillance and systemic risk management.

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