

**MEMO# 31541**

January 3, 2019

# Hong Kong SFC Issues Guidance on Funds' Use of Derivatives

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January 3, 2019 TO: ICI Members

ICI Global Members

Derivatives Markets Advisory Committee SUBJECTS: Derivatives

International/Global

Trading and Markets RE: Hong Kong SFC Issues Guidance on Funds' Use of Derivatives

On 17 December, the Hong Kong Securities and Futures Commission (“SFC”) issued guidance on SFC-authorized funds’ (“funds”) use of financial derivative instruments that is intended to supplement the SFC’s recent amendments to its Code on Unit Trusts and Mutual Funds (“UT Code”).<sup>[1]</sup> The guidance provides basic information and general direction to market practitioners on funds’ use of derivatives, including on the calculation of “net derivative exposure” (as defined in the UT Code). As previously reported, the SFC will use net derivative exposure to classify and impose enhanced distribution restrictions on funds.<sup>[2]</sup> The guidance also provides information that each fund must disclose in its Key Facts Statement (“KFS”) regarding its derivatives use.<sup>[3]</sup> The SFC notes that the guidance is not intended to be exhaustive and may be updated and revised from time to time.

## I. Calculating Net Derivative Exposure and Defining Excluded Circumstances

Funds will compute net derivative exposure by aggregating the exposure of most individual derivatives.<sup>[4]</sup> Consistent with our comments on the UT Code amendments, the SFC expanded the types of derivatives that could be excluded from the net derivative exposure calculation (“Excluded Circumstances”) to include not only derivatives acquired for hedging purposes (as proposed) but also derivatives for: netting, risk mitigation, cash flow management, market access or exposure replication (without incremental leverage at the fund portfolio level),<sup>[5]</sup> and investment in conventional convertible bonds.<sup>[6]</sup> Specifically, derivatives used for cash flow management, market access, or exposure replication (without incremental leverage at the fund portfolio level), and derivatives embedded in conventional convertible bonds may be excluded from the calculation. Derivatives used for netting, hedging, or risk mitigation, can be used to offset corresponding derivative positions or, if the arrangement involves cash positions, the market value of the cash positions can be used to offset the exposure of the derivatives involved.

Accordingly, a fund's net derivative exposure will equal the sum of:

- a. the absolute value of each individual derivative not involved in the Excluded Circumstances; and
- b. the absolute value of the residual exposure (after offsets) of each individual derivative used in netting, hedging, or risk mitigation arrangements.

The guidance proceeds to define the Excluded Circumstances and provides additional information about them.[\[7\]](#)

- *Netting Arrangements:* The guidance clarifies that netting arrangements are combinations of trades on derivatives and/or cash positions referring to the *same* underlying asset(s) (irrespective of the maturity dates of the derivatives), where the trades are concluded with the sole aim of *eliminating* the risks linked to the positions taken through the other derivatives and/or cash positions.[\[8\]](#)
- *Hedging and Risk Mitigation Arrangements:* The guidance clarifies that hedging and risk mitigation arrangements are combinations of trades on derivatives and/or cash positions which *do not* necessarily refer to the same underlying asset(s), where the trades are concluded with the sole aim of *offsetting* risks linked to the positions taken through the other derivatives and/or cash positions. The guidance reiterates, per the initial consultation on the UT Code amendments, that hedging (and risk mitigation) arrangements that qualify as Excluded Circumstances only may be excluded from the net derivative exposure calculation if they are consistent with the principles set under Chapter 7.25 of the UT Code.[\[9\]](#) In addition, to qualify as Excluded Circumstances, derivatives involved in hedging or risk mitigation arrangements that do not reference the same corresponding underlying assets as those hedged must meet the following requirements:
  - Such arrangements must be in the best interests of investors, with consideration of the costs involved, where derivatives referencing the same corresponding underlying assets are not available and/or the use of such derivatives is not cost effective;
  - Such arrangements should be used in a prudent and consistent manner with provable empirical evidence demonstrating that such arrangements are efficient in limiting, offsetting, or eliminating the risk of the fund's portfolio;
  - On an ongoing basis, the fund's manager should regularly monitor and review factors such as correlation, effectiveness of such arrangement, and the hedged positions;
  - Where such arrangements are deemed to be less effective, the fund manager should consider other alternatives and take appropriate actions to limit the risks or exposure; and
  - The residual risks are properly managed in all market circumstances.

Finally, the guidance states that Excluded Circumstances do not include hedging or risk mitigation arrangements under market neutral or long/short investment strategies.

- *Cash Flow Management Arrangements:* The guidance clarifies that cash flow management arrangements are those that use derivatives to adjust the exposure of a fund on a temporary and transient basis (e.g., for (i) subscription or redemption management; (ii) portfolio rebalancing or asset allocation; and (iii) securities settlement), as well as the acquisition of derivatives passively through corporate actions (provided the fund does not intend to hold the derivatives for a prolonged period of time).

- *Market Access or Exposure Replication (without incremental leverage at the fund portfolio level) Arrangements:* The guidance clarifies that market access or exposure replication arrangements refer to derivatives used to gain access to a restricted market or to replicate the exposure of an investment or basket of investments. These arrangements qualify as Excluded Circumstances, if:
  - a. The arrangement swaps the performance of financial asset(s) held in the fund for the performance of other reference financial asset(s), and the derivative:
    - i. totally offsets the market risk of the swapped asset(s) held in the fund, so that the fund's performance does not depend on the performance of the asset(s) swapped out; and
    - ii. does not include additional optional features, leverage, or risks as compared to a direct holding of the reference financial asset(s); or
  - b. The combined positions of the derivative relating to the financial asset(s) and the cash or cash equivalents<sup>[10]</sup> the fund holds for the derivative is equivalent to holding a cash position in the reference financial asset(s) (*i.e.*, the relevant amount of cash and cash equivalents should equal the total underlying market value of the derivative involved); and the derivative does not generate any incremental leverage or market risk.
- *Investments in Conventional Convertible Bonds:* The guidance clarifies that the embedded derivative in a conventional convertible or exchangeable bond a fund holds can be treated as an Excluded Circumstance, if:
  - a. the fund holds the conventional convertible or exchangeable bond as a single instrument and has no intention to: (i) dispose the bond component by retaining the embedded derivative; or (ii) strip out the embedded derivative in the bond for trading; and
  - b. the fund has the choice (under the embedded derivative) to convert the option to other securities.

To assist fund managers in applying the Excluded Circumstances, the guidance also provides illustrative examples on each type of Excluded Circumstance.<sup>[11]</sup>

## II. Disclosure

Funds must provide in their KFS the purposes of and the expected maximum net derivative exposure arising from derivatives. In addition to calculating and monitoring net derivative exposure on an ongoing basis, fund managers must establish an appropriate risk management framework to effectively monitor and measure the risks of the fund's derivatives positions (including, market risk, liquidity risk, counterparty risk and operational risk) and the contribution of these risks to the overall risk profile of the fund. Consistent with our concerns, the SFC noted that funds should not exceed the expected maximum threshold "under normal market conditions," thus implicitly acknowledging that funds could exceed the threshold, if necessary, under abnormal market conditions. If a fund's threshold is exceeded, the fund manager must take all necessary steps to reduce the fund's leverage within a reasonable period to ensure the disclosure is not misleading, while considering the interests of the fund's investors.

[1] See SFC, *Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds* (December 17, 2018), available at [https://www.sfc.hk/web/files/PCIP/FAQ-PDFS/Guidance%20on%20the%20use%20of%20FI%20for%20unit%20trusts%20and%20mutual%20funds\\_20181217.pdf](https://www.sfc.hk/web/files/PCIP/FAQ-PDFS/Guidance%20on%20the%20use%20of%20FI%20for%20unit%20trusts%20and%20mutual%20funds_20181217.pdf). See also, SFC, *Consultation Conclusions on Proposed Amendments to the Code on Unit Trusts and Mutual Funds* (December 6, 2018), available at <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=17CP8>. For a summary of the amendments to the UT Code, please see ICI Memorandum No. 31524 (December 18, 2018), available at [https://www.ici.org/my\\_ici/memorandum/memo31524](https://www.ici.org/my_ici/memorandum/memo31524).

[2] Under the amendments to the UT Code, the SFC will classify and impose restrictions on a fund's use of derivatives based on the fund's net derivative exposure under an adjusted gross notional exposure test. The test classifies funds into three categories: "plain vanilla" funds; derivatives-based funds; and retail hedge funds. "Plain vanilla" funds could invest up to 50 percent of their net assets in derivatives. Derivatives-based funds could invest more than 50 percent and up to 100 percent of their net assets in derivatives, while retail hedge funds could invest more than 100 percent of their net assets in derivatives. Both derivatives-based funds and retail hedge funds will be subject to additional "know your customer" assessments, and retail hedge funds will be required to have a minimum initial subscription of at least \$50,000 US.

[3] In addition, the guidance provides information on the treatment of embedded derivatives and how restrictions and limitations apply to fund investments in derivatives. See guidance at Chapter 4. In particular, the guidance states that derivatives embedded in other securities should be included in the calculation of net derivative exposure and sets forth guidance on how asset-backed securities should be evaluated in determining whether they are derivatives. Further, the guidance explains that exposure to underlying assets through derivatives, together with other fund investments, should be aggregated for purposes of determining compliance with investment restrictions and limitations applicable to such underlying assets and investments. Moreover, it clarifies that the net counterparty exposure limits apply to over-the-counter derivatives and embedded derivatives.

[4] The guidance provides a non-exhaustive table showing how funds should compute the exposure of many categories of derivatives. See guidance at Annex 1.

[5] As indicated in the amendments to the UT Code, passively managed index funds (including exchange-traded funds) and structured funds will not be able to exclude market access or exposure replication arrangements, even if they do not create incremental leverage at the fund portfolio level.

[6] The SFC sets forth overarching principals regarding the derivatives that are used in the Excluded Circumstances and which may be excluded from the calculation of net derivative exposure, as follows:

- a. The use of derivatives must be in line with the fund's investment objectives and policies;
- b. No incremental leverage is created at the fund portfolio level as a result of the derivatives; and
- c. There is no material change to the overall risk profile of the fund (and, in the case of netting, hedging, and risk mitigation arrangements, fund managers must be able to

demonstrate verifiable reduction of risk through the use of derivatives at the fund portfolio level).

The SFC notes that fund managers have the onus of demonstrating these overarching principles.

[7] See guidance at Chapter 3, Part B.

[8] Funds that seek to net positions of interest rate derivatives fully or partially in accordance with duration netting rules that consider the correlation between the maturity segments of the interest rate curve should contact the SFC prior to doing so. See guidance at Chapter 3, paragraph 14.

[9] The SFC, per its initial consultation, only will exclude derivatives acquired for “hedging purposes” or risk mitigation if they meet all the following criteria: (a) they are not aimed at generating any investment return; (b) they are solely intended for the purpose of limiting, offsetting, or eliminating the probability of loss or risks arising from the investments being hedged; (c) although they may not necessarily reference the same underlying assets, they should relate to the same asset class with high correlation in terms of risk and return, and involve taking opposite positions, in respect of the investments being hedged; and (d) they exhibit price movements with high negative correlation with the investments being hedged under normal market conditions. See Chapter 7.25 of the UT Code.

[10] “Cash equivalents” refer to: short-term deposits; high quality money market instruments; and money market funds authorized under Chapter 8.2 of the UT Code or regulated in a manner generally comparable with the requirements of the SFC and acceptable to the SFC.

[11] See guidance at Annex 2.