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Newsletter

Financial Services

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Update on streamlined requirements for eligible ETFs adopting a master-feeder structure

Pinky Siu and Calvin Li

On 16 May 2024, Hong Kong's Securities and Futures Commission (**SFC**) updated the circular on streamlined requirements for eligible exchange traded funds (**ETFs**) adopting a master-feeder structure (**Circular**) to expand the scope of eligible ETFs to cover both passive ETFs and active ETFs and relax certain requirements on the eligible ETFs (including requirements on home jurisdiction, fund size and track record).

By way of background, the streamlined requirements for eligible ETFs adopting a master-feeder structure were first introduced by the SFC in December 2019 (as discussed in our earlier article) and were updated on 25 February 2022 with the fund size and track record requirements relaxed (see our earlier article). In essence, provided that certain conditions are met, the SFC will allow an SFC-authorised feeder ETF to invest its assets in an overseas-listed master ETF without the latter obtaining the SFC authorisation.

Before the Circular of 16 May 2024, in order for a master ETF to be eligible under the streamlined master-feeder structure, it must meet the following conditions:

1. the master ETF be a passive ETF which adopts physical replication of the underlying index through either a full replication or a representative sampling strategy;

2. the master ETF must be a scheme regulated in a recognised jurisdiction managed by a management company in an acceptable inspection regime or a scheme eligible under a mutual recognition of funds arrangement;

3. the master ETF must have a fund size of not less than USD 400 million and a track record of more than one year at the time of the feeder ETF's listing on the Stock Exchange of Hong Kong;

4. the master ETF's engagement in securities financing transactions should not exceed 50% of its total net asset value unless there are comparable safeguards and disclosure.

The Circular of 16 May 2024 replaced the above conditions with the following:

1. the master ETF must be a scheme with satisfactory safeguards and measures in place to provide substantially comparable investor protection as an ETF authorised under the Code on Unit Trusts and Mutual Funds, taking into account its underlying assets, investment strategy, applicable rules and regulations in the home jurisdiction; and

2. the master ETF must have sizeable assets under management with a good track record.

The new conditions in the Circular expand the scope of the eligible ETFs to cover both passive ETFs and active ETFs and no longer restrict eligible ETFs to schemes regulated in a recognised jurisdiction managed by a management company in an acceptable inspection regime or a scheme eligible under a mutual recognition of funds arrangement.

In addition, the Circular no longer specifies the minimum fund size and track record of the eligible ETFs and replaces it with a generic requirement of "sizeable assets under management with a good track record". The restrictions related to securities financing transactions have also been removed.

Notwithstanding the above relaxation, the Circular continues to require that the master ETF, its management company and trustee/custodian, must have a good compliance record with the rules and regulations of its home jurisdiction and (in the case of master ETF) the listing venue.

The relaxations in the Circular shows that the SFC welcomes applications for authorisation of feeder ETFs that invest in overseas-listed ETFs through the streamlined master-feeder structure, with an aim to facilitate the development of ETF products in Hong Kong. As the Circular replaced some specific requirements (such as minimum fund size and track record) with generic requirements, it shows that the SFC will adopt a case-by-case approach and ETF issuers are advised to contact the Investment Products Division of the SFC to assess the eligibility of specific overseas-listed ETFs under the Circular.

Hong Kong SFC licensing and compliance hints – May 2024

Distribution of non-exchange traded investment products

Lilian Lai

The Securities and Futures Commission (**SFC**) and the Hong Kong Monetary Authority issued a joint circular (**Circular**) on findings from their concurrent thematic review of intermediaries' practices in the distribution of non-exchange traded investment products, mainly related to product due diligence (**PDD**), suitability assessments, client information provision, and ensuring products are in clients' best interests.

The key deficiencies observed by the SFC during its examination of selected licensed corporations' (**LC**) internal controls in the distribution of structured products (including accumulators and decumulators), corporate bonds, and funds, as further set out in Annex 1 of the Circular are set out below. A particular focus was placed on structured products, due to their popularity, complex structure and great potential risks including unlimited loss.

Product: Inadequate, incomplete and unsupervised PDD process

- Lack of understanding of products: Staff involved in selling accumulators were unable to clearly explain the mechanism and features of such high-risk products and the risk associated with such investments.

- Incomplete assessments: Some LCs merely relied on their internal risk scoring mechanisms or the nature of the underlying investment in assigning the risk level of investment products, but failed to identify special features and qualitative factors which could significantly impact the risk profile of investment products, e.g. credit events related to the product issuer, changes in market and industry risks and/or political and economic environments.

- Inconsistent assessments: Some LCs failed to provide adequate guidance to staff on the criteria for determining investment risk or how staff should exercise discretion in adjusting or deviating from the LC's risk assessment methodology, leading to inconsistent assessment results.

- Lack of management supervision: Senior management failed to conduct appropriate inquiries or verification of the products and approved them for client offerings despite omissions and errors in the PDD process.

- Insufficient ongoing PDDs: Some LCs failed to conduct ongoing PDD for approved products to ensure they remain suitable for clients, at regular intervals or events triggering a need to reassess the product risks, e.g. issuer default/change of fund manager/decreased product return.

Client: Biased, inadequate, incomplete suitability assessments

- Biased risk profiling of clients: When risk profiling questionnaires (**RPQs**) are used to assess the client's risk tolerance levels, the design of some RPQs may produce skewed results towards high risk tolerance or place disproportionate correlation on one attribute, e.g. investment experience rather than taking a holistic assessment.
- Inadequate consideration of clients' concentration risk: Coupled with recent SFC disciplinary actions concerning failure to manage/disclose portfolio concentration risks, the SFC observed that some LCs failed to: (1) provide clear guidance, e.g. interpretation of asset classes in concentration risk assessments, (2) take all available information into account, e.g. aggregated exposure of high-risk products comprising different asset classes; and (3) justify deviation from set concentration thresholds.
- Reliance on client's consent: It is not sufficient to rely solely on risk acceptance statements made by clients in discharging the LC's suitability obligations – the SFC expressed concerns about such practices.

Non-disclosure or misleading information to clients

- Common deficiencies include: (1) failure to disclose the maximum percentage of monetary benefits received; (2) inaccurate representations of independence; and (3) providing information to clients in a misleading manner which may result in confusion as to the applicability of certain investor protection/information requirements.

What should LCs do to address the concerns arising from this thematic review?

LCs should at all times act with due skill, care and diligence in the best interests of clients when conducting business activities. Below are suggested measures aimed at enhancing an LC's distribution process in light of the SFC's findings :

- Regular staff training: Make sure your staff thoroughly understand what they are selling; keep abreast of market/industry developments that may affect product risks and client suitability, and keep updated on the applicable regulatory requirements.
- Clear and comprehensive PDD and suitability policies: Ensure your PDD and suitability assessment is properly and comprehensively designed, to capture all relevant factors to be considered in order to produce accurate and unbiased assessment outcomes.
- Regular review of policies and practice: Make sure your compliance personnel and senior management review and update PDD and suitability policies, and conduct mock applications to test their effectiveness regularly and when required. Conduct sample checks on PDD and suitability assessment results, and implement any required remedial measures immediately if any deficiencies are identified.
- Senior management supervision: Ensure senior management exercises sufficient supervision over the PDD and suitability process. Reporting lines should be clearly communicated to staff responsible for assessment outcome approval, exception or deviation.

Deacons regularly assists LCs in establishing compliance programmes and advises LCs on regulatory issues in relation to the distribution of investment products, including preparation and review of policies and procedures, compliance health-checks and preparation for SFC routine inspections.

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Recent publications

The long awaited Construction Industry Security of Payment Bill gazetted on 17 May 2024 for LegCo's first reading on 29 May 2024

Data breaches: how ready are you?

Want to know more?

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