

**Risk Disclosure Statement for Derivative Products (Cash Account / Margin Account)**

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**Some Risks Associated with Exchange Traded Funds (ETFs)**

## 1. Market risk

ETFs are typically designed to track the performance of certain indices, market sectors, or groups of assets such as stocks, bonds, or commodities. ETF managers may use different strategies to achieve this goal, but in general they do not have the discretion to take defensive positions in declining markets. Investors must be prepared to bear the risk of loss and volatility associated with the underlying index / assets.

## 2. Tracking errors

Tracking errors refer to the disparity in performance between an ETF and its underlying index / assets. Tracking errors can arise due to factors such as the impact of transaction fees and expenses incurred to the ETF, changes in composition of the underlying index / assets, and the ETF manager’s replication strategy. (The common replication strategies include full replication / representative sampling and synthetic replication which are discussed in more detail below.)

## 3. Trading at discount or premium

An ETF may be traded at a discount or premium to its Net Asset Value (NAV). This price discrepancy is caused by supply and demand factors, and may be particularly likely to emerge during periods of high market volatility and uncertainty. This phenomenon may also be observed for ETFs tracking specific markets or sectors that are subject to direct investment restrictions.

## 4. Foreign exchange risk

Investors trading ETFs with underlying assets not denominated in Hong Kong dollars are also exposed to exchange rate risk. Currency rate fluctuations can adversely affect the underlying asset value, also affecting the ETF price.

## 5. Liquidity risk

Securities Market Makers (SMMs) are Exchange Participants that provide liquidity to facilitate trading in ETFs. Although most ETFs are supported by one or more SMMs, there is no assurance that active trading will be maintained. In the event that the SMMs default or cease to fulfill their role, investors may not be able to buy or sell the product.

## 6. Counterparty risk involved in ETFs with different replication strategies

## (a) Full replication and representative sampling strategies

An ETF using a full replication strategy generally aims to invest in all constituent stocks / assets in the same weightings as its benchmark. ETFs adopting a representative sampling strategy will invest in some, but not all of the relevant constituent stocks / assets. For ETFs that invest directly in the underlying assets rather than through synthetic instruments issued by third parties, counterparty risk tends to be less of concern.

## (b) Synthetic replication strategies

ETFs utilising a synthetic replication strategy use swaps or other derivative instruments to gain exposure to a benchmark. Currently, synthetic replication ETFs can be further categorized into two forms:

## (i) Swap-based ETFs

Total return swaps allow ETF managers to replicate the benchmark performance of ETFs without purchasing the underlying assets.

Swap-based ETFs are exposed to counterparty risk of the swap dealers and may suffer losses if such dealers default or fail to honor their contractual commitments.

## (ii) Derivative embedded ETFs

ETF managers may also use other derivative instruments to synthetically replicate the economic benefit of the relevant benchmark. The derivative instruments may be issued by one or multiple issuers.

Derivative embedded ETFs are subject to counterparty risk of the derivative instruments’ issuers and may suffer losses if such issuers default or fail to honour their contractual commitments.

Even where collateral is obtained by an ETF, it is subject to the collateral provider fulfilling its obligations. There is a further risk that when the right against the collateral is exercised, the market value of the collateral could be substantially less than the amount secured resulting in significant loss to the ETF.

It is important that investors understand and critically assess the implications arising due to different ETF structures and characteristics.

**Some Risks Associated with Structured Products**

## 1. Issuer default risk

In the event that a structured product issuer becomes insolvent and defaults on their listed securities, investors will be considered as unsecured creditors and will have no preferential claims to any assets held by the issuer. Investors should therefore pay close attention to the financial strength and credit worthiness of structured product issuers.

Note: "Issuers Credit Rating" showing the credit ratings of individual issuers is now available under the Issuer and Liquidity Provider Information sub-section under Derivative Warrants and under CBBCs section on the HKEx corporate website.

## 2. Uncollateralised product risk

Uncollateralised structured products are not asset backed. In the event of issuer bankruptcy, investors can lose their entire investment. Investors should read the listing documents to determine if a product is uncollateralised.

## 3. Gearing risk

Structured products such as derivative warrants and callable bull / bear contracts (CBBCs) are leveraged and can change in value rapidly according to the gearing ratio relative to the underlying assets. Investors should be aware that the value of a structured product may fall to zero resulting in a total loss of the initial investment.

## 4. Expiry considerations

Structured products have an expiry date after which the issue may become worthless. Investors should be aware of the expiry time horizon and choose a product with an appropriate lifespan for their trading strategy.

## 5. Extraordinary price movements

The price of a structured product may not match its theoretical price due to outside influences such as market supply and demand factors. As a result, actual traded prices can be higher or lower than the theoretical price.

## 6. Foreign exchange risk

Investors trading structured products with underlying assets not denominated in Hong Kong dollars are also exposed to exchange rate risk. Currency rate fluctuations can adversely affect the underlying asset value, also affecting the structured product price.

## 7. Liquidity risk

The Exchange requires all structured product issuers to appoint a liquidity provider for each individual issue. The role of liquidity providers is to provide two way quotes to facilitate trading of their products. In the event that a liquidity provider defaults or ceases to fulfill its role, investors may not be able to buy or sell the product until a new liquidity provider has been assigned.

**Some Additional Risks Involved in Trading Derivative Warrants**

## 1. Time decay risk

All things being equal, the value of a derivative warrant will decay over time as it approaches its expiry date. Derivative warrants should therefore not be viewed as long term investments.

## 2. Volatility risk

Prices of derivative warrants can increase or decrease in line with the implied volatility of underlying asset price. Investors should be aware of the underlying asset volatility.

**Some Additional Risks Involved in Trading CBBCs**

## 1. Mandatory call risk

Investors trading CBBCs should be aware of their intraday "knockout" or mandatory call feature. A CBBC will cease trading when the underlying asset value equals the mandatory call price / level as stated in the listing documents. Investors will only be entitled to the residual value of the terminated CBBC as calculated by the product issuer in accordance with the listing documents. Investors should also note that the residual value can be zero.

## 2. Funding costs

The issue price of a CBBC includes funding costs. Funding costs are gradually reduced over time as the CBBC moves towards expiry. The longer the duration of the CBBC is, the higher the total funding costs. In the event that a CBBC is called, investors will lose the funding costs for the entire lifespan of the CBBC. The formula for calculating the funding costs are stated in the listing documents.