Risk Explanation for Exchange-Traded Derivatives

The below risk explanation is provided pursuant to Hong Kong regulatory requirements relating to trading in exchange-traded derivatives by those of our clients who are not Professional Investors (as defined in the Securities and Futures Ordinance of Hong Kong). This does not seek to introduce, and should not be seen as imposing, any obligation or liabilities on us beyond those defined in the CLSA Asia-Pacific Markets Terms of Business (be it in contract or tort), except otherwise imposed on us due to operation of law. This risk explanation is modelled on sampled risk disclaimers adopted by certain exchanges and does not mean to be exhaustive. The information herein has been obtained from sources we believe to be reliable, but we do not guarantee or warrant the accuracy or completeness of the information. Clients must not rely on this risk explanation but must refer to the relevant product documents for the detailed risk factors of the specific product before commencing trading. Where there is any contradiction or inconsistency between this risk explanation and the relevant product document of the specific product, the latter shall prevail.

Except agreed otherwise with you in writing, we do not provide investment advice and the risk explanation herein is for your reference only. Though we are happy to provide further information in relation to this risk explanation upon your request on a best effort basis, it is your responsibility to consider whether the specific exchange-traded derivative is suitable for your particular circumstances and fully understand the relevant risks associated with the products which you want to trade and, if appropriate, seek professional advice, including tax advice.

	Risk factor (please refer to footnotes below for the explanation)	Callable bull/bear contracts/ Knock-out Barrier	Contract for difference	Derivative warrants	Exchange traded fund ("ETF")	Futures contract	Options contracts
		Derivative products traded on various exchanges that CLSA offers for trading (collectively referred as "Derivative Products")					
1.	Commission and other charges	X	X	X	X	X	X
2.	Collateral risk				X		
3.	Counterparty risk	X	X	X	X	X	X
4.	Early termination or expiry	X		X			
5.	Electronic trading facilities	X	X	X	X	X	X
6.	Expiry considerations	X		X		X	X
7.	Extraordinary price movements	X	X	X	X	X	X
8.	Foreign exchange risk	X	X	X	X	X	X
9.	Funding costs	X					
10.	Gearing risk	X	X	X		X	X
11.	Hedging imperfections					X	
12.	Issuer default risk	X		X			
13.	Liquidity risk	X	X	X	X	X	X
14.	Mandatory call risk	X					
15.	Market risk	X	X	X	X	X	X
16.	Off-exchange transactions				X	X	X
17.	Property and risk					X	X
18.	Statutory fund for investor protection	X	X	X	X	X	X
19.	Suspension or restriction of trading	X	X	X	X	X	X
20.	Terms and conditions of contracts	X	X	X	X	X	X
21.	Tracking errors				X		
22.	Trading strategies		X			X	X
23.	Transactions in other jurisdictions	X	X	X	X	X	X
24.	Uncollateralised product risk	X		X			
25.	Volatility risk			X			

Footnotes:

1. Commission and other charges: Please note that trading of Derivative Products is / may be subject to commission, fees and other charges. These charges will affect your net profit (if any) or increase your loss. Please contact us for details of commission, fees and other charges before you begin to trade.

2. Collateral risk: Certain Derivative Product may require swap/derivative provider to pledge collateral as a mitigating measure against counterparty risk (as explained below). Even where collateral is obtained by the Derivative Product, 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 Derivative Product.

3. Counterparty risk:

   (a) For trading in the Derivative Product, you should familiarize yourself with the protections over the money or other property that you deposit for domestic and foreign transactions, particularly in the event of insolvency or bankruptcy of the financial intermediary. The extent to which you may recover your money or property may be governed by specific legislation or local rules. In some jurisdictions, property which had been specifically identifiable as your own will be pro- rated in the same manner as cash for purposes of distribution in the event of a shortfall.

   (b) For ETF, some ETFs which utilise a synthetic replication strategy use swaps or other derivative instruments to gain exposure to a benchmark. Synthetic replication ETFs can be further categorized into two forms:

      ❖ For swap-based ETFs, total return swaps allow ETF managers to replicate the benchmark performance of ETFs without purchasing the underlying assets. These are exposed to counterparty risk of the swap dealers and may suffer losses if such dealers are in default or insolvent or fail to honor their contractual commitments. Net asset value per share of the ETF may be adversely affected and investors may sustain a loss in their investment in the ETF.

- For derivative embedded ETFs, ETF managers may use other derivative instruments issued by third party (typically participatory notes which are usually unsecured obligations of the issuer) 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 issuers and may suffer losses if such issuers are in default or insolvent or fail to honour their contractual commitments. As a consequence, you could lose the corresponding value of their investment in the ETF.

4. Early termination or expiry: In certain circumstances a Derivative Product may be terminated or lapse before the expiry date. Issuers may have reserved the right to nominate extraordinary events which may result in the early expiry of the Derivative Product with the consent of the exchange. These events may vary depending on the terms of the issue. The expiry date may be brought forward or the Derivative Product may simply lapse with a payment in certain circumstances.

5. Electronic trading facilities: Derivative Product may be traded on the proprietary trading platform of the exchange. Undertaking such transactions may expose you to risks associated with the system including the failure of hardware and software. The result of any system failure may be that your order is either not executed according to your instructions or is not executed at all. Electronic trading facilities are supported by computer-based component systems for the order-routing, execution, matching, registration or clearing of trades. As with all facilities and systems, they are vulnerable to temporary disruption or failure.

6. Expiry considerations: Derivative Products have an expiry date after which the issue may become worthless and can no longer be exercised. Clients should be aware of the expiry time horizon and choose a product with an appropriate lifespan for their trading strategy and for the market views to be realised. Not all Derivative Products can be viewed as long term investments. All things being equal, the value of a Derivative Product will decay over time as it approaches its expiry date. Upon expiry, the value remaining will be the intrinsic value. In certain market such as Australia, if the warrant is not sold or exercised prior to expiry and has intrinsic value, the issuer is required to provide the holder with an "assessed value payment", while in other market such as Hong Kong, the derivative warrants that are in-the-money on the expiry day may be exercised automatically and then the warrant holders are then paid a positive cash settlement amount according to the terms and conditions in the listing documents.

7. Extraordinary price movements: The price of Derivative Product may not match its theoretical price due to outside influences such as market supply and demand factors, liquidity or high volatility and uncertainty. As a result, actual traded prices can be higher or lower than the theoretical price. For ETF, ETF may be traded at a discount or premium to its net asset value. This phenomenon may also be observed for ETFs tracking specific markets or sectors that are subject to direct investment restrictions. For futures and options contract, normal pricing relationships between the underlying assets and the futures/options contract also may not exist. This can occur when, for example, the futures contract underlying the options contract is subject to price limits while the options contract is not. The absence of an underlying reference price may make it difficult to judge 'fair' value.

8. Foreign exchange risk: The profit or loss in transactions in foreign currency-denominated Derivative Product (whether they are traded in your own or another jurisdiction) will be affected by fluctuations in currency rates where there is a need to convert from the currency denomination of the Derivative Product to another currency. Clients trading the Derivative Product with underlying assets not denominated in local currency of the market are also exposed to exchange rate risk. Currency rate fluctuations can adversely affect the underlying asset value, also affecting the price.

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

10. Gearing risk:

    (a) Derivative Products are leveraged and can change in value rapidly according to the gearing ratio relative to the underlying assets. Clients should be aware that the value of a Derivative Product may fall to zero resulting in a total loss of the initial investment.

(b) For futures contracts, futures contract is a legally binding agreement to buy or sell the underlying at the agreed price, no matter what the price level is at maturity of the contract. Both the buyer and the seller of a futures contract face potentially unlimited losses and hence transactions in futures contract carry a high degree of risk. The amount of initial margin is small relative to the value of the futures contract. A relatively small market movement will have a proportionately larger impact on the funds you have deposited or will have to deposit. 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.

11. Hedging imperfections: You may use futures contract to hedge against the risk of either a price rise or a fall in the underlying. By selling futures contract you can protect the value of the underlying. By buying futures contract you can lock in the purchase price of the underlying at a future date. The principle behind using futures contract to hedge is that a profit in one market will offset a loss in the other market. The success of any hedging strategy depends in part on how close the futures market and market of the relevant underlying move.

12. Issuer default risk: In the event that the issuer of the Derivative Product is in default or insolvent, investors may be considered as unsecured creditors and will have no preferential claims to any underlying assets held by the issuer. Clients should therefore pay close attention to the financial strength and credit worthiness of the issuers.

13. Liquidity risk: This is the risk that you may not be able to trade the Derivative Product for a reasonable price in the market. This could be because there are insufficient orders in the market, or the price spread at which other investors are prepared to trade them is very large. In some cases a lack of liquidity of the Derivative Product may be due to a lack of liquidity of the underlying asset. Issuers of certain Derivative Products may have appointed a liquidity provider/market maker or the issuer itself may have committed to make a market. Generally speaking, the role of liquidity providers/market makers is to provide two way quotes to facilitate trading of their products and there is no assurance that active trading will be maintained. In the event that a liquidity provider/market maker defaults or ceases to fulfill its role, investors may not be able to trade the Derivative Product until a new liquidity provider/market maker is appointed.

14. Mandatory call risk: Clients trading Derivative Product should be aware of their intraday "knockout" or mandatory call feature. A Derivative Product 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 Derivative Product as calculated by the product issuer in accordance with the listing documents. Investors should also note that the residual value can be zero.

15. Market risk:

(a) Market price of Derivative Product is affected by demand and supply which are subject to the same risks that affect all stock market or the market of underlying assets (such as movements in domestic and international markets, the present and anticipated economic environment, market sentiment, interest rates, exchange rates and volatility). Principally if the direction of the underlying asset does not fulfil your expectations, the Derivative Product will not perform and may lead to losses compared to holding the underlying asset.

(b) For ETFs, ETFs are typically designed to track the performance of certain indices, market sectors, or groups of assets such as stocks, bonds, or commodities and hence this is subject to the day-to-day fluctuation in the ETF's net asset value and the ETF's trading price in response to market movements of underlying assets. Market fluctuation may erode or increase investment returns on the ETF. Besides, 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 assets.

16. Off-exchange transactions: Off-exchange transactions may be allowed in some jurisdictions under certain circumstances. It may be difficult or impossible to liquidate an existing position, to assess the value, to determine a fair price or to assess the exposure to risk. Off-exchange transactions may be less regulated or subject to a separate regulatory regime. Before you undertake such transactions, you should familiarize yourself with applicable rules and attendant risks.

CLSA Limited
18/F One Pacific Place, 88 Queensway, Hong Kong
Tel: (852) 2600 8888 Fax: (852) 2868 0189

17. Property and risk: Some Derivative Products allow physical delivery of the underlying assets. Where you choose or are required to deliver (or to be delivered) the underlying assets in physical form, you should refer to the contract specification about mode of delivery and the concerned requirement or arrangement. You should also take note how and when the property and risk of the underlying assets will be transferred during the course of delivery as defined in the contract specification.

18. Statutory fund for investor protection: Some markets may have set up a pool of assets that is available to meet valid claims arising from dealings with financial intermediary in certain circumstances. Under certain circumstances you may be able to claim against the fund in relation to the trading but only to the extent covered under the local rules.

19. Suspension or restriction of trading: Market conditions and/or the operation of the rules of certain markets may increase the risk of loss by making it difficult or impossible to effect transactions or liquidate/offset positions. For example, some market such as Australia may suspend the related derivative warrants automatically if the underlying share is suspended. Also the exchange may expire and delist the product in accordance with its rules and power.

20. Terms and conditions of contracts: You should refer to the terms and conditions of the specific Derivative Product which you are trading and associated obligations (e.g. the circumstances under which you may become obliged to make or take delivery of the underlying asset of a futures contract and, in respect of options contract, expiration dates and restrictions on the time for exercise). Under certain circumstances the specifications of outstanding contracts (including the exercise price of an options contract) may be modified by the exchange or clearing house to reflect changes in the underlying assets.

21. Tracking errors: Tracking errors refer to the disparity in performance between the Derivative Product and its underlying assets. Tracking errors can arise due to factors such as the impact of transaction fees and expenses incurred to the Derivative Product, changes in composition of the underlying assets, and the replication strategy. This may affect performance return.

CLSA Limited
18/F One Pacific Place, 88 Queensway, Hong Kong
Tel: (852) 2600 8888 Fax: (852) 2868 0189

22. Trading strategies:

(a) For futures contract and contracts for difference

For a holder of a short position, a continuing adverse market price movement (e.g. market price rise), can result in theoretically unlimited losses being accumulated.

The placing of certain 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.

(b) For options contract

Transactions in options contract carry a high degree of risk. Purchasers and sellers of options contracts should familiarize themselves with the type of options contracts (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 contract must increase for your position to become profitable, taking into account the premium and all transaction costs.

(i) The purchaser of options contract may offset or exercise the options contract or allow the options contract to expire. The exercise of an options contract results either in a cash settlement or in the purchaser acquiring or delivering the underlying assets. If the options contract is on futures contract, the purchaser will acquire a futures position with associated liabilities for margin. If the purchased options contract expires worthless, you will suffer a total loss of your investment which will consist of the options 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 contract becoming profitable ordinarily is remote. Certain exchanges in some jurisdictions permit deferred payment of the options premium, exposing the purchaser to liability for margin payments not exceeding the amount of the premium. When the options contract is exercised or expires, the purchaser is responsible for any unpaid premium outstanding at that time.

(ii) Selling options contract generally entails considerably greater risk than purchasing options contracts. 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 against him. The seller will also be exposed to the risk of the purchaser exercising the options contract and the seller will be obligated to either settle the options contract in cash or to acquire or deliver the underlying assets. If the options contract is on futures contract, the seller will acquire a position in futures contract with associated liabilities for margin. If the options contract is covered by the seller holding a corresponding position in the underlying assets, the risk may be reduced. If the options contract is not covered, the risk of loss can be unlimited.

23. Transactions in other jurisdictions: Transactions on markets in other jurisdictions, including markets formally linked to a domestic market, may expose you to additional risk. Such markets may be subject to regulation which may offer different or diminished investor protection. Before you trade, you should enquire about any rules relevant to your particular transactions. Your local regulatory authority will be unable to compel the enforcement of the rules of regulatory authorities or markets in other jurisdictions where your transactions have been effected.

24. Uncollateralised product risk: Uncollateralised Derivative Products are not asset backed. In the event of issuer insolvency, investors can lose their entire investment. Clients should read the listing documents to determine if the Derivative Product is uncollateralised.

25. Volatility risk: Prices of Derivative Product can increase or decrease in line with the implied volatility of the price of the underlying asset. Clients should be aware of the volatility of the underlying asset.