



Hong Kong

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## SFC GUIDANCE TO ETF FUND MANAGERS AND MARKET MAKERS AFTER TEMPORARY HALT BY ETF MARKET MAKER AMID COVID-19 PANDEMIC

The Securities and Futures Commission (SFC) issued a Circular to Management Companies and Market Makers of SFC-Authorised Exchange Traded Funds<sup>1</sup> (the **SFC ETF Circular**) on 17 April 2020 reminding management companies and market makers<sup>2</sup> of SFC-authorized exchange traded funds (ETFs) of their risk management obligations amid the COVID-19 outbreak. This followed the temporary suspension of market making functions by the sole market maker of one ETF due to some of its traders being under mandatory COVID-19 quarantine, raising concerns as to ETF management companies' and market makers' ability to manage this risk.

The SFC has already issued guidance in March 2020<sup>3</sup> to remind fund management companies, trustees and custodians of SFC-authorized funds of their obligations to safeguard their clients' interests amid the COVID-19 outbreak. The latest circular serves as additional guidance on ETFs, which includes SFC-authorized passive and active ETFs and listed unit and share class(es) of unlisted SFC-authorized funds.

Our newsletter on the SFC's March 2020 COVID-19 guidance to fund management companies, trustees and custodians of

SFC-authorized funds is available at <https://www.charltonslaw.com/sfc-publishes-guidance-to-fund-industry-in-view-of-covid-19-outbreak/>.

### ETF Fund Managers' Risk Management Obligations

The SFC ETF Circular reminds ETF fund managers of their overarching responsibility to manage ETFs in the best interests of the investors. Part of that responsibility is to closely monitor ETFs' operations and activities, including secondary market trading and ETF liquidity.

The SFC reminds ETF fund managers that, to ensure the fair and orderly trading of SFC-authorized ETFs, they should:

1. conduct due diligence on and regularly monitor market makers engaged by the fund manager as required by the SFC's Code on Unit Trusts and Mutual Funds.<sup>4</sup> Fund managers need to be satisfied that the market maker(s) are able to properly discharge their market making functions and have suitable contingency plans in place;
2. closely monitor the liquidity and secondary market trading of the ETFs under their management, as well as the activities and performance of the market maker(s);

1 SFC. 17 April 2020. Circular to management companies and market makers of SFC-authorized exchanged traded funds – ETF market making. Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=20EC31>

2 "Market makers" include Securities Market Makers and Designated Specialists as defined in the Hong Kong Stock Exchange's Listing Rules.

3 SFC. Circular to management companies and trustees and custodians of SFC-authorized funds. Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=20EC22>

4 Under 8.6(p) of the SFC's Code on Unit Trusts and Mutual Funds, management companies of ETFs are generally expected to use their best endeavours to have arrangements in place so that there is at least one market maker for the units/shares (traded in each counter) of the ETF.

3. be proactive in maintaining close contact with each market maker of the ETFs under their management and have arrangements in place to ensure that a market maker will immediately notify the fund manager if it foresees or experiences difficulties or disruptions in carrying out its functions as a market maker;
4. effectively manage the risk of relying on a single market maker for secondary market liquidity for an ETF. For example, securing more than one market maker for an ETF or making arrangements for another market maker to be immediately available to step in if the existing market maker cannot perform its functions;
5. be familiar with and comply with the requirements and administrative arrangements relating to ETFs that are listed on the Hong Kong Stock Exchange, including the procedures and cut-off times for publishing announcements and notices on the Hong Kong Stock Exchange website;
6. in the event of a temporary or permanent halt of market making activities,<sup>5</sup> or upon notice of such occurrence, fund managers are required to:
  - a) inform the SFC immediately;
  - b) assess the impact of the halt of market making activities on investors' interests;
  - c) keep investors informed by way of announcements and publication of information<sup>6</sup>; and
7. promptly inform the SFC of any unusual circumstances relating to ETFs under their management, including (among others) any issue which might adversely impact the operations, secondary market trading and the liquidity of their ETFs, such as receipt of resignation notice from a single market maker.

## ETF Market Makers' Risk Management Obligations

The SFC ETF Circular reminds market makers of ETFs to comply with applicable Hong Kong laws, and requirements of

the rules and codes issued by the SFC and the Hong Kong Stock Exchange.

Specifically, market makers are reminded to:

1. have in place the internal controls and risk management procedures necessary to ensure that they can conduct their market making functions. Market makers need to establish and maintain contingency business plans appropriate to the size of the firm,<sup>7</sup> which should identify situations in which they might be prevented from performing their market making duties temporarily or permanently, and specify backup arrangements and personnel to ensure continuity of its market making operations;
2. enforce the contingency plan in time in anticipation of potential issues affecting their operations; and
3. inform the ETF fund manager, the SFC and the Hong Kong Stock Exchange immediately if they face or are likely to face difficulties in properly carrying out their market making function.

The SFC invites fund managers and market makers of SFC-authorized ETFs to contact it if they have any questions on the circular.

<sup>5</sup> Please refer to FAQ12 of the Frequently Asked Questions on Exchange Traded Funds and Listed Funds for details

<sup>6</sup> Code 8.6(q) of the SFC Code on Unit Trusts and Mutual Funds. Available at <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/section-ii-code-on-unit-trusts-and-mutual-funds/section-ii-code-on-unit-trusts-and-mutual-funds.pdf>

<sup>7</sup> Paragraph 36 of the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission

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