



Derivative Products Risk Disclosure Statement

Derivative Warrants

Derivative warrants are an instrument which gives investors the right – but not the obligation – to buy or sell underlying asset (e.g. a stock) at a pre-set price on or before a specified date. Derivative warrants are generally divided into two types: calls and puts. Derivative warrants can be linked with a single stock, a basket of stocks, an index, a currency, a commodity or a futures contract. Derivative warrants are usually settled in cash when they are exercised at expiry. Holder of call warrants have the right, but not obligation, to purchase from the issuer a given amount of the underlying asset at a predetermined price (also known as the Exercise Price”) within a certain time period. Conversely, holders of put warrant have the right, but not obligation, to sell to the issuer a given amount of the underlying asset at a predetermined price within a certain time period. Investor should be aware that other factors being equal the value of derivative warrant will decrease over time. Derivative warrants should never be viewed as products that are brought and held as long term investments.

Exchange Traded Funds

Exchange Traded Funds (“ETFs”) are passively-managed and open-ended funds, which are traded on a stock exchange (operated in a country or territories) and authorized to trade through such stock exchange by its own regulatory authority.

The ETFs in Hong Kong are traded through the securities market of Hong Kong Exchanges and Clearing Limited (HKEX). All listed ETFs in Hong Kong are authorized by the Securities and Futures Commission (SFC) as collective investment schemes.

Most ETFs track a portfolio of assets to provide diversified exposure to selected market themes. However, ETFs may also track single underlying assets.

ETFs can be broadly grouped into Physical ETFs and Synthetic ETFs. Many of Physical ETFs directly buy all the assets needed to replicate the composition and weighting of their benchmark (e.g. constituents of a stock index). However, some only buy a portion of the assets needed to replicate the benchmark or assets which have a high degree of correlation with the underlying benchmark but are not part of it. Some physical ETFs with underlying equity-based indices may also invest partially in futures and options contracts. Lending the shares they own is another strategy used by some physical ETFs. On the other hand, Synthetic ETFs do not buy the assets in their benchmark. Instead, they typically invest in financial derivative instruments to replicate the benchmark’s performance. Synthetic ETFs are subject to counterparty risk associated with derivatives issuers and may suffer losses if the derivatives issuers default or fail to honour their contractual commitments. Investors should read the ETF prospectus carefully to ensure they understand how the fund operates.

Leveraged and Inverse Products (L&I Products)

Leveraged Products typically aim to deliver a daily return equivalent to a multiple of the underlying index return that they track. For example, if the underlying index rises by 10 per cent on a given day, a two-time (2x) Leveraged Product aims to deliver a 20 per cent return on that day.

Inverse Products typically aim to deliver the opposite of the daily return of the underlying index that they track. For example, if the underlying index rises by 10 per cent on a given day, an Inverse Product should incur a 10 per cent loss on that day.

To produce the specified leveraged or inverse return, these products have to rebalance their portfolios, typically on a daily basis. L&I Products are derivative products. L&I Products structured as Exchange Traded Funds (ETFs) are authorised by the Securities and Futures Commission (SFC) as Collective Investment Schemes (CIS) and are listed and traded on the securities market of HKEX. It is different from conventional exchange traded funds as it typically seeks inverse investment results relative to the index and on a daily basis.

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Exchange Traded Notes (ETNs)

ETN is a type of unsecured, unsubordinated debt security issued by an underwriting bank, designed to provide investors access to the returns of various market benchmarks. The returns of ETNs are usually linked to the performance of a market benchmark or strategy, minus applicable fees. Similar to other debt securities, ETNs have a maturity date and are backed only by the credit of the issuer.

You can buy and sell the ETNs on the exchange or receive a cash payment at the scheduled maturity or may early redeem the ETNs directly with the issuer based on the performance of the underlying index less applicable fees, with redemption restrictions, such as the minimum number of ETNs for early redemption, may apply.

Listed equity linked instruments (ELI/ELN)

Equity Linked Instruments (“ELIs”) are structured products which can be listed on a stock exchange (operated in a country or territory) and authorized to trade through such stock exchange by its own regulatory authority. In Hong Kong, ELIs are listed and traded on the HKEx under Chapter 15A of the Main Board Listing Rules. They are marketed to investors who want to earn a higher interest rate than the rate on an ordinary time deposit and accept the risk of repayment in the form of the underlying shares or losing some or all of their investment.

An ELI’s investment returns are often linked to the performance of their underlying stock(s). But for the purpose of increasing the overall return from that of plain-vanilla ELIs, some issuers may include additional features, such as early call, knock-in and daily accrual coupon. These features may affect the return of the ELIs in different ways. Investors should note that short selling of ELI is prohibited.

Callable Bull/Bear Contracts

Callable Bull/Bear Contracts (“CBBC”) are a type of derivative product that tracks the performance of an underlying asset without requiring investors to pay the full price required to own the actual asset. They are issued either as Bull or Bear contracts with a fixed expiry date, allowing investors to take bullish or bearish positions on the underlying asset. CBBC are issued with the condition that during their lifespan they will be called by the issuers when the price of the underlying asset reaches a level (known as the “Call Price”) specified in the listing document. If the Call Price is reached before expiry, the CBBC will expiry early and the trading of that CBBC will be terminated immediately. Once the CBBC is called, even though the underlying asset may bounce back in the right direction, the CBBC which has been called will not be revived and investors will not be able to profit from the bounce-back.

Rights Issue

A rights issue is a one-time offering of shares in a company to existing shareholders, allowing them an opportunity to maintain their proportional ownership without being diluted by buying additional new shares at a discounted price on a stated future date. Until the date at which the new shares can be purchased, investors may trade the rights to the market the same way they would trade ordinary shares. If the investors do not exercise their rights within the specified period of time, the rights will expire. If the investors do not intend to exercise their rights, they can sell them on the open market. Once exercised, the rights cannot be used again.

Risk of Trading Derivative Warrants

Issuer default risk

In the event that a derivatives warrant 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 derivative warrant issuers.

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Uncollateralised product risk

Uncollateralised derivative warrants 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.

Gearing risk

Derivative warrants 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 derivative warrant may fall to zero resulting in a total loss of the initial investment.

Expiry considerations

Derivative warrants have 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.

Extraordinary price movements

The price of a derivative warrant 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.

Foreign exchange risk

Investors trading derivative warrants 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 derivative warrant price.

Liquidity risk

The Stock Exchange of Hong Kong Limited requires all derivative warrant 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 fulfil its role, investors may not be able to buy or sell the product until a new liquidity provider has been assigned.

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.

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.

Market risk

Derivative warrants may also be exposed to the economic, political, currency, legal and other risks of a specific sector or market related to the single stock, basket of stocks, index, currency, commodity or futures contracts that it is tracking.

Risk of Trading Exchange Traded Funds (“ETFs”)

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

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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.

Tracking error

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).

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.

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.

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 fulfil their role, investors may not be able to buy or sell the product.

Counterparty risk forward 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 categorised 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 benefits 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.

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Risks involved in futures-based ETFs

Risk of rolling futures contracts

Futures contracts are binding agreements that are made through futures exchanges to buy or sell the underlying assets at a specified time in the future. "Rollover" occurs when an existing futures contract is about to expire and is replaced with another futures contract representing the same underlying but with a later expiration date. When rolling futures contracts forward (i.e. selling near-term futures contracts and then buying longer-term futures contracts) in a situation where the prices of the longer-term futures contract are higher than that of the expiring current-month futures contract, a loss from rolling (i.e. a negative roll yield) may occur. Under such circumstances, the proceeds from selling the near-term futures contracts will not be sufficient to purchase the same number of futures contracts with a later expiration date which has a higher price. This may adversely affect the NAV of the futures-based ETFs.

Risk of statutory restrictions on number of futures contracts being held

There is a statutory position limit restricting the holding of futures contracts traded on the recognised exchange company to no more than a specific number of such futures contracts. If the holding of such futures contracts of a futures-based ETFs grows to the limit, this may prevent the creation of units of the product due to the inability to acquire further futures contracts. This may lead to differences between the trading price and the NAV of the product units listed on the exchange.

Risk of Trading Leveraged and Inverse Products (L&I Products)

Investment risk

Trading L&I Products involves investment risk and are not intended for all investors. There is no guarantee of repaying the principal amount.

Volatility risk

Prices of L&I Products may be more volatile than conventional exchange traded funds (ETFs) because of using leverage and the rebalancing activities.

Unlike conventional ETFs

L&I Products are different from conventional ETFs. They do not share the same characteristics and risks as conventional ETFs.

Long-term holding risk

L&I Products are not intended for holding longer than the rebalancing interval, typically one day. Daily rebalancing and the compounding effect will make the L&I Product's performance over a period longer than one day deviate in amount and possibly direction from the leveraged/inverse performance of the underlying index over the same period. The deviation becomes more pronounced in a volatile market.

As a result of daily rebalancing, the underlying index's volatility and the effects of compounding of each day's return over time, it is possible that the leveraged product will lose money over time while the underlying index increases or is flat. Likewise, it is possible that the inverse product will lose money over time while the underlying index decreases or is flat.

Risk of rebalancing activities

There is no assurance that L&I Products can rebalance their portfolios on a daily basis to achieve their investment objectives. Market disruption, regulatory restrictions or extreme market volatility may adversely affect the rebalancing activities.

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Liquidity risk

Rebalancing typically takes place near the end of a trading day (shortly before the close of the underlying market) to minimize tracking difference. The short interval of rebalancing may expose L&I Products more to market volatility and higher liquidity risk.

Intraday investment risk

Leverage factor of L&I Products may change during a trading day when the market moves but it will not be rebalanced until day end. The L&I Product's return during a trading day may be greater or less than the leveraged/opposite return of the underlying index.

Portfolio turnover risk

Daily rebalancing causes a higher levels of portfolio transaction when compared to conventional ETFs, and thus increases brokerage and other transaction costs.

Correlation risk

Fees, expenses, transactions cost as well as costs of using financial derivatives may reduce the correlation between the performance of the L&I Product and the leveraged/inverse performance of the underlying index on a daily basis.

Termination risk

L&I Products must be terminated when all the market makers resign. Termination of the L&I Product should take place at about the same time when the resignation of the last market maker becomes effective.

Leverage risk (for leveraged products only)

The use of leverage will magnify both gains and losses of leveraged products resulting from changes in the underlying index or, where the underlying index is denominated in a currency other than the leveraged product's base currency, from fluctuations in exchange rates.

Unconventional return pattern (for inverse products only)

Inverse products aim to deliver the opposite of the daily return of the underlying index. If the value of the underlying index increases for extended periods, or where the exchange rate of the underlying index denominated in a currency other than the inverse product's base currency rises for an extended period, inverse products can lose most or all of their value.

Inverse products vs short selling (for inverse products only)

Investing in inverse products is different from taking a short position. Because of rebalancing, the performance of inverse products may deviate from a short position in particular in a volatile market with frequent directional swings.

Risk of Trading Exchange Traded Notes (ETNs)

ETNs have a maturity date and are backed only by the credit of the issuer.

There is no guarantee that investors will receive at maturity, or upon an earlier repurchase, investors' initial investment back or any return on that investment. Significant adverse monthly performances for investors' ETNs may not be offset by any beneficial monthly performances. The issuer of ETNs may have the right to redeem the ETNs at the repurchase value at any time. If at any time the repurchase value of the ETNs is zero, investors' investment will expire worthless. ETNs may not be liquid and there is no guarantee that you will be able to liquidate your position whenever you wish.

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Although both ETFs and ETNs are linked to the return of a benchmark index, ETNs as debt securities do not actually own any assets they are tracking, but just a promise from the issuer to pay investors the theoretical allocation of the return reflected in the benchmark index. It provides limited portfolio diversification with concentrated exposure to a specific index and the index components. In the event that the ETN issuer defaults, the potential maximum loss could be 100% of the investment amount and no return may be received, given ETN is considered as an unsecured debt instrument.

The value of the ETN may drop despite no change in the underlying index, instead due to a downgrade in the issuer's credit rating. Therefore, by buying ETNs, investors get direct exposure to the credit risk of the issuer and would only have an unsecured bankruptcy claim if the issuer declares bankruptcy. The principal amount is subject to the periodic application of investor fees or any applicable fees that can adversely affect returns. Where you trade ETNs with underlying assets not denominated in local currencies investors are also exposed to exchange rate risk. Currency rate fluctuations can adversely affect the underlying asset value, also affecting the ETN price.

Investors may have leveraged exposure to the underlying index, depending on the product feature. The value of ETNs can change rapidly according to the gearing ratio relative to the underlying assets. You should be aware that the value of an ETN may fall to zero resulting in a total loss of the initial investment.

Risk of Trading Equity-linked Instrument ("ELI")

Where you instruct the Company to use the Account for trading equity-linked instrument, you acknowledge that ELIs are not principal protected and you may suffer a loss if the price(s) of the reference asset(s) of an ELI go against your view. In extreme cases, you could lose your entire investment. The risk of loss may be substantial in certain circumstances and should not deal in them unless you understand the nature of the transactions entering into and the extent of your exposure to risk. You should carefully consider whether the transactions are suitable in the light of your circumstances and financial position.

You understand that the potential gain on your ELI may be capped at a predetermined level specified by the issuer. During the investment period, you have no rights in the reference asset(s). Changes in the market prices of such reference asset(s) may not lead to a corresponding change in the market value and/or potential payout of the ELI.

You are fully aware that an investment in ELI exposes you to equity risk. You are exposed to price movements in the underlying security and the stock market, the impact of dividends and corporate actions and counterparty risks. You accept the legal obligation to take the underlying instrument at the pre-agreed conversion price instead of receiving the principal of the ELI, if the price of the underlying instrument falls below the conversion price. You will therefore receive an instrument that has fallen in value to the extent that it is less than your original investment, and might even lose the entire principal or deposit if the underlying instrument become worthless. ELIs are not secured on any assets or collateral.

You are fully aware that when you purchase an ELI, you rely on the credit-worthiness of the issuer. In case of default or insolvency of the issuer, you will have to rely on your distributor to take action on your behalf to claim as an unsecured creditor of the issuer regardless of the performance of the reference asset(s). Issuers may provide limited market making arrangement for their ELIs. However, if you try to terminate an ELI before maturity under the market making arrangement provided by the issuer, you may receive an amount which is substantially less than your original investment amount. Equity-linked instrument may be "non-transferable" and it may be impossible for you to close out or liquidate them. Issuer of an ELI may also play different roles, such as the arranger, the market agent and the calculation agent of the ELI. Conflicts of interest may arise from the different roles played by the issuer, its subsidiaries and affiliates in connection with the ELI.

Investors should note that any dividend payment on the underlying security may affect its price and the payback of the ELI at expiry due to ex-dividend pricing. Investors should also note that issuers may make adjustments to the ELI due to corporate actions on the underlying security.

Potential yield Investors should consult their brokers on fees and charges related to the purchase and sale of ELI and payment / delivery at expiry. The potential yields disseminated by HKEX have not taken fees and charges into consideration.

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Risk of Trading Callable Bull/Bear Contracts (“CBBCs”)

Issuer default risk

In the event that a CBBC 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 CBBC issuers.

Uncollateralised product risk

Uncollateralised CBBCs 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.

Gearing risk

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 CBBC may fall to zero resulting in a total loss of the initial investment.

Expiry considerations

CBBCs 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.

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Extraordinary price movements

The price of a CBBC 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.

Foreign exchange risk

Investors trading CBBCs 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 CBBC price.

Liquidity risk

The Stock Exchange of Hong Kong Limited requires all CBBC 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 fulfil its role, investors may not be able to buy or sell the product until a new liquidity provider has been assigned.

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.

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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, 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.

Risks associated with Rights Issue

It is easy to be enticed by shares offered at a discount, but you should not assume that you are getting a bargain. An informed decision should be made by looking at the rationale behind the fund raising exercise.

A company may use a rights issue to cover debt, especially when they are unable to borrow money from other sources. You should be concerned with whether or not the management are addressing any underlying problems.

If you decide not to take up the rights your overall shareholding in the company will be diluted as a result of the increased number of shares in issue.

If you do not participate in the rights issue within the specified time-frame your nil-paid rights will lapse. The company will sell these entitlements and distribute any net proceeds after deduction of the offer price and costs. The amount of lapsed proceeds, if any, will not be known until the offer has closed. Lapsed proceeds are not guaranteed.

Investments and income arising from them can fall in value and you may get back less than you originally invested.

Last update date 5 November 2018