Financial Services Commission

Press Release

May 18, 2020

MEASURES TO IMPROVE ETF AND ETN MARKETS

The FSC announced the measures to improve the exchange-traded fund (ETF) and exchange-traded note (ETN) markets on May 15, which seek to contain overheated investment demand and mitigate excessive concentration on particular investment products.

The measures are aimed at (a) preventing indiscriminate investment behavior in ETF and ETN markets by requiring minimum deposits and mandatory online education for retail investors, (b) improving brokerage firms' management of disparate ratios to minimize investor damages from speculative demand, and (c) creating an environment for the development of diverse investment products to break up excess demand on particular instruments.

BACKGROUND

ETFs and ETNs are exchange listed investment products structured to enable diversification of investment for retail investors in traditional investment assets, such as stocks and bonds, and to allow small-sum investing in a variety of alternative assets including foreign exchanges and commodities.

The ETF market has grown as a major publicly offered fund market and ETNs have provided a niche market where ETF offering remained difficult.[1]

Recently, there has been excessive concentration toward leveraged ETFs and ETNs amid the COVID-19 pandemic-induced market volatility. After the collapse of international oil prices, investors flocked to major oil ETFs and ETNs with an expectation for a rebound in oil prices, thereby raising the potential for losses.[2]

Trend followers who lack information about the risk characteristics of these products also flocked to invest in oil ETFs and ETNs, artificially pushing up trading prices well above their intrinsic asset values.[3]

A series of investor alerts and cautions by securities companies, the Korea Exchange and the FSS as well as transaction suspensions have been issued, but they have yet to successfully curb the overheated demand. Thus, the financial authorities drew up measures to cool overheated investor demand and more effectively manage markets.

[1] ETF's market capitalization (in trillion): KRW2.4 (2007)→KRW6.1(2010)→KRW21.6(2015)→KRW51.6(2019)
ETN's market capitalization (in trillion): KRW0.5 (2014)→KRW5.2(2017)→KRW7.6(2019)

[2] Average daily transaction of oil ETPs: KRW6.2 billion (2019) → KRW266.7 billion (May 2020, up 3,556%)
Proportion of retail investors in oil ETP investment: 52.3% (2019) → 77.1% (May 2020, up 24.8%p)

[3] Disparate ratio (market value minus net asset value over net asset value x 100) of 4 major leveraged oil ETNs (as of May 12): Samsung (289.6%), NH (282.5%), Shinhan (212.4%) and Mirae (93.3%)

Recent Issues with ETFs & ETNs

I. Lack of Safeguards against Indiscriminate Investor Behavior

Novice investors who lack general knowledge about the structure and pricing system of ETNs began to invest in ETNs in large numbers as they could easily engage in trading simply by opening an account even when they lack sufficient understanding about the risks.[4] A rise in the availability of penny stocks in the wake of sharp drops in oil ETN prices also contributed to this phenomenon.

II. Inadequate Management of Disparate Ratio by Securities Firms

The 15-day time delay between the issuance of new ETNs and the taking effect of the stock registration statements created a vicious cycle between a market price hike and an influx of speculative demand. Thus, the 15-day waiting period put in place as a measure to protect investors played a part in preventing the securities firms from supplying new ETNs in response to surge in demand. Also, the securities firms failed to effectively manage their disparate ratios.[5]

III. Lack of Market Management Mechanisms in Emergency Situations

Despite spikes in disparate ratios, the securities firms and the KRX were not able to play an effective role as relevant mechanisms to allow early liquidation or delisting of particular products did not function properly.

IV. Lack of Product Diversification Leading to Excess Concentration

With a rise in domestic investors' transactions in overseas stock markets, investment in particular commodity ETNs rose sharply. The current restrictions placed on ETNs from using major indexes in KOSPI 200 as a means to distinguish them from ETFs further aggravated the concentration on oil ETNs.

Key Measures

I. Control Excessive Speculative Demand

► **Separate Management of Leveraged ETFs & ETNs (Q3 2020):** Set up a leveraged ETF and ETN market system that is separately managed from general stock markets and classify ETFs and ETNs based on the level of risks of their derivatives in order to give variations for their evaluations for listing and investors' access depending on their risk characteristics

► **Minimum Deposit for Leveraged ETFs & ETNs (in September):** Require ETF and ETN investors[6] to place minimum deposits in the amount of KRW10 million

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[4] Number of active ETN accounts in 2020: 28,000 (Jan) → 32,000 (Feb) → 110,000 (Mar) → 238,000 (Apr)
[5] Difference between market value and total underlying asset value, calculated as market value minus net asset value over net asset value x 100
[6] Applies to retail investors only

and restrict leveraged investment in order to curb speculative demand

► **Mandatory Education for Leveraged ETFs & ETNs (in September):** Require mandatory online education for retail investors to help them gain information about the risk characteristics (disparate ratio, compounding interest effect, rollover effect, etc.) and transaction mechanisms of particular leveraged ETPs

► **Reverse Split of ETNs (in September):** Allow reverse split of ETNs to help absorb speculative demand arising from penny stocks due to drops in index values

II. Improve Efficiency in Managing Disparate Ratio

► **Strengthen KRX's Market Oversight Function (in September):** Prevent spikes in disparate ratios by lowering the bar (from the current disparate ratio of 30 percent to 6 percent and 12 percent[7]) for the Korea Exchange to single out items that need to be closely watched for management

When a particular instrument is designated for investor alert due to high disparate ratio, a single price method will be used for trading, and if no further correction in its disparate ratio takes place, a trade ban will be issued.

► **Require Brokerage Firms (LPs) to Maintain Minimum Liquidity (in July):** Require liquidity providers (ETN issuing firms) to maintain at least 20 percent of the total listed securities so that a sufficient supply of ETNs can help prevent spikes in disparate ratios

► **Strengthen Requirements for ETN Issuing Firms to More Effectively Manage Disparate Ratio (in July):** Conduct performance evaluations for liquidity providers more frequently (from quarterly to monthly) and increase penalties to encourage more effective management of disparate ratios

► **Allow Early Redemption to Protect Investors (in July):** Allow early redemption of ETNs after a review by the KRX if it is considered necessary to protect investors

► **Set Up Emergency Response Mechanisms for Adequate Supply of ETNs (in September):** Establish provisions for exemptions on investor protection measures against ETNs to more flexibly and swiftly respond to changes in market conditions

III. Promote Development of Diverse ETN Products

► **Allow ETNs on Domestic Benchmark Indexes (in July):** Allow ETN products to be listed on the domestic benchmark indexes, such as KOSDAQ 150 and KRX 300, which had been previously restricted as a way of preventing excessive competition with ETFs

[7] 3% of domestic underlying assets or 6% of overseas underlying assets multiplied by two

► **PROMOTE DEVELOPMENT OF ALTERNATIVE ETNS & ALLOW SELF-INDEXING (IN JULY):** Ease requirements for underlying index composition to allow tracking of yields on overseas blue-chip stocks in order to promote the development of alternative ETN products that can help absorb domestic investors' demand for foreign stocks

► **LOWER DELISTING STANDARDS (IN JULY):** Allow delisting of ETN products that are underperforming or turning burdensome for liquidity management

SCHEDULE

The FSC will begin implementing the measures that require revisions to the rules of the Korea Exchange in July. For those requiring changes in laws and development of relevant systems, the implementation will begin in September.

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