SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

A Consultation Paper on

Proposed Index Funds Provisions
for the Code on Unit Trusts and Mutual Funds

July 2001
Securities and Futures Commission

Introduction

1. The Securities and Futures Commission invites comments on the proposed new provisions on index funds for incorporation into the Code on Unit Trusts and Mutual Funds (the Code).

2. Index funds are funds which track, replicate or correspond to an index on equities or debt securities, with an aim of closely matching or corresponding to the index performance.

3. In view of the market's increasing interest in index funds, the Commission considers it necessary to provide clearer guidance to the industry on the offering of such funds. Index funds will generally be expected to comply with the provisions, when implemented, and any other relevant requirements under the Code in order to be authorised in Hong Kong.

4. The proposed provisions may be found in Appendix 1. The discussion that follows should be read in conjunction with the Code and the proposed provisions.

Regulatory Approach

5. The Commission is mindful of the need to strike a balance between market development and investor protection. The Commission therefore invites comments on any aspects of the proposed provisions and in particular on a number of specific issues set out below (paragraphs 11 to 16).

6. In drafting the provisions, the Commission has taken into account overseas rules and regulations. However, despite their increasing popularity not many overseas jurisdictions have yet introduced special rules on index funds. For example, the European Commission has proposed that an index fund can invest up to 20% of its net asset value in the securities of a single issuer, provided that the index fulfils certain criteria. However, it has not prescribed any detailed standards on such criteria.

7. The Commission is also mindful of the fact that the methodology and rules for the composition or maintenance of indices differ among providers.

8. The absence of any established regulatory standards and the diversity of index rules suggests an approach largely based on broad principles and full disclosure to investors.

Proposed Code Provisions

General [Please see proposals numbered (a) to (d)]

9. It is proposed that an index fund may invest in other instruments such as derivatives (within permissible limits) in seeking to achieve its investment objectives. This flexibility is also available under the proposals of the European Commission, and is particularly useful where the funds are subject to strict exposure limits or where they are unable to replicate the exact weightings of the constituent securities.

Acceptable Indices [(e)(i) to (e)(v)]

10. Broad principles, supplemented by notes, are set out for consultation.

11. Under (e)(ii), it is proposed that an acceptable index should be broadly based. This stems from the generally accepted principle of risk spreading. The proposed weighting caps at 40% for a single constituent and 75% for the top five constituents should reasonably exclude indices that are highly concentrated.

12. It may, alternatively, be argued that there is no need to require "diversification" as long as the objective of an index fund is fully disclosed and warnings consistent with the concentration risks are provided. While an index may be heavily weighted in a particular security, it may accurately represent the relevant security markets or sectors it refers to. The setting of an artificial cap may defeat the fund's objective of tracking a particular index.

13. The Commission's approach is to attempt to strike a balance on this issue. The proposed caps are for guidance only. Exceptions may be made, if merited, on a case by case basis. Market comments are particularly sought on this issue.

14. Comments are also sought, in particular, on the important factors that may affect the investibility of an index (paragraph (e)(iii)) and if there should be any prescribed criteria.

15. Under (e)(v), it is proposed that rules governing the construction of an index, including those on changes to constituents and weightings, must be clear, transparent, and as objectively based as possible. However, the Commission does not consider it appropriate to specify any particular construction method. The construction method is a matter that affects the risk issues arising and will generally be the subject of disclosure requirements in the interest of investor protection (see (j)(viii)).

Reporting Requirements [(f)]

16. Comments are sought, in particular, on whether the reporting obligations under (f)(iii) should be subject to a materiality test. If there is to be a materiality test, the Commission will need to determine an appropriate threshold (for example, in terms of a percentage or percentage point change in the weighting of any constituent security). Gradual changes in weightings, due to normal market fluctuations, are not ordinarily expected to trigger a reporting or notification obligation.

Investment Restrictions [(g) to (i)]

17. It is proposed under (g) that Chapter 7 requirements should generally apply to index funds, with the exceptions of 7.1, 7.4 and 7.5.[1]

Disclosure [(j)(i) to (j)(xvi)]

18. Additional disclosure is required to enhance investors' understanding of index funds in general and specific features of the underlying indices of individual funds.

Replacement of the Underlying Index [(k)]

19. Replacement of the underlying index may be considered a change of investment objective. This provision is consistent with the current Code requirements regarding change of investment objective.

Financial Statements [(l)]

20. This largely reflects an existing requirement.

The Consultation

21. Interested parties are invited to give their comments by 20 August 2001. The Commission will publish information on the results of the consultation and its response to the comments received. A further announcement will be made when the finalised provisions are to be introduced.

[1] Chapter 7 requirements of the Code are currently under review. It should be noted that given the nature of index funds, waivers from compliance with Chapter 7.1 of the Code have been granted on a number of occasions on conditions as set out under (h)(i) and (h)(ii). Exceptions to 7.4 and 7.5 are incidental to the 7.1 relaxation.

Written comments may be sent

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For further information, please contact the Investment Products Department at (852) 2840 9259.

Thank you.

Appendix 1

Proposed Code Provisions for Index Funds

General

(a) An index fund is a collective investment scheme, the principal objective of which is to track, replicate or correspond to an index on equities or debt securities, with an aim of providing or achieving investment results or returns that closely match or correspond to the performance of the index.

(b) An index fund may seek to track an index by investing all or substantially all of its assets in the constituent securities of the underlying index, broadly in proportion to the respective weightings of the securities, or it may invest in a representative sample of constituent securities of the index.

Note: The use of sampling where the securities in the portfolio are not the constituent securities of the index is acceptable if the portfolio matches the characteristics of the index and this method is necessary for the reduction of tracking error.

(c) In achieving its investment objective, the fund may invest in other appropriate investment instruments, such as derivatives permitted under the Code or otherwise accepted by the Commission, in accordance with the fund's disclosed investment strategies and restrictions.

(d) In general, the Commission will consider authorising an index fund only if the underlying index is acceptable to the Commission. Such acceptance does not imply official approval or endorsement of the index. The Commission reserves the right to withdraw the authorisation if the index is no longer considered acceptable.

Acceptable Indices

(e) The acceptability of an index will be assessed on the following criteria:

(i) The index should have a clearly defined objective and/or the market or sector it aims to represent should be clear.

Note: The Commission must be satisfied that the index appropriately reflects the characteristics of the market or sector. The index should be able to reflect the price movements in its underlying constituents and to change the composition and weightings of these constituents to reflect changes in the underlying market or sector. The Commission may, where relevant, request information on *the market capitalisation of the constituent securities in relation to the total value of the market or sector that an index purports to represent.*

(ii) The index should in general be broadly based.

Note: *An index with a single constituent security weighing more than 40% or with its top five constituent securities weighing more than 75% would generally be considered too concentrated. Exceptions may be made on a case by case basis, particularly where the constituent securities are Government or other public securities.*

(iii) The index should be investible.

Note: *The Commission expects the constituent securities to be investible and reasonably liquid. For example, normal trading volume should be at reasonable levels (taking into account the respective weightings of the securities in the index), so that a fund may adjust its portfolio readily by acquiring or disposing of such securities.*

(iv) The index should be transparent and published in an appropriate manner.

Note: *The latest index level and other important news should be either published in Hong Kong daily newspapers or conveniently accessible by investors (for example, by enquiring of the Hong Kong Representative or through relevant websites). The Commission may also consider whether the index is easily accessible through market data vendors.*

(v) The construction, maintenance and review rules of the index should be well documented, consistent and transparent. Accurate and timely data must be available for the calculation of the index. The index provider is expected to possess the necessary expertise and technical resources.

Note: *The Commission may request the submission of the rules of the index. The Commission may also request the resumes of the directors and key personnel of the index provider.*

Reporting Requirements

(f) Significant events affecting the index should be reported to the Commission. These may include, but not be limited to:

(i) a change in the methodology for compiling or calculating the index;

(ii) a change in the composition of the index due to, for example, the inclusion or deletion of any security; and

(iii) a change in the weightings of the index constituents due to, for example, corporate activities (such as mergers and acquisitions) or significant market movements.

The SFC will determine if a notice to holders (a newspaper announcement may be acceptable) is required and the contents of the notice. Notification is generally expected unless it can be demonstrated to the Commission that there is already adequate transparency of the event concerned and that the interests of holders will not be prejudiced.

Any events which may result in the concentration levels (as set out in the Note to paragraph (e)(ii)) being exceeded should be reported to the Commission. The Commission will determine if the acceptability of the index is affected, as well as any notification requirement.

Investment Restrictions

(g) The core requirements in Chapter 7 will apply with the following exceptions (h) and (i).

(h) Despite Chapter 7.1, an index fund may acquire and hold constituent securities issued by a single issuer even if the value of the fund's holding in the securities exceeds 10% of its net asset value, provided that:

(i) it is limited to any constituent securities that each accounts for more than 10% of the weighting of the index; and

(ii) that the fund's exposure to any such constituent securities may not in any case exceed their respective weightings in the index.

(i) Subject to (h) above, the 30% limit in Chapter 7.4 may be exceeded. Furthermore, subject to (h) above, an index fund may invest all of its assets in Government and other public securities in any number of different issues despite Chapter 7.5.

Disclosure

(j) In addition to the requirements under Appendix C, the offering document of an index fund must make the following disclosure and warnings:-

(i) a description of the market or sector the index aims to represent;

(ii) the characteristics and general composition of the index and, where applicable, concentration in any economic sectors and/or issuers;

(iii) the latest weightings of the top 10 largest constituent securities of the index;

(iv) where necessary, a statement to the effect that the investment of the fund may be concentrated in the securities of a single issuer or several issuers;

(v) a warning of lack of discretion to adapt to market changes due to the inherent investment nature of index funds and that falls in the index are expected to result in corresponding falls in the value of the fund;

(vi) a statement to the effect that there is no guarantee or assurance of exact or identical replication at any time of the performance of the index;

(vii) circumstances that may lead to tracking errors and the related risks, and strategies employed in minimising such errors;

(viii) a brief description of the index rules and/or an indication of the means by which the investors may obtain such information (for example, by providing the website address of the index provider);

(ix) a warning that index composition may change and securities may be delisted;

(x) any circumstances that may affect the accuracy and completeness in the calculation of the index;

(xi) a warning in relation to any licensing conditions (including indemnity given to the index provider, if any) for using the index, and the contingency plan in the event of cessation of the availability of the index;

(xii) a statement on whether the index provider and the management company of the fund (or its connected persons) are independent of each other. If not, the means by which possible conflicts of interests may be addressed;

(xiii) for exchange traded index funds which pay redemption proceeds in kind, a warning that investors may not redeem for cash;

(xiv) for exchange traded index funds, a warning that investors may not be able to deal during any period of suspension in the trading of the funds on the exchanges on which they are listed;

(xv) the Commission reserves the right to withdraw the authorisation of the fund if the index is no longer considered acceptable; and

(xvi) any other information which is relevant and material for investors to make an informed investment decision.

Replacement of the Underlying Index

(k) Following the authorisation of the fund, a replacement of the underlying index may only be made in accordance with the provisions of its constitutive document and with the prior approval of the Commission.

Note: A replacement of the underlying index may be necessary under circumstances including where the index is no longer available or considered acceptable.

Financial Statements

(l) The interim and annual financial statements of the fund must disclose a list of those constituent securities, if any, that each accounts for more than 10% of the weighting of the index as at the end of the relevant period and their respective weightings. The statements must also provide a comparison of the fund performance and the actual index performance over the relevant period.

Name of Fund

(m) The name of the fund must reflect the nature of an index fund.

Note: The words "index", "tracking" and/or "tracker" are expected to appear in the name of the fund.