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

SFC
證監會

A CONSULTATION PAPER ON THE DRAFT GUIDELINES FOR REGULATING INDEX TRACKING EXCHANGE TRADED FUNDS UNDER THE CODE ON UNIT TRUSTS AND MUTUAL FUNDS

Hong Kong
March 2003

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The Securities and Futures Commission invites market participants and interested parties to submit written comments on the proposals discussed in this consultation paper or to comment on related matters that might have a significant impact upon the proposals **no later than 17 April 2003**. Any person wishing to comment on the proposals should provide details of any organization whose views they represent.

Please note that the names of the commentators and the contents of their submissions may be published on the SFC website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this consultation paper.

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Written comments may be sent

By mail to:	Investment Products Department The Securities and Futures Commission 12/F Edinburgh Tower The Landmark 15 Queen’s Road Central Hong Kong
By fax to:	(852) 2877 0318
By on-line submission:	http://www.hksfc.org.hk
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For further information, please contact the Investment Products Department at (852) 2840 9259.

Additional copies of the consultation paper may be obtained from the above address of the SFC. A copy of this paper can also be found on the SFC website at *http://www.hksfc.org.hk*.

Investment Products Department
Securities and Futures Commission
Hong Kong

18 March 2003

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A copy of the Privacy Policy Statement adopted by the SFC is available upon request.

A Consultation Paper on the Draft Guidelines for regulating Index Tracking Exchange Traded Funds under the Code on Unit Trusts and Mutual Funds

Introduction

1. The Securities and Futures Commission invites comments on the Draft Guidelines for regulating Index Tracking Exchange Traded Funds under the Code on Unit Trusts and Mutual Funds (the "Code").

2. The aim of this Consultation Paper is to solicit public response to the proposals for modification of existing Code requirements that are applicable to the authorisation of passively managed index tracking exchange traded funds (referred to as "Exchange Traded Funds" or "ETFs" in this Paper[2]). The purpose of such proposals is to remove constraints in the current regulatory requirements imposed on ETFs so as to facilitate the development of a regional ETF market in Hong Kong. At the same time, it is also hoped that through such proposals, the public is offered a wider choice of investment products. The proposals involve the granting of general and specific reliefs to ETFs on the basis that investors would be given enhanced transparency and timely disclosure of information relevant to investments in ETFs.

3. We also take this opportunity to invite public comments on new initiatives that we would like to introduce to enhance product disclosure in the context of ETFs. These include electronic dissemination of product description documents or offering documents (as the case may be) and financial reports of ETFs and the publication of a Key Features Summary.

4. It is intended that the Draft Guidelines, as set out in **Annex I**, would provide clear guidance to fund management companies for making ETFs available to the investing public in Hong Kong and offer appropriate protection to investors through enhanced disclosure requirements for ETFs.

What are ETFs?

5. ETFs are basically index funds that are listed and traded on exchanges just like stocks. The creation and redemption characteristics of exchange traded funds are fundamentally different from non-exchange traded traditional funds although most ETFs take the legal form of mutual fund corporations or unit trusts. Given the index tracking nature, they are generally passively managed and adopt either a representative sampling strategy or a replication strategy.

6. Unlike traditional funds where individual units or shares are created by the fund upon receipt of subscription monies from investors, ETFs only issue shares in large blocks, say 50,000, called "Creation Units". Authorised Participants would initiate the creation of the ETF shares by submitting a portfolio deposit equivalent to the aggregate net asset value of the ETF shares in the Creation

[2] Important Note: the term "ETFs" used in this consultation paper and in the draft ETF Guidelines does not cover actively managed non-index tracking funds.

Unit. The portfolio deposit consists of a basket of stocks that mirrors the composition of the ETF portfolio and some cash to account for the difference in value between the value of the basket of stocks and the net asset value of the ETF shares. Brokers who wish to meet their customers' orders for ETF may purchase the ETF shares from the Authorised Participants or in the case of purchases in an amount less than the Creation Units, brokers may purchase them in the open market.

7. Similarly, ETFs may be redeemed only in "Redemption Units" whereby the redeeming investor would receive a basket of stocks underlying the index and a small cash component. ETFs do not redeem individual shares or units at NAV. Investors who wish to dispose of ETFs that are fewer in number than the prescribed amount of "Redemption Units" would have to sell them in the secondary market as there is no direct redemption by an ETF. The market price of an ETF may be higher or lower than the NAV of the ETF shares. Similar to the trading of equity stocks, investors would have to pay brokerage commission for ETF shares and stamp duty as appropriate.

8. Unlike traditional funds where the units or shares are normally offered to the public through sales agents or direct subscriptions, investors often purchase ETFs in the secondary market except for institutional investors which can deposit portfolio of securities in exchange for creation units. ETFs seldom conduct direct subscriptions as in the case of the Tracker Fund of Hong Kong ("HK Tracker"). This makes the conventional way of distributing offering documents and financial reports at sales points less relevant to effective communication of relevant product information to investors of ETFs. A comparative study of various overseas ETF markets shows that ETFs traded on these exchanges would make their product description documents or offering documents and trading information readily available via the websites of the exchanges.

9. ETFs share a lot of common features with stocks but also, they have the benefit of a mutual fund or a unit trust which achieves diversification through their portfolio of underlying stocks. The main attributes of ETFs are:

- *Structural Flexibility:* ETFs reflect the performance of different sectors in the market or different markets
- *Exchange trading:* ETFs can be bought and sold on the exchange like stocks through a brokerage account or automated order routing systems
- *Intraday trading*: ETF investors may enter and exit on an intra-day basis whereas for traditional funds, one can only transact as of the end of the day
- *Marginability*: like stocks, ETFs can be purchased on margin
- *Short selling:* unlike stocks, some overseas markets allow ETFs to be sold short on a down tick e.g. the US and Canada and this is a feature useful for executing hedges[3]
- *Transparency:* some overseas listed ETFs post their holdings on a regular basis

[3] Under the SEHK trading rules, tick rule exemption is given to all ETFs trading under the Pilot Programme and to ETFs (other than those in the Pilot Programme) approved by the Commission on a case by case basis for tick rule exemption.

- *Full investment:* unlike traditional funds where cash has to be held in anticipation of redemptions, ETFs do not have to hold cash for such purpose. This would assist the ETFs in participating in the total return from their investments
- *Lower management costs*: with the passive management nature of ETFs, the general management expense ratio is much lower than that of traditional funds

10. While ETFs may have features appealing to investors who wish to use them for managing sector exposure, arbitraging or hedging, ETFs do have their own constraints as investment tools. Tracking error may occur as the portfolio of an ETF may not comprise all the constituent securities of the underlying index or as a result of other factors such as fees and expenses borne by it, corporate actions, difference in trading hours between the ETF and the constituent securities of an index. ETF market prices may diverge from the underlying net asset value and it is expected that this difference would be corrected by arbitraging activities in the market. It is also noted that ETF only tracks the performance of an index and may not be able to achieve returns outperforming the market or sector pertaining to the underlying index.

Overview of global and local ETF markets

11. The first ETF was launched in 1993 in the United States on the American Stock Exchange. ETFs such as SPDRs and QQQ are among the longstanding ETFs that are still trading today. In the last decade, the market saw a significant increase in terms of numbers of ETFs available and their total assets under management. As at the end of 2002, there were 280 ETFs worldwide with US$ 141.62 billion of assets under management.[4] In recent years, there has been rapid development in the types of exchange traded funds ranging from passively managed index tracking funds to actively managed funds which seek to outperform market indices. Exchanges such as the American Stock Exchange, the Deutsche Börse, the London Stock Exchange and the Tokyo Stock Exchange have become major trading platforms offering a wide range of exchange traded funds.

12. In Hong Kong, HK Tracker is the first exchange traded fund which began trading in November 1999 on the Stock Exchange of Hong Kong ("SEHK"). As at the end of 2002, its assets under management stood at about US$3.059 billion and was ranked among the top 10 largest ETFs in the world in terms of assets under management.[5] Excluding HK Tracker, the total assets under management held by the ETFs traded on the SEHK totalled about US$34 million as of the end of 2002. At present, there are 4 ETFs trading on the SEHK but only half of them are primarily listed on the SEHK. The rest have become available for trading in the Hong Kong market via an HKEx Pilot Programme for cross-trading US securities.

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[4] Morgan Stanley Equity Research, "*Exchange Traded Funds – A Global Overview*" as of December 2002.

[5] Ibid.

13. As compared with the major ETF markets, ETFs are still at a developing stage in the Hong Kong market. While the success of a market depends on various factors and a combination of complex economic variables, we believe a set of appropriate standards for regulating ETFs in the Hong Kong market would go a long way in facilitating its development.

Regulatory framework for ETFs in Hong Kong

14. Currently, ETFs (either in the form of unit trusts or mutual funds) are considered in much the same way as non-exchange traded traditional funds when they seek authorisation under the Code. In order to obtain authorisation under the Code for an ETF, an ETF has to meet all the applicable Code requirements including the provisions for index funds under Chapter 8.6.[6]

15. If an ETF seeks to be listed on the SEHK, it has to apply separately for listing pursuant to Chapter 20 of the SEHK listing rules. For the purpose of listing, an ETF would have to appoint a sponsor for listing and submit a listing document for clearance with the SEHK.

16. We gathered from previous experience in authorising ETFs that some of the specific requirements in the Code, in particular, Chapter 8.6 could raise onerous compliance hurdles for ETFs in general. This is particularly seen in overseas listed ETFs where these ETFs are already subject to comparable regulatory requirements in their home jurisdictions. Even after an ETF obtains our authorisation under the Code, it still has to undergo a separate listing approval process of the SEHK. This two-tier approval system for the listing of an ETF under the current regulatory framework has, to some extent, lessened the attractiveness of Hong Kong as an ETF market.

17. Apart from the authorisation route under the Code as described in paragraph 14 above, some overseas listed ETFs attempted to tap the local market via the cross trading Pilot Programme that allows unauthorised overseas listed ETFs to be traded on the HKEx. However, unauthorised ETFs may encounter more difficulties than authorised ETFs in marketing to a wider audience in view of the following factors:

    - Unauthorised ETFs cannot conduct public marketing pursuant to the Code;

    - In general, authorised and listed funds including ETFs are more popular among institutional investors as they would prefer to invest in authorised vehicles with a readily available secondary market, sufficient liquidity and transparency; and

    - If ETFs have obtained SFC authorisation as a mutual fund or a unit trust pursuant to the Code, they would have the exemption status from profits tax under section 26A(1)(a) of the Inland Revenue Ordinance. This in turn would benefit the investors of ETFs as the gains occurred at the ETF level

[6] Reference to “Chapters” in this paper shall mean chapters in the Code unless otherwise specified.

are not taxed as profits tax. On the other hand, unauthorised ETFs would not be entitled to such profits tax exemption status.

What is the possible impact of the implementation of the Draft Guidelines to the fund industry and the investing public of Hong Kong?

Wider choice of investment products

18. The existing regulatory regime for ETFs has in some ways imposed constraints on developing Hong Kong into a regional ETF market. We believe that with the implementation of the Draft Guidelines, these constraints would be removed. It follows that a wider variety of ETFs, both home-grown and overseas listed, could be made readily available to the local market. This would not only offer local investors a wider choice of investment products, but would also help develop Hong Kong into a regional ETF market.

Possible impact on management fees of actively managed funds

19. The development of a local ETF market may impact on the management fee structure of the local fund industry. It is commonly observed that actively managed equity funds would charge management fees in the range of about 1% to 2%[7] per annum. Also, there are upfront fees charged by actively managed equity funds for expenses incurred for establishment of the fund and the sales commission for distribution agents. On the other hand, ETFs generally charge much lower management fees and administrative expenses. This relatively lower fee charging structure of ETFs may be attributed to a number of factors. Unlike actively managed equity funds, ETFs incur less cost in active portfolio trading and this reduces trading costs e.g. commissions and spreads. This is mainly attributed to the passive management nature of ETFs. ETFs also have a lower administrative expenditure as they do not have the same extent of record keeping for shareholders and service expenses which are otherwise incurred by equity funds due to individual redemptions. Most retail ETFs investors purchase and trade their shares in the secondary market, thereby saving a portion of the upfront fees attributable to sales commission or distribution fees.

20. In the face of competition from ETFs, actively managed funds may wish to offer more competitive rates for management fees. This, in turn, may bring about a more cost efficient investment regime for the investing public. On the other hand, however, actively managed funds may see a short-term impact in terms of lower profit margins if their fees have to remain competitive with ETFs. In the longer term, we believe competition among fund managers would motivate fund managers to provide more value added services and innovative products to the market.

[7] Source from website of Investment Fund Association: Frequently Asked Questions on Fund Investment.

Potential increase in market turnover

21. Another possible impact is the potential increase in the market turnover in the Hong Kong securities and capital market. This proposition is made having considered the impact of ETF development in other major financial centres.

22. The global ETFs markets have grown dramatically since the first ETF was launched in the US in 1993. In the US, the total assets under management in 1993 was about US$0.46 billion and as at the end of 2002, the total assets under management of the US ETF market reached US$102.28 billion.[8] On the European continent, tremendous growth is experienced in the ETF markets as evidenced by the boom in number of ETFs launched and the total assets under management. Back in early 2000, there were only 3 ETFs listed in the European market, and within a period of two years, the number of ETFs increased by more than thirty-fold to 118 commanding about US$10.69 billion total assets under management.

23. On the Asian side, Japan ranks as the top ETF market since its first ETF was launched in July 2001. As at the end of 2002, the Japanese market had 18 ETFs with US$21 billion assets under management.[9] Earlier in 2002, Singapore aunched its first local ETF, and Korea also launched their first two local ETFs on 14 October 2002.

24. Despite the downturn in global equity markets in the past few years, the ETF markets have experienced a boom in both their numbers and market turnover. This suggests that there is considerable investor demand on this type of exchange traded product on a worldwide level. It is possible, though not conclusively, that if the Hong Kong ETF market were to follow similar growth patterns as seen in the overseas markets, the number of ETFs traded on HKEx and their turnover might experience significant growth.

Potential for developing wider variety of ETFs and related derivative products

25. Recently, there is a trend in the global ETF markets of introducing new product types. Earlier in 2002, we saw the launch of fixed income ETFs on AMEX and the launch of options on DIAMONDS exclusively on Chicago Board of Exchange. In November 2002, Eurex[10] launched ETF options and has also become the first exchange worldwide to offer futures on ETFs. The development of ETF derivative products not only adds variety to the types of investment products available in the market, but it also facilitates the liquidity of the securities markets.

8 Source: Morgan Stanley Research as at 31 December 2002.
9 Data as of December 2002 and sourced from Bloomberg, Morgan Stanley Research.
10 Sourced from Newsletter Issue 49, November of Eurex (www.eurexchange.com)

What are our initiatives to develop an efficient regulatory framework for Hong Kong's ETF market?

26. Recognising the limitations implicit in the current regulatory framework, we propose to adopt the following initiatives to facilitate the development and growth of a local ETF market:

- Revise the existing Code requirements and introduce new provisions to ensure that ETFs are subject to a set of regulatory principles and rules that are purposeful and appropriate; and
- Work with the SEHK to streamline the current approval procedures for listing of ETFs.

We will also continue our discussions with HKEx to enhance the current trading, clearing and settlement systems so as to provide an optimal trading environment for ETFs.

27. The regulatory intent is that, through the implementation of these initiatives, ETFs that have been authorised by the SFC, whether primarily listed on overseas exchanges or not, would be able to obtain listing status on the SEHK via a streamlined process. Alternatively, an authorised ETF could, instead of being listed, opt for having a trading only status on the SEHK. In either case, an authorised ETF would be able to conduct public marketing in accordance with the revised Code requirements.

28. As part of the measures to develop the ETF market, the new regulatory requirements would also aim to improve product transparency. Thus, trading information about an ETF would be required to be made readily available via either HKEx trading and database systems such as the teletext screen[11] or by other established information vendors.

Q1: Would you or your client be interested in investing in ETFs or launching ETFs on the SEHK?

Q2: What is your view on the initiatives proposed above for developing an efficient regulatory framework in Hong Kong?

Q3: What regulatory initiatives, other than the above listed, should be undertaken in order to develop the ETF market?

Regulatory Approach of the Draft Guidelines

29. The Draft Guidelines are intended to complement the existing Code requirements to provide a distinct regulatory framework for regulating ETFs. We intend to remove provisions in the Code that may be less appropriate for regulating ETFs, and to introduce new requirements that cater to their specific

[11] The teletext screen in this paper stands for the information page on which basic trading data of a listed stock on the HKEx is shown to investors including the stock code, bid/ask prices and queues, previous day's closing prices and cross references to information pages where relevant information about a listed stock can be found.

trading and creation characteristics. In addition, we believe it would help investors compare investment features of various ETFs if information on ETF features are presented in a standardised format and useful trading data of an ETF were more directly conveyed to investors via various electronic platforms or systems. We, therefore, propose the publication of an ETF Product Description Document for ETFs that are not conducting public offerings (instead of the HK Offering Document), a Key Features Summary and announcements through electronic media such as the HKEx website (whether by way of direct posting or hyperlinks), and making its trading data available on the teletext screen or via information vendors such as Bloomberg or Reuters.

30. The Draft Guidelines are based on a three-pronged approach:

- *General relief be given to all ETFs (see paragraphs 34 to 45 for details):*

  This relief allows relaxation from strict compliance with certain index fund provisions in Chapter 8.6 of the Code and post-authorisation requirements.

- *Specific relief be given to ETFs from an Acceptable ETF Regime (see paragraphs 46 to 56 for details):*

  Relying on the principle that an ETF should be pre-dominantly governed by the regulatory framework of its home jurisdiction where there is substantial interest in the ETF and where primary listing is undertaken, we consider it acceptable, in appropriate cases, to give specific relief to these overseas listed ETFs from strict compliance with certain Code requirements.

  In assessing whether a specific relief should be given, the Hong Kong regulatory regime would act as the benchmark. An overseas listed ETF may enjoy the specific relief on the basis that its home regulations and regulatory infrastructure for investor protection, when benchmarked against the Hong Kong regime, are able to provide an overall comparable regulatory framework.

  Overseas listed ETFs, however, would still be required to comply with certain Code requirements that, we believe, should be observed by both local and overseas listed ETFs to ensure appropriate measures are in place to safeguard investors' interest. This includes regular publication of a Key Features Summary, disclosure on a semi-annual and annual basis of the statistics about premium and discount of trading prices compared to NAV, and publication of an ETF Product Description Document/Hong Kong Offering Document (as the case may be) and financial reporting documentation via HKEx website.

- *Enhanced disclosure and electronic dissemination of ETF information for all ETFs (see paragraphs 57 to 79 below for details):*

  We suggest that given the relative simple investment objective of an ETF, that is, to track the performance a particular index, disclosure of an ETF could be simplified by the use of Key Features Summary to enhance easy comprehension and comparison by its investors. We also propose to introduce the use of a Product Description Document to replace the Hong Kong Offering Document for ETFs that are not conducting IPOs or open public subscriptions. The content requirements for an ETF Product Description Document are intended to appropriately reflect the investment characteristics and risks of an ETF. In the case where the ETFs are not conducting IPOs, the ETF provider may simply make the Key Features Summary and the Product Description Document electronically available via the HKEx website.

To achieve enhanced disclosure, we propose that an ETF should (i) publish a Key Features Summary, (ii) provide timely disclosure of trading data on a real-time or near real-time basis via teletext screens of HKEx and/or information vendors; and (iii) publish the Product Description Document/Hong Kong Offering Document (as the case may be), the key features summary, notices and public announcements via HKEx website.

It should be noted that in order for an ETF to rely on the general and specific reliefs under the Draft Guidelines, it would be a prerequisite for the ETF to comply with all the conditions introduced under the Draft Guidelines including the condition where the ETF should either be listed or traded on the SEHK or will be doing so upon authorization.

Draft Guidelines

Basic principles

31. The Draft Guidelines aim to provide a clear and efficient regulatory framework for the approval of ETFs without compromising investor protection. This involves streamlining the provisions applicable to index funds in the Code.

32. We propose that ETFs should no longer be required to comply rigidly with the strict letter of the provisions in Chapter 8.6. Rather, they should comply with the general principles which are stated in Chapter 8.6(a) to (d) and other parts of the Code that are applicable to ETFs as collective investment schemes e.g. diversification, segregation of assets and good corporate governance principles.

33. We also propose as a condition for authorisation of ETFs that they should either be listed or traded on the SEHK or will be so upon authorisation.

(A) General relief from strict compliance with existing Code provisions for all ETFs

Dispensation with strict application of investment restrictions

34. Since ETFs are passively managed funds that track the performance of a broadly based index, we note that some of the specific percentage restrictions on underlying constituent securities of an ETF would be restrictive in view of the investment strategy of the ETF. This is most notable in the case of Chapter

8.6(h) of the Code that has caused compliance difficulties to ETFs that adopt a representative sampling strategy.

35. There are broadly two types of tracking strategies: replication and representative sampling. Replication attempts to track closely an index such that an ETF holds substantially all the index constituents in the same weightings as in the underlying benchmarks. Representative sampling is used by ETFs that hold a sample of stocks that have similar characteristics such as market capitalisation, industry weights, and liquidity to the underlying index. This strategy would be useful when a full replication strategy is difficult e.g. foreign currency controls on investments or liquidity issue. ETFs using this strategy tend to have relatively more tracking risks than those using full replication.

36. When an ETF adopts the representative sampling strategy, an ETF might have to be overweighted in a constituent stock if the stock shares common characteristics with another constituent stock that is difficult to acquire from the market. The restrictions in Chapter 8.6(h) would be onerous to ETFs that are adopting the sampling strategy.

37. In the case of home-grown ETFs such as MSCI China Tracker, waiver from strict compliance with Chapter 8.6(h) has been granted on the basis that these excesses are subject to certain limits. We understand some ETFs that adopt a representative sampling strategy have voluntarily subjected themselves to self-imposed limits on excess weightings as a matter of risk control and to avoid concentration in a few underlying stocks.

38. In view of the practical difficulties for strict compliance with the restrictions in Chapter 8.6(h) for ETFs with representative sampling strategy, we consider it appropriate to propose a relief to home-grown ETFs that adopt this strategy. These ETFs could be exempted from strict compliance with these restrictions on condition that their excessive weightings are subject to certain practical limits that would operate to minimizing exposures. ETFs should first consult with the Commission on the levels of these limits, and the ETF's Product Description Document/Hong Kong Offering Document (as the case may be) must make clear disclosure of these limits and levels.

39. We believe similar relief from Chapter 8.6(h) should be extended to overseas listed ETFs from an Acceptable ETF Regime (which concept is further elaborated in paragraph 46). However, we would not wish to mandate limits to be imposed on the excess weightings of an ETF primarily governed by an Acceptable ETF Regime as we do in the case of home-grown ETFs. The rationale is, an Acceptable ETF Regime shall have comparable safeguards for regulating ETFs on risk diversification in light of excess weightings. The principles upon which an overseas regulatory framework under an Acceptable ETF Regime is recognised are discussed in paragraphs 46 to 52.

40. In the case where an overseas listed ETF has adopted self-imposed limits on excess weightings due to representative sampling strategy, such limits should be clearly disclosed in the Product Description Document/Hong Kong Offering Document (as the case may be).

41. We believe, by way of such relief, ETFs that rely on representative sampling strategy may have more flexibility while at the same time, the composition of these ETFs and their related tracking risks would become transparent to investors.

Modification to risk warnings

42. At present, Chapter 8.6(j) mandates various risk warning statements to be included in the Hong Kong Offering Document of an index fund. To mandate adoption of exact wording of these warning statements in a Product Description Document of an ETF could, in some circumstances, have the undesirable consequence of preventing the ETF from adopting the most appropriate wording to accurately reflect the ETF's inherent risks.

43. Instead of requiring exact replication of these risk warnings, we intend to give relief to ETFs from strict compliance on the condition that they make appropriate risk warnings in the Product Description Document/Hong Kong Offering Document (as the case may be), taking account of the tracking risks, liquidity risks and fluctuations in returns due to index performance. We suggest it should be a pre-requisite for this relief that information about the underlying index is readily available to investors in Hong Kong.

Dispensation with certain post authorisation requirements for ETFs

44. Having regard to the possibility of relying on the HKEx website for timely publication of an ETF's notices e.g. dividend notices, it is believed that certain changes to ETF documentation and the publication of notices may be made without prior approval of the Commission.

45. We propose to give relief from strict compliance with Chapters 11.1, 11.3 and 11.11 to immaterial changes to the constitutive documents and the Product Description Document/Hong Kong Offering Document (as the case may be), adjustments in management fees that require no shareholders' approval and non-marketing public notices (other than notices for material changes to an ETF such as mergers or liquidation). The relief is conditional upon timely notification to holders of ETFs either via the HKEx website or the more conventional means of posting notices to individual investors as seen in the case of traditional funds.

Q4: What is your view on the general approach of giving general relief to ETFs, both local and overseas listed ETFs?

Q5: What other factors should be taken into account in formulating the general relief?

(B) Specific Relief for overseas listed ETFs from an Acceptable ETF Regime

The concept of Acceptable ETF Regime

46. To facilitate the development of a regional ETF market in Hong Kong, our regulatory framework must be open and flexible so as to permit both home-

grown ETFs and overseas listed ETFs to be offered on a level playing field. At present, home-grown ETFs that are offered in the Hong Kong market are only required to comply with the Code. On the other hand, overseas listed ETFs such as those in the US have to comply with both their home regulations and the Hong Kong requirements in order to be authorised under the Code. In many instances, these overseas regulations share a similar regulatory philosophy with our Code.

47. On the basis of comparative studies of various major ETF markets, the Commission proposes to recognise the home regulations of an overseas listed ETF where these regulations afford comparable investor protection to Hong Kong investors. This would simplify the authorisation procedures for ETFs from these major markets.

48. The concept of "regulatory equivalence" is not new to the Code. In Appendix A1, traditional funds that are established in one of the Recognised Jurisdictions[12] would be regarded as complying in substance, with the core investment restrictions in Chapter 7.

49. For the purpose of the Draft Guidelines, the notion of "Acceptable ETF Regime" is introduced to stand for "regulatory equivalence" in the context of ETF. This depends, to a large extent, on the comparability of an overseas regulatory framework to that of the Hong Kong regime in regulating ETFs under the Code and the applicable listing rules of the SEHK.

50. In devising the "Acceptable ETF Regime", we have considered the following basic regulatory principles for recognition of overseas investment products:

- the acceptability of the relationship between the Commission and the overseas securities regulator which are principally responsible for administering the overseas ETF regulations. It is expected that there shall be in place an agreement for mutual co-operation and assistance on fund management activities between the principal securities regulator in an Acceptable ETF Regime and the Commission. The Commission may via such arrangements solicit assistance from or exchange information with the overseas regulators in regulating ETFs launched in Hong Kong;
- the similarity or comparability of the overseas regulations governing the ETF, in particular the authorisation and post-authorisation requirements on the ETF under the Code;
- the operations of the listing rules of the overseas exchange on which the ETF is listed and the effectiveness of the communication channels for information to be disseminated to investors; and
- the overall and combined effect of the overseas rules and regulations, the overseas regulatory infrastructure and the effectiveness of the administration of the applicable rules by the overseas securities regulator.

51. As the overseas listing status of an ETF would be crucial to its recognition as an ETF from an Acceptable ETF Regime, the cessation of an ETF's listing status

[12] The recognised jurisdictions under the Code are set out in Appendix A1 including the UK, the US, Germany, France etc.

in an Acceptable ETF Regime would possibly affect the specific reliefs granted to overseas ETFs under the Draft Guidelines. However, if this should occur, we suggest ETF operators contact us for early consultation regarding possible impact arising from de-listing. We would consider each case in its own context and would assess in a fair and reasonable manner as to whether an ETF would still be able to comply with the core provisions in the Code despite its de-listing in an Acceptable ETF Regime.

52. As the Commission is at the initial stage of implementation of the concept of "Acceptable ETF Regime", only a small number of overseas jurisdictions has been under review. At this stage, we note that the US SEC regulations and the listing rules of the American Stock Exchange together provide a regulatory framework that shares the Commission's regulatory philosophy for regulating ETFs. A comparative table for the regulatory requirements under the US rules and the current Hong Kong Code requirements for ETFs is set out in **Table A**.

Acceptability of index

53. It is proposed that an ETF that complies with the home regulations of an Acceptable ETF Regime would be deemed to have met the index acceptability test under Chapter 8.6(e)(i) to (iii) and (f) subject to one condition: any significant events affecting the acceptability of the underlying index of an ETF, where such events are required by the ETF's home regulations to be notified to its holders, must be notified to the Commission and ETF holders in Hong Kong on a timely basis. Such notification to ETF holders may be made without prior approval of the Commission.

54. It is also proposed that the requirements to seek prior approval of the Commission under Chapter 8.6(k) for the replacement of an underlying index be dispensed with for ETFs from an Acceptable ETF Regime. This is proposed on the following bases:

- The Acceptable ETF Regime would provide oversight and enforcement of regulatory provisions governing the acceptability of an underlying index of an ETF;
- Prior disclosure of possible change of underlying index and appropriate risk warnings are made in the ETF's Product Description Document/Hong Kong Offering Document (as the case may be); and
- Timely disclosure of the replacement of the underlying index is made to investors in Hong Kong.

Contents of Financial Reports

55. The financial reports of an overseas listed ETF are primarily governed by the rules in an Acceptable ETF regime that is considered acceptable for regulating ETFs. Therefore, to mandate these financial reports to conform strictly to the financial reporting requirements stated in the Code would add unnecessary regulatory burden to these overseas listed ETFs, with no additional benefits to investors.

56. It is proposed that where an Acceptable ETF regime does not mandate the inclusion of any particular information in the financial reports of its ETFs, to the extent that such information is mandated under the Code to be so included, such information would only need to appear in the Key Features Summary.[13] In these circumstances, the ETF should publish an updated Key Features Summary at the same time as the semi-annual and annual reports.

Q6: What is your view on the basic regulatory principles that we have considered under the "Acceptable ETF Regime"?

Q7: What is your view on the scope of the specific relief proposed for overseas listed ETFs?

(C) Enhanced Disclosure and additional requirements for all ETFs

Publication of Key Features Summary

57. In comparing the practice of several major ETF markets, we note that it is common for an ETF to publish a factsheet via the website of the exchange on which it is traded. This factsheet usually summarises the key features of the ETF and provides relevant trading information to investors. Very often the factsheet is updated on a frequent basis, say weekly, monthly or quarterly.

58. As most retail investors would access ETFs via the secondary market, we consider it useful if an ETF Key Features Summary is used to serve as a standardised investment aid to investors for comparing key features of different ETFs including the bases for fees and charges. In exploring various ways to simplify product disclosure in the fund industry, we consider the use of a Key Features Summary one of the plausible means to facilitate meaningful comparison among the same types of products.

59. We believe if a Key Features Summary is required to be published by an ETF in the new regime, this should be made available via the exchange on which the ETF is traded. We propose an ETF should follow the prescribed format suggested in **Appendix II** of the Draft Guidelines (see **Annex I**) and it should be written in plain Chinese and English.

60. To facilitate investors' understanding of an ETF, we suggest that a Key Features Summary is available on the first day of the commencement of its trading on HKEx or its initial public offering, where applicable. Thereafter, we propose to require the Summary to be updated, at least, on a half yearly basis at the same time as the ETF's semi-annual and annual reports.[13] Of course, a more frequent updating of the Key Features Summary is encouraged to afford greater transparency to investors. In addition, whenever there are any material changes to an ETF that would affect the information disclosed in the Key Features

[13] It is noted if the first updating of a Key Features Summary is effected coinciding with the ETF's forthcoming semi-annual or annual report, the time period between the publication of the first Summary and the first updating of this Summary may be shorter than six months. However, this shorter revision period would only occur for the first updating and subsequent updates are expected to be regularised at a six-month interval.

Summary (save for information inserted according to Chapter 8.6(j)(iii)), an ETF provider shall ensure that such changes are reflected in the Summary immediately.

61. We suggest that ETFs should have their Key Features Summary directly available on HKEx website or hyperlinked from the HKEx website provided that the provisions of the CIS Internet Guidance Note is complied with.

Q8: What is your view on the proposed introduction of a Key Features Summary for all ETFs?

Q9: What is your view on the contents of the proposed Key Features Summary as stated in Annex I to this Paper?

Q10: What is your view on requiring a Key Features Summary to be updated at least on a semi-annual basis? Would you prefer other updating frequency to be laid down in the Draft Guidelines: weekly, monthly, quarterly or half yearly or other basis?

Replacement of Hong Kong Offering Document by Product Description Document for ETFs not conducting public offerings

62. We noted from prior experience in authorising ETFs that market practitioners have concerns about the appropriateness and practical difficulties of requiring an ETF to produce a Hong Kong Offering Document according to the Code when ETFs are not conducting IPOs or open subscriptions from the public. Given the nature of ETFs, they are not usually sold over the counters like traditional funds nor are they like equity stocks where direct subscriptions would be conducted. It would be more appropriate, we believe, for an ETF to produce a Product Description Document that serves as an information memorandum for investors in the secondary market. The contents of the Product Description Document will largely resemble those required of an authorised fund with appropriate modifications to cater to the special features of an ETF. We propose that the Product Description Document has to be written in both Chinese and English.

63. On the other hand, if ETFs are offered for subscriptions through sales agents like traditional funds or are offered as in the case of the IPO of HK Tracker, we would expect physical copies of Hong Kong offering documents and the related application forms to be made available to investors at designated distribution points and sales agents in accordance with the applicable laws and the provisions in the Code.

Efficient Use of Product Description Document and Key Features Summary

64. In our proposals, we believe the combined use of the Key Features Summary and the Product Description Document could facilitate the streamlining and efficient management of ETF documentation. This combination is particularly useful in the case where a series of ETFs are launched by the same ETF provider.

65. A Product Description Document could be a stand-alone document that contains all the prescribed information in our proposals. In that case, the Key Features

Summary is a summary form of the key characteristics of the ETF described in the Product Description Document. However, whenever a stand-alone Product Description Document is updated and revised simply to accommodate the inclusion of a new ETF product, the regulatory and compliance costs for this new addition may be disproportionate to the total costs for the launch of this new product. As an alternative, we would accept a master Product Description Document and supplemented by a Key Features Summary.

66. We consider it acceptable if a Product Description Document is prepared in the form of a master description document describing the key elements of the ETF series that are common for the ETFs contained in the same master umbrella fund structure such as the applicable risk warnings, the constitutional provisions of the fund structure and the key parties to the product. This sort of programme documentation using a master document and updated on specific products by inserting product specific supplements or term sheets are already commonly used in the debt securities field. The specific product details of an ETF such as its investment objectives and the name of the index that it tracks could be left to the Key Features Summary. The Key Features Summary could be a multi-product summary in that it contains the summaries of various ETFs of the same series.

67. In the case where the Key Features Summary is amended to reflect material changes to information in it, the ETF provider should ensure there is consistency in the information disclosed between the Summary and the Product Description Document.

68. The overall and combined effect of the master Product Description Document as supplemented by the relevant Key Features Summary is that they would constitute the Product Description Document under the Draft Guidelines.

Publication of Product Description Document/Hong Kong Offering Document, financial reports and public announcement via HKEx website

69. We are also mindful of the need to ensure that relevant ETF information should be readily available to investors. Other than the Key Features Summary, we propose that all semi-annual and annual financial reports, public notices and announcements and the Product Description Document/Hong Kong Offering Document of an ETF (as the case may be) shall be published via the HKEx website. As with the case for Key Features Summary, publication of these materials may be made directly or indirectly via the HKEx website.

70. Separately, we would like to invite the public views on the language requirements of public notices or announcements made available to Hong Kong investors by an overseas listed ETF via the HKEx website, directly or indirectly. Generally, under the Code, we expect a mutual fund having retail investors in Hong Kong to publish its notices and announcements in both Chinese and English. For overseas listed ETFs, they may have to overcome some practical difficulties by way of posting on the HKEx website a Chinese translation or a Chinese summary of the day’s notices. We believe the availability of the Chinese version of the public notices and announcements are in line with the general aim of providing greater transparency and protection to

retail investors in Hong Kong. As we do not have a definitive proposal in the Draft Guidelines on this point, we wish to hear from various sectors of the market and the investing public on this issue before proceeding further with the formulation of the relevant requirements.

71. In addition to the above suggestions, we believe it would enhance investor protection if on the HKEx website, there is clear guidance to investors, whether by way of hyperlinks, pop-up windows or otherwise, to lead investors to the areas where ETF information is displayed. We would expect individual ETFs, when making their information available via the HKEx website, to adhere to the provisions set out in the CIS Internet Guidance Note.

Disclosure of premiums and discounts of trading prices vs. NAV in semi-annual and annual financial reports

72. While ETFs tend to trade closely to their NAVs, their trading prices may sometimes exhibit premiums or discounts to their latest NAVs. Some industry practitioners believe that the level of premiums and discounts and the frequency of their occurrence play a key role in the price discovery process for an ETF.

73. On the other hand, some market practitioners believe that for an ETF that is thinly traded on an exchange, the disclosure of the premium/discount of its last traded price versus its NAV would not be particularly useful. The last traded price of an illiquid ETF might represent the price of a transaction that has been executed some time ago and it could arguably be misleading to quote this last traded price for comparison with the latest NAV of the ETF.

74. On balance, we believe it would be useful to help investors to understand the performance of an ETF as compared with its NAV. We therefore propose that a statistical summary of the premium and discount of the ETF's trading prices versus its NAVs be included in the semi-annual and annual financial reports of an ETF together with the percentage of the trading days on which the premium and discount occurs over on the total number of trading days. For ETFs established in an Acceptable ETF Regime, it would be sufficient if they disclose the statistical summary of the performance data of the ETF in the overseas principal market in which the ETF is primarily listed and traded.

75. It is generally observed that the liquidity of an ETF is seen in both on-the-market trades as well as trades conducted by the Authorised Participants in the creation and redemption of large blocks of ETFs. However, newly established ETFs may encounter liquidity issues and thus need time to boost their trading volume through market making or otherwise. Therefore, it may not be appropriate to mandate the disclosure of the statistical summary for a newly established ETF when it is still developing its market share. We therefore propose that the statistical summary for premium and discount of trading prices of an ETF versus its NAV is only required for ETFs that have been established for one year or above.

Dissemination of ETF trading information on a real-time basis

76. In addition, we would like to explore means through which useful trading information for ETFs may be disclosed to the market on a real-time basis. At present, we note that the teletext screens are able to provide the following additional information on a real-time or near real-time basis:

- Previous day's NAV at closing
- Intraday estimated NAV known as "R.U.P.V"[14]

77. We propose, apart from the basic information that is currently available for ETFs listed on the SEHK as mentioned in paragraph 76 above, additional information such as the comparative performance of an ETF against its underlying benchmark be made available to investors on a real-time basis. For the avoidance of doubt, the R.U.P.V and the performance of the ETF compared against the underlying benchmark index would be based on the previous closing price when the market of the index is closed.

78. To compare the performance of an ETF against its benchmark index, we would consider it acceptable if the comparison is made between the index performance measured in monetary unit as compared with the R.U.P.V. of the ETF. We welcome the market comments on how best to achieve the benchmark comparison of an ETF with its underlying index on a real time or near real time basis.

79. At present, we do not have any conclusive view on the types of trading information that the Draft Guidelines should require ETFs to disclose and the channels through which such information should be disseminated to the public. We therefore invite public comments on the above proposed disclosure items and any recommendations that you might have on ways to enhance clear and transparent disclosure of ETF information in the secondary market.

Q11: What is your view on requiring all ETFs to make available the following information on a real or near real-time basis?

- ***Their previous day NAV***
- ***Their real-time RUPV***
- ***Their performance against the benchmark index***

And what would be the most appropriate channels: the HKEx website, the teletext screen or others?

Q12: What other information relating to ETF should, in your view, be published on a real-time or near real-time basis to ensure greater transparency to investors?

Q13: Would you consider it adequate disclosure if the ETF information mentioned in Q11 above is made available only **via** ***information vendors such as Bloomberg or Reuters rather than via the teletext screen?***

Q14: What is your view on requiring a Chinese version or a Chinese summary of the notices and public announcements of an overseas listed ETF to be made available to Hong Kong investors? Alternatively, what would be an

[14] "RUPV" stands for "Reference Underlying Portfolio Value" which is the real-time estimate of an ETF's NAV based on the market price of the securities held by the ETF. On the teletext screen, this information is updated every 15 seconds.

appropriate measure to keep investors in Hong Kong fully informed of the latest published notices and announcements of an overseas listed ETF?

Q15: What is your view on the requirement to disclose the statistics of the premiums and discounts of the ETF's trading prices to its NAV and the reasons accounting for the disparity on a semi-annual and annual basis? Do you have any other suggestions on how investors may access information about the discrepancy between the NAV and the trading price of an ETF during trading hours?

Implications of Disclosure of Securities provisions under Part XV of the Securities and Futures Ordinance to holders of Hong Kong listed ETFs

80. Under Part XV of the Securities and Futures Ordinance (the "SFO"), a holder of a notifiable interest in a listed corporation and any changes thereof has to disclose this interest to the listed corporation and the SEHK. The percentage of the notifiable interest is 5% and the reporting timeline is 3 business days. Part XV will replace the Securities (Disclosure of Interests) Ordinance ("SDIO") upon the SFO becoming effective in early 2003.

81. If an ETF is being listed on the SEHK, its investors who are holding a notifiable interest would have to comply with the disclosure requirements under the SFO unless an exemption is granted by the Commission. We note that, at present, the two listed home-grown ETFs are not operated in the form of mutual fund corporations and the need for exemption from SDIO is not called into question.

82. However, moving forward, it is expected that a good portion of ETFs would be in the form of mutual fund corporations. Having regard to the rationale behind Part XV for the disclosure of interests in listed securities, we consider this requirement irrelevant and onerous to holders of listed ETFs. We believe that listed ETFs in Hong Kong should be exempt from the disclosure of interest requirements in Part XV.

83. Pursuant to Section 309 of the SFO, the Commission may, having regard to the guidelines published under the SFO, exempt an applicant corporation from all of the provisions in Part XV (disclosure of interests) on a case by case basis. Subject to the responses to this consultation paper, the Commission proposes to waive the fees that are chargeable to ETFs authorised by the SFC and listed on the SEHK pursuant to Part XV of the SFO.

Q16: What is your view on our proposal that listed ETFs should be exempt from the application of the disclosure of interests requirements in Part XV of the SFO?

ETF Marketing Materials

84. Turning to the distribution of marketing materials for ETFs in Hong Kong, we would like to remind fund management companies that unless exempted by law, marketing materials of a collective investment scheme are generally required to be authorised before being circulated to the public. The reliefs contained in the Draft Guidelines do not exempt any ETFs from compliance with the authorisation requirements under the Code.

85. An ETF, whether home-grown or overseas listed, that intends to conduct public marketing in Hong Kong should therefore submit their marketing materials to the Commission for authorisation. These marketing materials would be required to comply with the advertising guidelines laid down in Appendix F of the Code and such other requirements as the Commission considers appropriate in the circumstances.

86. The other requirements that we usually request ETF marketing materials to comply with, as seen in the case of HK Tracker and China Tracker, are:

- Proper warnings to investors directing them to read the Product Description Document/HK Offering Document (as the case may be) before investing;
- Upfront disclosure of the means through which Product Description Document/HK Offering Document (as the case may be) are available;
- A brief description of the main differences between ETFs and traditional non-exchange traded mutual funds that are actively managed.

We believe the above requirements would enhance investors' awareness of the nature of ETFs. It is intended that such requirements would continue to apply in respect of marketing materials for ETFs that are authorised pursuant to the Draft Guidelines in future.

Miscellaneous

87. It is proposed that existing authorised and listed ETFs would be subject to grand-fathering provisions so that they need not comply with the new requirements under the Draft Guidelines. However, if these ETFs wish to take advantage of the reliefs under the Draft Guidelines, they would have to comply with such new requirements applicable under the new ETF regulatory framework. For ETFs that have submitted applications for authorisation before the effective date of the Draft Guidelines, they would have the option of electing to comply with the Draft Guidelines in order to enjoy the reliefs.

Conduct of Intermediaries

88. Intermediaries, when advising clients on dealings with ETFs, should ensure they adhere to the spirit and the letter of the applicable provisions in the Code of Conduct for Persons Registered with the Commission and other applicable codes and guidelines for the marketing of collective investment schemes. Particular attention should be paid to making available the relevant Key Features Summary, Product Description Document/Hong Kong Offering Document (as the case may be) and other related materials to their clients and ensuring the suitability of such investments for them before dealing in ETFs on behalf of their clients.

Way Forward

89. The Draft Guidelines are part of the Commission's overall efforts to consult the market in our review of the Code to help develop a better regulatory framework for the fund industry in Hong Kong while ensuring sufficient safeguards for investors. We will conduct in-depth reviews of other parts of the Code where necessary following the implementation of the Securities and Futures Ordinance.

90. We adopt an open approach to any suggestions that may improve the current regulatory framework for collective investment schemes in Hong Kong. It is possible that some of the proposals made in this Paper such as simplified product disclosure or publication of fund information may, after appropriate modification, be extended to other types of collective investment schemes if they are considered useful to market development and investor protection. We will consult the public on any further initiatives including the future development of other types of exchange traded funds such as actively managed non-index tracking funds upon completion of our review of the Code.

The Consultation

91. Interested parties are invited to send their comments to the Commission by 17 April 2003. To facilitate consideration by the public of the main points raised for consultation, a summary of questions is attached to the end of this paper as **Annex II.** The Commission will publish information on the results of the consultation and its responses to the comments received. A further announcement together with a paper on Consultation Conclusions will be released when the Guidelines are finalised.

Annex I

Guidelines for regulating Index Tracking Exchange Traded Funds under the Code on Unit Trusts and Mutual Funds

Introduction

1. These guidelines apply to passively managed index tracking exchange traded funds (which shall be referred to as "Exchange Traded Funds or ETFs" throughout these guidelines[15]). These guidelines should be read in conjunction with the Code on Unit Trusts and Mutual Funds (the "Code") for an overall view of the regulatory framework for ETFs. In case of doubt, an applicant should consult the Commission at the earliest possible time on whether these guidelines would apply to an exchange traded fund seeking authorisation under the Code.

2. These guidelines are devised on the basis that ETFs, whether established in Hong Kong or overseas, should comply with common principles for safeguarding investors' interests. General relief from compliance with certain Code requirements is given to ETFs, wherever originated, in view of the creation, redemption and trading characteristics of ETFs which are fundamentally different from schemes that are actively managed and not traded on exchanges.

3. Specific relief is given to overseas listed ETFs regulated in an Acceptable ETF Regime on the basis that the home regulations of such regimes provide regulatory safeguards comparable to the Code requirements.

4. In addition, new requirements catering to the features of ETFs are included in these guidelines to ensure more efficient regulation of ETFs and to standardise disclosure requirements for ETFs for the investing public.

Basic requirements

5. ETFs, like other types of schemes seeking authorisation under the Code, must comply with the structural, operational and core investment requirements under the Code. ETFs must also abide by on-going compliance and reporting requirements in the Code subject to the applicable reliefs laid down in these guidelines.

6. The general principles set out in Chapter 8.6 (a) to (d) are broadly applicable to ETFs. For ETFs that do not conduct initial public offerings or open public subscriptions, the requirement to produce a Hong Kong Offering Document as stated in Chapter 6.1 of the Code shall be replaced by the requirement to prepare a Product Description Document. In so far as the Code refers to the term "offering document" for such ETFs, this shall be replaced by the term "Product Description Document" (see Paragraph 10.1 below).

[15] Important Note: the term "ETFs" used in the draft ETF Guidelines does not cover actively managed non-index tracking funds

7. It shall be a condition for authorising an ETF under the Code that the ETF shall be either listed or traded on the SEHK.

General relief for all ETFs

8. All ETFs must comply with the Code requirements not otherwise modified or waived by these guidelines. For avoidance of doubt, ETFs must comply with all the applicable provisions governing index funds in Chapter 8.6 of the Code unless varied by these guidelines.

9. Investment restrictions:

   9.1 Chapter 8.6(h): Restrictions in (h)(i) and (ii) need not be complied with in full on condition that:

      (a) an ETF adopts a representative sampling strategy which does not involve the full replication of the constituent securities of the underlying index in the exact weightings of such index;

      (b) the strategy is clearly disclosed in the Product Description Document/Hong Kong Offering Document (as the case may be) of the ETF;

      (c) the excess of the weightings of the constituent securities held by the ETF over the weightings in the index are caused by the implementation of the representative sampling strategy;

      (d) any excess weightings of the ETF holdings over the weightings in the index shall be subject to a maximum limit reasonably determined by the ETF after consultation with the Commission and having regard to the characteristics of the underlying constituent securities, their weightings and the investment objectives of the index and any other suitable factors;

      (e) limits laid down by the ETF pursuant to paragraph 9.1(d) above shall be disclosed in the Product Description Document/Hong Kong Offering Document (as the case may be);

      (f) disclosure shall be made in the ETF's semi-annual and annual reports whether the limits in paragraph 9.1(d) have been complied with in full. If there is non-compliance with the said limits during the relevant reporting period, this shall be reported to the Commission immediately and an account for such non-compliance should be stated in the report relating to the period in which the non-compliance occurs; and

      (g) nothing in paragraphs 9.1(d), (e) and (f) above shall apply to an overseas listed ETF governed by an Acceptable ETF Regime provided that (i) if such ETF elects to impose its own maximum limits of the nature described in paragraph 9.1(d), these limits shall be disclosed in the Product Description Document/Hong Kong Offering Document (as the case may be); and (ii) if there is any non-compliance with such limits, it shall be reported to the Commission as soon as practicable together with the steps taken (or will be taken) to rectify the non-compliance.

10. Disclosure requirements

10.1 An ETF that is not conducting public offers in Hong Kong shall, instead of preparing an Offering Document in accordance with Chapter 6.1 of the Code, be required to prepare a Product Description Document in both the Chinese and the English languages and shall contain information in Appendix C (as modified) which is set out in more detail in **Appendix I** to these guidelines. For avoidance of doubt, provisions relating to disclosure of index funds information in Chapter 8.6(j) shall not be applicable where the same is not required in **Appendix I**.

10.2 Chapter 8.6(j)(iii): An ETF that discloses the weightings of the top 10 largest constituent securities of the ETF in its Key Features Summary pursuant to the requirements in **Appendix II** does not have to comply with this specific requirement to disclose top 10 largest constituent securities of the index in its Product Description Document/Hong Kong Offering Document (as the case may be).

11. Name of the ETF: Chapter 8.6(m) need not be complied with by an ETF if the name adopted is not misleading or deceptive as to the nature of the ETF and its investment objectives and strategy.

12. Post-authorisation notification and approval procedures: The notification and approval requirements under Chapters 11.1, 11.3 and 11.11 are modified to the following extent:

(a) Chapter 11.1 applies only to material changes to the Product Description Document/Hong Kong Offering Document (as the case may be) and constitutive documents. Immaterial changes arisen due to legislative or regulatory changes, typographical or stylistic changes may be effected without prior approval from the Commission.

(b) The requirement for prior approval in Chapter 11.3 would not apply to adjustments in management fees that do not require shareholders' approval if notification is made as stated in the proviso of this paragraph 12;

(c) Chapter 11.11 applies to marketing materials that are targeted at the investing public of Hong Kong. Public announcements, not being marketing materials, made by ETFs pursuant to the applicable listing rules, the regulatory requirements of the relevant Acceptable ETF Regime or HKEx, or other applicable rules need not be subject to the approval procedures under Chapter 11.11.

For avoidance of doubt, nothing in paragraph 12 (c) shall exempt an ETF from compliance with Chapter 11.4 and 11.5 of the Code.

Provided always that any changes in paragraph 12 (b) shall be notified to holders of the ETFs at the same time as or before the changes are effected either via HKEx website or other appropriate means e.g. posting notices to individual holders and that the public announcements in paragraph 12 (c) shall be made available to the holders via the HKEx website. All the above notifications and public announcements shall be filed with the Commission upon their release.

Specific relief for ETFs in an Acceptable ETF Regime

13. Specific relief is given to overseas listed ETFs that are subject to both the securities regulations of an overseas jurisdiction and the governance of the listing rules of a recognised overseas exchange which are considered to be acceptable (together called "the Acceptable ETF regime") taking into account the factors in paragraph 14 below. The Commission will publish and update on a regular basis the list of the Acceptable ETF regimes.

14. In determining whether a regime is an Acceptable ETF regime, the following principles will be considered:

    (a) There must be a mutual co-operation and assistance agreement for fund management activities between the principal securities regulator of an Acceptable ETF regime and the Commission.

    (b) The similarity or comparability of the overall securities regulatory framework provided by the overseas jurisdiction where there is substantial interest in the ETF and in which it is primarily listed. This overseas regulatory framework must impose structural and operational requirements and full disclosure standards comparable or equivalent to those required by the Commission for collective investment schemes.

    (c) The overall and combined effect of the rules and regulations, the regulatory infrastructure of an Acceptable ETF regime where the ETF is primarily listed and in which there is substantial interest and the effectiveness of the administration of these rules and regulations, must afford comparable investor protection to that provided under the Hong Kong regulatory framework; and

    (d) The overseas stock exchange on which primary listing of the ETF takes place shall provide a system for trading and dissemination of information comparable to that of the recognised exchange in Hong Kong so that market information about the ETF and the index is readily accessible by the investing public in Hong Kong.

15. An ETF that seeks to rely on the specific relief in paragraph 16 shall comply with the following conditions:

    (a) Compliance with the applicable laws and regulations of the relevant Acceptable ETF regime;

(b) Compliance with the applicable listing rules and trading rules of the overseas exchange on which the ETF is primarily listed;

(c) There are no changes in the laws and regulations of the Acceptable ETF regime and the relevant overseas listing rules governing the offering and the listing of the ETF that would materially affect the Regime's comparability with that of Hong Kong. Where any material changes would be made to the securities regulations or the applicable listing rules of the Acceptable ETF regimes thereby affecting their comparability with those of Hong Kong, the ETF or its management company shall inform the Commission as soon as practicable ; and

(d) The ETF complies in full with the applicable provisions in these guidelines.

16. ETFs that meet the conditions set out in paragraph 15 above may rely on the following relief:

(a) *Acceptability of index*: The index that such an overseas listed ETF tracks shall be deemed to have complied with Chapter 8.6(e)(i) to (iii).

(b) *Replacement of index*: Chapter 8.6(k) shall not apply on condition that there is prior disclosure in the ETF's Product Description Document/Hong Kong Offering Document (as the case may be) of the circumstances under which replacement of the underlying index of the ETF would take place and that disclosure of the replacement of the underlying index be notified to the Commission and the holders in Hong Kong on a timely basis.

(c) *Reporting requirements*: Chapter 8.6(f) only applies to the extent that any significant events relating to the index that might affect the acceptability of the index or its equivalent assessment criteria in an Acceptable ETF Regime for which the Acceptable ETF Regime would require notification to investors, shall similarly be notified to the holders of the ETF in Hong Kong and the Commission on a timely basis. No prior approval of such notices by the Commission would be required.

(d) *Financial reports*: ETFs that have prepared their semi-annual and annual financial reports in accordance with the applicable overseas securities regulations and financial reporting requirements of an Acceptable ETF Regime, which reports are not qualified by their auditors, may be relieved from full compliance with the contents requirements of Appendix E and Chapter 8.6(l).

Any information about an ETF that is required by Chapter 8.6(l) but is not mandated by the applicable overseas securities regulations of the Acceptable ETF regime shall be provided in a Key Features Summary to be issued at the same time as the financial reports to the investors.

Key Features Summary

17. It shall be a condition for authorisation of ETFs that a Key Features Summary is made available to investors in the following manner:

    (a) The first Key Features Summary shall be available at or before the first date of trading in the Hong Kong market or the first date of initial public offering of the ETF (whichever is earlier or applicable);

    (b) Subsequent to the first Key Features Summary, a Key Features Summary shall, at least, be updated half yearly and yearly and be available at the same time as the publication of each semi-annual and annual report of the ETF; and shall be updated whenever there are material changes to the information contained in the Key Features Summary save for information included under paragraph 10.2 of these guidelines.

    (c) If an overseas listed ETF is required to contain additional information by paragraph 16(d), it shall ensure that the Key Features Summary be updated accordingly at the prescribed dates for publication.

18. Key Features Summary shall present information in the format prescribed by **Appendix II**. The Summary shall be written in plain Chinese and English. Key Features Summary shall be submitted for approval by the Commission and filed with the Commission each time it is published.

Publication of ETFs materials via HKEx website

19. An ETF authorised pursuant to the Code as modified by these guidelines shall publish the following documents both in Chinese and English via HKEx website (whether by way of direct posting or hyperlinks):

    (a) Product Description Document/Hong Kong Offering Document (as the case may be);

    (b) Key Features Summary;

    (c) Latest version of the semi-annual and annual financial reports; and

    (d) All notices and public announcements issued by the ETFs in the Acceptable ETF regime and in Hong Kong (or a summary thereof).

Disclosure of Premiums and Discounts of Market Prices to NAV

20. In addition to the information required to be disclosed in the interim and annual reports pursuant to Appendix E of the Code, any ETF, except as provided in paragraph 20 (c) below, shall disclose in its interim and annual reports a summary illustrating the differences between the daily closing price on the exchanges of the ETF and the ETF’s net asset value over the reporting period in the following manner:

(a) Premiums and discounts to the NAV, as represented by the difference between daily closing price of the ETF on SEHK or the principal exchange in the relevant Acceptable ETF Regime (as the case may be) and its NAV on the same day, shall be expressed as a percentage to the NAV of the ETF on that given day;

(b) A summary (whether by way of graphical presentation or otherwise) showing the statistics of the occurrence of premiums and discounts between the ETF's trading prices (on the SEHK or the principal exchange in an Acceptable ETF Regime) to its NAV against the number of trading days during the reporting period covered by semi-annual or the annual report, as the case may be;

(c) Nothing in paragraphs 20(a) and (b) above shall apply to ETFs that have been established in Hong Kong and traded on SEHK for a period of less than one year; and

(d) Paragraphs 20(a) and (b) above shall be considered as complied with by an ETF from an Acceptable ETF Regime if its interim and annual reports prepared in accordance with the regulatory requirements of the Acceptable ETF Regime contain a statistical summary of the premiums and discounts of the ETF's trading prices in the principal market as compared with its NAV in that Regime during the applicable reporting period or equivalent information.

Dissemination of trading information of ETF via teletext and other information vendors

21. The following trading information about ETFs shall be made available to the public on a real-time or near real-time basis via the teletext screen of HKEx in addition to information commonly available for stocks (e.g. bid/ask prices and queuing displays):

- Previous day's closing NAV;
- Intraday estimated NAV (commonly referred to as "RUPV" on HKEx)
- Performance of the ETF compared against the underlying index. *(Note: the measurement of the underlying index could be a translation of the index level into its equivalent in monetary unit for ease of comparison with the RUPV of the ETF)*

For the avoidance of doubt, the R.U.P.V and the performance of the ETF compared against the underlying benchmark index would be based on the previous closing price when the market of the index is closed.

Provided that if it is unduly burdensome for any of the above information to be made available on the teletext screen of HKEx, dissemination of such information through alternative means such as via information vendors that are capable of transmitting information in a reliable and timely manner is acceptable.

Grandfathering provisions and transitional arrangements

22. Existing authorised ETFs may continue to remain authorised under the Code without having to comply these guidelines. In the case where existing authorised ETFs seek to rely on any relief provided in these guidelines, they are required to comply in full with the guidelines herein and to submit a revised Product Description Document/Hong Kong Offering Document (as case may be) and a set of the Key Features Summary for the Commission's approval.

23. With respect to ETFs that have been submitted to the Commission for approval pursuant to the Code before the date of these guidelines, they may elect to comply with the Code as amended by these guidelines. In the case where an ETF does not elect within one month from the date of these guidelines or such later date as may be agreed with the Commission, the application would be processed on the basis of the Code without regard to these guidelines.

Miscellaneous

24. As of the date of these guidelines, the securities regulatory framework provided by the SEC Regulations of the United States and the American Stock Exchange are an Acceptable ETF regime for the purpose of these guidelines.

25. These guidelines do not preclude the right of the Commission to impose any conditions for approval of an ETF as may be reasonable in the circumstances.

Dated 18 March 2003

Appendix I of the Draft ETF Guidelines

Information Required to be Disclosed in the Product Description Document

This list is not intended to be exhaustive. The Commission may require further information to be disclosed which may be necessary for investors to make an informed investment decision.

Summary of Information to be Disclosed	**Sections under Appendix C and Chapters of the Code, and Other Relevant Information for ETFs Authorized Pursuant to the Proposed ETF Guidelines**
Constitution of the ETF	C1
Investment Objectives and Restrictions	C2
Description of Underlying Index	• 8.6(j)(i)* • 8.6(j)(ii)*
Other Information regarding the Index	• 8.6(j)(xiii) • Circumstances under which replacement of the underlying index would take place
Means by which investors may obtain the relevant information regarding the ETF and the index	• Sources from which real-time pricing of the ETF could be obtained, e.g. stock code, ticker symbol etc.* • 8.6(j)(viii)* • 8.6(j)(ix)*
Operators and Principals	• C3* + any other relevant operators such as authorized participants etc.*
Characteristics of Units/Shares	• C4 (if applicable)* + trading lot size* • C5 • C6 • C7
Subscription and Redemption Procedures	• C8 • C9 + procedures for buying/selling units/shares on SEHK* • C10 (if applicable) • C11 • C12
Distribution Policy	• C13
Fees and Charges	• C14(a) (if applicable) • C14(b)* (see 6.16 and 6.18) • Fees borne by investors trading on SEHK, e.g. brokerage fee, transaction levy, stamp duty etc.* • C14(c) *[Note: Fees should be clearly presented under tabular form]*
Connected Party Transaction	C15
Taxation	C16
Reports and Accounts	• C17 • C18

Warnings	• C19* • Proper risks warnings suitable for passively managed index tracking ETFs, including those for tracking errors, liquidity of underlying securities, circumstances that may affect the accuracy and completeness in the calculation of the index etc.* *[Note: With proper risk warnings, 8.6(j)(iv)- (vii), (x) – (xii) and (xiv) need not be strictly adhered to.]*
General Information	• C20 • C21 • C22 • C23 • 6.15 • Provisions on stock lending
Termination of the ETF	C24 (see 11.4 and 11.5)
Authorization conditions and Waivers Granted to the ETF	• Self-imposed limits for any excess weightings of the ETF holdings over the weightings in the index • Authorization conditions imposed on ETFs of an Acceptable ETF Regime • Waivers granted from compliance with the Code

** Such information is also required to be disclosed in the Key Features Summary in a summary form.*

Format of Key Features Summary and Disclosure Requirements

[Name of the ETF] [Date]

[**Important –** This is only a summary of the key features of [the name of ETF] and is not intended to be or to replace the Product Description Document/Hong Kong Offering Document (as the case may be). **You should read the Product Description Document/Hong Kong Offering Document (as the case may be) carefully before you invest.** The Product Description Document/Hong Kong Offering Document (as the case may be) is available from your broker free of charge upon your request or may be downloaded via the website of the Stock Exchange of Hong Kong (*Website link: HKEx*).

You should consult your professional advisers if you have doubts about the contents of this summary or the Product Description Document/Hong Kong offering document (as the case may be).]

1. ***What is the ETF's objective and what index does it track?***
A: Describe the investment objective of the ETF and name the underlying index.

2. ***Where is the ETF traded?***
A: State which exchange(s) on which the ETF is traded and whether it is fungible between markets.

3. ***What is the index comprised of?*** *[Note: Information may be presented in tabular form where appropriate]*
A: Describe the objective of the index, e.g. the sector/market it seeks to reflect.

4. ***What is the strategy or methodology employed by the ETF in order to track the index?***

5. ***How can I obtain market and trading information about the ETF and the underlying index?***
A: State the relevant information that investors should be aware of and provide the corresponding website addresses. For example:

- ETF's own website (if any);
- Latest index information and news *(Website Link: index provider*);
- HKEx announcement *(Website Link: HKEx);*
- Announcements/notices posted on the overseas exchange on which primary listing of the ETF takes place *(Website Link: the primary overseas exchange where the ETF is being traded);* and
- Sources where additional trading information could be found, e.g. names of information vendors.

[A statement to alert investors that they should actively check the above information on a regular basis since the above information may materially impact on their investment holdings.]

6. ***Quick Facts*** *[Note: Information may be presented in tabular form where appropriate]*
   - Stock code;
   - Sources where the NAV, R.U.P.V and the underlying index level in monetary units are published;
   - Ticker symbol;
   - Trading lot size;
   - Main operators – e.g. management company, authorized participants, Hong Kong representative etc.; and
   - Top 10 holdings of the ETF.

7. ***What are the risks associated with the ETF?*** *[Note: Insert proper risk warnings depending on the nature of the ETF and the index, including but not limited to the following suggested warnings]*
   - Liquidity risks;
   - Tracking error risks and the circumstances under which tracking errors may occur;
   - Trading risks – e.g. disruptions to the creation and redemption process, suspension of trading etc.;
   - Risks and constraints arisen from the employment of certain strategies; and
   - Applicable risk warnings required under Appendix C19 of the Code on Unit Trusts and Mutual Funds.

8. ***How can I purchase and sell the ETF?***

9. ***What are the charges involved in this investment?*** *[Note: Fees of the ETF should be clearly presented under a **Fees Table**]*

A: State all the fees and charges involved and divide them into the following four categories:
   a) Fees and charges payable by investors dealing via the HKEx
   b) Brokerage commission paid by investors on trading of the ETF
   c) Fees payable by investors dealing directly with the ETF e.g. block creation and redemption
   d) Fees borne by the ETF

10. ***Will I receive any income or dividend from the investment?***

11. ***Who can I contact for enquiries or to obtain further information?***

12. ***If applicable - Insert any information that is required to be disclosed in the financial reports by Chapter 8.6(l) but is not mandated by the applicable overseas regulations of the Acceptable ETF Regime.***

Annex II

Summary of Questions

Q1: ***Would you or your client be interested in investing in ETFs or launching ETFs on the SEHK?***

Q2: ***What is your view on the initiatives proposed above for developing an efficient regulatory framework in Hong Kong?***

Q3: ***What regulatory initiatives, other than the above listed, should be undertaken in order to develop the ETF market?***

Q4: ***What is your view on the general approach of giving general relief to ETFs, both local and overseas listed ETFs?***

Q5: ***What other factors should be taken into account in formulating the general relief?***

Q6: ***What is your view on the basic regulatory principles that we have considered under the "Acceptable ETF Regime"?***

Q7: ***What is your view on the scope of the specific relief proposed for overseas listed ETFs?***

Q8: ***What is your view on the proposed introduction of a Key Features Summary for all ETFs?***

Q9: ***What is your view on the contents of the proposed Key Features Summary as stated in Annex I to this Paper?***

Q10: ***What is your view on requiring a Key Features Summary to be updated at least on a semi-annual basis? Would you prefer other updating frequency to be laid down in the Draft Guidelines: weekly, monthly, quarterly or half yearly or other basis?***

Q11: ***What is your view on requiring all ETFs to make available the following information on a real or near real-time basis?***

- ***Their previous day NAV***
- ***Their real-time RUPV***
- ***Their performance against the benchmark index***

And what would be the most appropriate channels: the HKEx website, the teletext screen or others?

Q12: ***What other information relating to ETF should, in your view, be published on a real-time or near real-time basis to ensure greater transparency to investors?***

Q13: ***Would you consider it adequate disclosure if the ETF information mentioned in Q11 above is made available only via information vendors such as Bloomberg or Reuters rather than via the*** **teletext screen?**

Q14: ***What is your view on requiring a Chinese version or a Chinese summary of the notices and public announcements of an overseas listed ETF to be made available to Hong Kong investors? Alternatively, what would be an appropriate measure to keep investors in Hong Kong fully informed of the latest published notices and announcements of*** **an overseas listed ETF?**

Q15: ***What is your view on the requirement to disclose the statistics of the premiums and discounts of the ETF's trading prices to its NAV and the reasons accounting for the disparity on a semi-annual and annual basis? Do you have any other suggestions on how investors may access information about the discrepancy between the NAV and the trading price of an ETF during trading hours?***

Q16: ***What is your view on our proposal that listed ETFs should be exempt from the application of the disclosure of interests requirements in Part XV of the SFO?***

Table A

Comparison between Index Fund Guidelines under the Code on Unit Trusts and Mutual Funds ("the Code") and AMEX Listing Rules for Index Funds[16]

Regulatory Principles	Index Funds Guidelines	AMEX Listing Rules	Remarks
Market Capitalization: the index should be representative as to the sector/market it aims to reflect.	No prescriptive rules on the market capitalisation of the stocks. However, the guidelines state that the index must appropriately reflect the characteristics of the market or sector.	Component stocks that in aggregate account for at least 90% of the weight of the index or the portfolio shall have a minimum market value of at least US$75m.	
Liquidity: component stocks in the index must be sufficiently liquid so that fund managers can freely acquire or dispose of the stocks in order to replicate the holdings of the index.	The component stocks in the index should be sufficiently liquid, and may be readily acquired or disposed of under normal market circumstances without trading restrictions.	The component stocks shall have a minimum monthly trading volume during each of the last 6 months of at least 250,000 shares for stocks representing at least 90% of the weightings of the index or the portfolio.	
Diversification: index should be broadly based.	• A single stock cannot weight more than 40% in the index; • Top 5 constituent securities in aggregate should not be more than 75% in the index.	• The most heavily weighted component stock cannot have a weighting of more than 30% of the index or the portfolio; • The 5 most heavily weighted component stocks cannot exceed 65% of the index or portfolio. • The index or portfolio must include at least 13 stocks.	
Index Transparency: Index should be transparent so that the latest index level and news of the index can be readily available.	The latest index level should be conveniently accessible by investors, e.g. published on newspaper or website etc.	All securities in the index or the portfolio must be listed on a national securities exchange or NASDAQ.	
Index Methodology and Calculation	No prescriptive rules. However, the index provider should possess	• The underlying index should be calculated based on certain prescribed strategies[17].	

[16] Information as of 30 June 2002
[17] The underlying index must be calculated based on either the market capitalization, modified market capitalization, price, equal-dollar or modified equal-dollar weighting methodology.

	relevant expertise and sufficient resources to construct, maintain and review the methodology/ rules of the index.	• If the index is maintained by a broker-dealer, the broker-dealer should erect a "fire wall" around the personnel who have access to information concerning changes and adjustments to the index. The index should be calculated by a 3rd party who is not a broker-dealer.	
Reporting Requirements: significant events relating to the index have to be notified to investors.	The Commission should be consulted on any events that may affect the acceptability of index. Significant events relating to the index should be notified to the holders as soon as practicable.	Nil	Since AMEX requires that all the securities in the index or the fund must be listed, no reporting on the fund's level is required in US.
Investment Restriction: to avoid the objective of an index fund be undermined and avoid the abuse of over-concentration of securities' weightings in the fund.	More than 10% of the fund's NAV can invest in a single component stock provided that: - the weighting of this component stock accounts for more than 10% of the weighting of the index; - the fund's holding of such component stock may not exceed their respective weighting in the index.	Nil.	Waivers from Chapter 8.6(h)(i) & (ii) have been granted to an index fund in May 2002. The Commission recognised the difficulties for an index fund to comply with Chapter 8.6(h) since it adopts the representative sampling strategy[18].
Distribution of Offering Document	The Hong Kong offering document must be prepared in accordance with the disclosure requirements listed under the Index Funds Guidelines and Appendix C of the Code. Application form of the fund must be accompanied by the offering document.	A "Product Description" containing the terms and characteristics of the ETF, in a form prescribed by AMEX, must be delivered to investors no later than the time a confirmation of the first transaction is made. A prospectus should be provided upon request of investors.	

[18] By "sampling" the constituents in the index, the Fund seeks to replicate the performance of the index without actually owning all the component securities in the index. "Sampling" strategy is useful to an index fund in the case where there are difficulties in acquiring some of the constituent securities due to regulatory restrictions such as foreign ownership or exchange controls, or where there is a restricted market for such constituent securities.

Disclosure in Financial Reports: investors should be given the opportunity assess whether the fund has met its objective by comparing the index and fund performance.	Must include: - A list of component stocks that account for more than 10% of the weighting in the index; - A comparison of the fund performance and the actual index performance.	Form S-X[19] does not contain provisions specifically for ETFs. However, it is observed from the financial reports of some AMEX listed ETFs that comparisons between the fund performance and index performance are voluntarily included. In addition, according to the SEC speech dated 14 January 2002, ETFs agreed to disclose in its annual report regarding the fund's total return based on both NAV and market price. ETFs also have to indicate the frequency of an ETF's daily closing prices that trade at a premium or discount to the ETF's daily closing NAVs and disclose the magnitude of such.	
Name of Fund	Must reflect the nature of an index fund.	Nil	

[19] Form S-X listed out all the content requirements in annual and interim financial reports. The disclosure requirements of Form S-X are comparable to Appendix E of the Code.