

4 July 2014

Circular to Management Companies of SFC-authorized Exchange Traded Funds and Unlisted Index Funds

Disclosure of Tracking Difference and Tracking Error

1. The purpose of this circular is to provide a set of guidance on the disclosure requirements of tracking difference and tracking error. These requirements are applicable to all SFC-authorized ETFs. In respect of SFC-authorized unlisted index funds, only requirements concerning disclosure of tracking difference, to the extent they relate to the offering documents, shall be applicable.

Background

2. In line with the recommendations relating to the regulation, operations and management of ETFs¹ issued by IOSCO, the Commission is introducing this set of guidance on the disclosure requirements for tracking difference and tracking error with a view to improving transparency and helping provide further information to investors concerning the performance tracking of ETFs and unlisted index funds.

Tracking Difference (跟蹤偏離度)

Methodology

3. Tracking difference (“TD”) is the return difference between an ETF and its underlying index² over a certain period of time.
4. An ETF tracking a total return index (“TRI”) should use the underlying TRI as a benchmark to measure the TD and an ETF tracking a price return index (“PRI”) should use the underlying PRI as the benchmark accordingly.
5. Set out below is the formula for calculating the TD of an ETF:

$$TD = [(NAV_{end} - NAV_{begin}) / NAV_{begin}] - [(Index Value_{end} - Index Value_{begin}) / Index Value_{begin}]$$

- a) NAV_{end} , $Index Value_{end}$ = Net asset value (“NAV”) per unit, index value on the last dealing day of the relevant calculation period, when both NAV of the ETF and index value are calculated and available.

¹ In June 2013, the International Organization of Securities Commissions (“IOSCO”) issued its final report on Principles for the Regulation of ETFs, which has outlined a set of principles for regulators and industry practitioners relating to the regulation, operations and management of ETFs. IOSCO suggests that regulators consider imposing requirements regarding disclosure in order to help provide adequate information to investors concerning the index and performance tracking. Such disclosure might include, among other things, the past performance of the ETF measured through its realized tracking difference and tracking error.

² For the purpose of this circular, the term “index” includes an ETF’s underlying benchmark where appropriate.



- b) $NAV_{\text{begin}}, \text{Index Value}_{\text{begin}} = \text{NAV per unit, index value on the last dealing day of the previous calculation period, when both NAV of the ETF and index value are calculated and available.}$
 - c) The calculation of actual TD of an ETF tracking TRI may be done on the assumption/basis that the actual distributions made by the ETF during the relevant calculation period are (immediately or as soon as reasonably practicable thereafter) reinvested into the ETF in a consistent manner.
6. For the purpose of disclosure of the TD of an ETF set out below, the TD shall be calculated and disclosed on a day when both the NAV of the ETF and the index value are calculated and available, as the purpose of this calculation is to assess how well the ETF tracks the index.

Disclosure of TD by newly listed ETFs

Estimated Annual TD

7. For a newly listed ETF, the estimated annual TD (the “Estimated Annual TD”) should be calculated and disclosed in the KFS and on the website on the following basis and assumptions:
- a) a reasonable estimate of the initial fund size by the ETF manager;
 - b) the performance of the index one year prior to the listing of the ETF as the performance of the ETF;
 - c) there is no creation/redemption during the first year; and
 - d) the assumptions, methodologies and treatment in respect of rebalancing, capital gains tax provisions, investment restrictions and dividend policies as disclosed in offering documents of the ETF.
8. The Manager shall ensure the accuracy of the Estimated Annual TD is kept under review. If the actual TD substantially deviates from the Estimated Annual TD as disclosed in the KFS and on the website, a notice should be issued to investors as soon as practicable to explain such deviation with an updated Estimated Annual TD based on the ETF Manager’s latest assumptions and updated information.

Website disclosure

9. Please see Appendices 1 and 2 for illustrative examples of website disclosure of TD of an ETF tracking a PRI and a TRI respectively during its first year of listing. Please note the following:
- a) The Estimated Annual TD should be disclosed on the website of the ETF upon its listing.
 - b) The following items shall be presented on the ETF’s website after the ETF has been listed for a period of at least a full month with a month-end date of that month during this period:
 - (i) the actual TD – this shall be presented in a graph showing both the index’s and ETF’s daily performance and shall be updated monthly on a rolling basis; and



- (ii) the actual cumulative TD since the ETF's listing date – this shall be presented in a table and such figure should be updated monthly.
- c) For ETFs tracking PRI, please disclose in the graph that “*ETF's performance is calculated on an NAV to NAV basis without any reinvestment of distributions*” (see Appendix 1).
- d) For ETFs tracking TRI, where applicable, please disclose in the graph that “*ETF's performance is calculated on an NAV to NAV basis and assumes reinvestment of distributions*” (see Appendix 2).
- e) If a notice is issued pursuant to paragraph 8 above, the Estimated Annual TD as well as other relevant information on the website should be updated accordingly.

KFS Disclosure

- 10. Please see Appendix 3 for an illustrative example of disclosure of TD by a newly listed ETF in the Product Key Facts Statement (“KFS”). Please note the following:
 - a) the Estimated Annual TD should be disclosed in the KFS of ETFs in addition to the estimated ongoing charges figure.
 - b) The KFS should contain a statement to the effect that the Estimated Annual TD is an estimated annual TD figure and that investors should refer to the ETF website for information on the actual TD.
 - c) If a notice is issued pursuant to paragraph 8 above, the Estimated Annual TD shall be updated accordingly. Any revisions to the KFS must be made in accordance with the requirements under the Code on Unit Trusts and Mutual Funds.
- 11. Please see Appendix 4 for an illustrative example of disclosure of TD by a newly launched unlisted index fund.

Disclosure of TD by ETFs beyond its first year of listing

Website disclosure

- 12. Please see Appendices 5, 6, 7 and 8 for illustrative examples of website disclosure of an ETF tracking a PRI and a TRI respectively beyond its first year of listing. Please note the following:
 - a) The actual TD for the past 12 months shall be presented on the website in a graph which shows both the index's and ETF's daily performance.
 - b) The actual TD for the past 12 months shall be updated monthly on a rolling basis.
 - c) If an ETF has been listed for more than one full calendar year, the actual TD of
 - (i) each of the last ten calendar years; or
 - (ii) each of the calendar years since the ETF was listed if the ETF has been listed for less than ten calendar years



should be presented (see Appendices 7 and 8).

- d) For ETFs tracking PRI, please disclose in the graph that “*ETF’s performance is calculated on an NAV to NAV basis without any reinvestment of distributions*” (see Appendices 5 and 7).
- e) For ETFs tracking TRI, where applicable, please disclose in the graph that “*ETF’s performance is calculated on an NAV to NAV basis and assumes reinvestment of distributions*” (see Appendices 6 and 8).

KFS Disclosure

- 13. Please see Appendix 9 for an illustrative example of disclosure of TD by an ETF which has been listed for more than one calendar year in the KFS. Please note the following:
 - a) The actual TD of the most recent calendar year shall be disclosed in the KFS.
 - b) The KFS shall also contain a statement to the effect that the TD disclosed in the KFS is the actual tracking difference of the most recent calendar year and that investors should refer to the ETF website for updated actual TD information.
 - c) ETF managers shall update the actual TD for the most recent calendar year on the KFS as soon as practicable after the calendar year end and in any event, no later than four months after 31 December (i.e. before end of April of the following year).
- 14. Please see Appendix 10 for an illustrative example of disclosure of TD by an unlisted index fund which has been launched for more than one calendar year in the KFS.

Tracking Error (跟蹤誤差)

Methodology

- 15. Tracking error (“TE”) measures how consistently an ETF follows its index and is an indicator of the quality of replication. It is also commonly referred to as the volatility (as measured by standard deviation) of the differences in returns between an ETF and its index.
- 16. The annual TE is measured by the standard deviation of the daily TD which is then “annualized” on the basis of the number of dealing days in the year when both the NAV of the ETF and index value are calculated and available.

The daily TD is calculated based on the following formula:

$$\text{Daily TD} = [(NAV_{T+1} - NAV_T)/NAV_T] - [\text{Index Value}_{T+1} - \text{Index Value}_T] / \text{Index Value}_T]$$

- a) T = dealing day when both NAV of the ETF and index value are calculated and available.
- b) The calculation of actual TD of an ETF tracking TRI may be done on the assumption/basis that the actual distributions made by the ETF during the



relevant calculation period are (immediately or as soon as reasonably practicable thereafter) reinvested into the ETF in a consistent manner.

Disclosure

17. An ETF should disclose its annual TE on its website after one year of its listing (See Appendices 5, 6, 7 and 8).
18. Such annual TE for the past year as disclosed on the website should be updated monthly on a rolling basis.

General

19. When considering the listing history of the ETF in complying with the requirements in this circular, the listing date of the ETF shall be the first listing date on its primary listing market, whether in Hong Kong or overseas. Similarly, the launch date of an unlisted index fund shall be the first launch date, whether in Hong Kong or overseas.
20. ETF managers shall publish the information of TD and TE on the ETF's website within 5 business days of each month end in respect of such information required to be disclosed or updated on a monthly basis under this circular.
21. This circular sets out the minimum requirements for disclosure of TD and TE. So long as the ETF has complied with the TD and TE disclosure required under this circular, the ETF manager may present additional TD and TE information, which shall only be in numerical presentation, using other basis and assumptions (e.g. with or without tax provision) provided that such basis and assumptions are clearly set out and the presentation is fair, accurate and not misleading.

Implementation

22. The effective date ("Effective Date") of this circular is 4 July 2014.
23. A transitional period of 6 months from the Effective Date will be provided for (i) existing SFC-authorized ETFs and unlisted index funds and (ii) ETFs and unlisted index funds for which applications for authorization were submitted to the Commission prior to the Effective Date to comply with the applicable disclosure requirements in this circular. ETFs and unlisted index funds for which applications for authorization are submitted on or after the Effective Date must comply with the requirements in this circular immediately upon the authorization of such products.
24. If you wish to clarify any aspects of this circular and/or in case of doubt on any issues arising from the disclosure requirements mentioned above, please contact the team supervisor or case officer of the Investment Products Division who is responsible for overseeing the SFC-authorized funds of your fund group or client.

Investment Products Division
Securities and Futures Commission