

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

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Contents

	Page
Introduction	1
Consultation Responses and Conclusions	
General	2
Paragraph (a) – definition of index funds	2
Paragraph (b) – underlying investments	3
Paragraph (c) – other permissible investments	4
Paragraph (d) – acceptable index	5
Paragraph (e) – criteria for acceptable indices	7
Paragraph (e)(ii) – index should be broadly based	7
Paragraph (e)(iii) – index should be investible	8
Paragraph (e)(iv) – index should be transparent and published in an appropriate manner	10
Paragraph (e)(v) – index construction, maintenance and review methodology	10
Paragraph (f) – reporting requirements	12
Paragraph (h)(ii) – investment restrictions	14
Paragraph (j) – disclosure	15
Paragraph (j)(iii) – disclosure of top 10 constituent securities	15
Paragraphs (j)(xiii) and (j)(xiv) – exchange traded funds	16
Paragraph (m) – name of fund	16
Implementation and Transitional Arrangements	17
Annex 1 – List of Respondents	18
Annex 2 – Marked-up version of the Provisions for Index Funds	19

Introduction

1. On 20 July 2001, the Securities and Futures Commission (“SFC”) issued a set of Provisions for Index Funds for public consultation, with the aim of incorporating these into the Code on Unit Trusts and Mutual Funds (the “Code”). This document summarises the responses received and the SFC’s conclusions on the consultation.
2. The consultation period ended on 20 August 2001 but late submissions were accepted and considered. A total of 10 submissions were received. A list of the respondents is annexed (Annex 1). After carefully considering the comments, the SFC conducted a second round of consultation with the respondents on certain proposals arising from their comments. The second round of consultation ended in November.
3. In addition to making comments, certain respondents sought clarification on a number of issues. Clarifications have been made to the provisions where they are conducive to the general understanding of the provisions by the industry. Other more specific issues were discussed with the respondents directly.
4. Certain amendments have been made to the proposed provisions. The revised or final provisions are published with this conclusions paper. The final version of the provisions, with the changes from the proposed provisions highlighted, is annexed for reference (Annex 2).
5. This paper should be read in conjunction with the Consultation Paper and the Code.
6. The Commission has approved the final provisions and these have been formally incorporated into the Code as Chapter 8.6.
7. The SFC would like to thank all the respondents and other interested parties who have made valuable suggestions and comments.

Consultation Responses and Conclusions

8. This section sets out the consultation responses and should be read in conjunction with the proposed and final provisions, and the Code. References are made to the specific paragraphs as they appeared in the proposed provisions.

General

9. Respondents welcomed the issuance of provisions on index funds. They generally considered that specific provisions on index funds would ensure a level playing field because market participants would be aware of the ground rules for the authorisation of such funds under the Code. This would facilitate market development while ensuring there was adequate investor protection. Index funds were regarded as providing investors with a cost-effective way to participate in regional or national markets and through those markets, in the growth of the respective economies.
10. There was general support of the disclosure approach to address issues relating to index funds. For example, one respondent said full disclosure of the investment objective and risks to investors was far more important than any arbitrary investment restriction, and investors should be informed of the limitations of the underlying benchmark, including completeness, investibility, rules and governance structure, accuracy of data, etc. Another said that the proposed disclosure and reporting requirements would foster greater education and prudent investing among individuals.
11. One respondent acknowledged that index funds were particularly important investment tools for investors because they allowed investment exposure to the full range of securities of a particular market or segment while operating under a lower cost structure when compared with traditional managed funds. It said, however, that many of the proposed provisions would add to the burden and costs of running an index fund without adding significant protection for investors.
12. A number of other respondents also noted the importance of minimising costs as a major concern of index funds.

Paragraph (a) – definition of an index fund

Comments

13. One submission suggested an amendment to the definition of index funds for the purpose of the provisions to enhance flexibility. It said an

index fund might track an index on equity or debt securities, or “other securities” as well. The respondent did not provide any examples of “other securities”.

The SFC’s views

14. The paragraph has been amended to reflect the comment. The SFC agrees that greater flexibility is desirable. The provisions have been drafted on the understanding that the most common type of index funds uses equity indices as their underlying indices. However, the SFC acknowledges the possibility of funds using other non-securities related indices. If a fund is tracking an index with constituent securities other than equities or debt instruments, it may be necessary for the SFC to consider how exactly the provisions may apply to the fund on a case by case basis. The industry would be welcome to consult the SFC.

Paragraph (b) – underlying investments

Comments

15. One submission suggested that the paragraph be tightened to require that an index fund investing in a representative sample of constituent securities of the index (as opposed to full replication) might do so provided that the sample would closely reflect the overall characteristics of the index.

The SFC’s views

16. The SFC welcomes the suggestion and agrees that it is important the overall characteristics of the index should be reflected and not be lost in a sampling strategy. It is because investors in an index fund should reasonably expect the fund to closely track the index and correspond to the characteristics of the market or sector that the index represents. The paragraph has been amended.

Comments

17. One respondent said the inclusion of non-constituent securities was inevitable in some cases. For example, a fund might sometimes find it difficult and costly to rebalance to the right mix within a relatively short time upon changes of index constituents, and might need to seek non-constituent securities with the same characteristics to achieve the investment objective. Moreover, it would be difficult to eliminate all the odd lots in the fund, which could be the result of previous rebalance or corporate actions.

The SFC's views

18. The SFC accepts the arguments for including non-constituent securities in the portfolio under certain circumstances. The original paragraph already indicated this would be acceptable under the provisos. The paragraph has been nonetheless slightly amended to clarify that the SFC does not generally consider it necessary or appropriate that the portfolio of an index fund is consisted entirely of non-constituent securities.

Paragraph (c) – other permissible investments

Comments

19. In general, the respondents welcomed the inclusion of derivatives as permissible investments for index funds, as derivatives were considered useful and cost-effective tools to manage cash flow without disrupting the fund or incurring significant costs which would fall on the long term investors in the fund. One said investments in derivatives were usually small and provided effective hedges for the funds' underlying portfolios.
20. One respondent said the SFC should consider “a more liberal but no less robust limitation” on derivatives so that their use was permitted as a substitute for physical securities in order to achieve transactional efficiency. It said derivative limits for market exposure should be established for each fund and disclosed in the offering document.
21. Another respondent sought clarification as to whether “derivatives” only referred to warrants and options, and futures as mentioned in the Code (Chapters 7.6 – 7.10), and whether the use of ELNs (equity linked notes), ETFs (exchange traded funds), and notes that were designed to replicate the performance of stocks would be allowed under the provisions.

The SFC's views

22. The SFC maintains its general position on the derivative limits for the present purpose. It is considered that the use of derivatives by index funds that track an equity or debt index should not be excessive.
23. The SFC also wishes to draw attention to the proviso in the paragraph that “the fund may invest in other appropriate investment instruments, such as derivatives permitted under the Code *or otherwise accepted by the SFC*”. The acceptability of instruments not explicitly provided for in the Code would be determined on a case by case basis. Nevertheless, ETFs, for example, are generally regarded as collective investment

schemes for the purpose of the Code and hence permissible investments, subject to applicable limits.

Comments

24. One respondent suggested that “100% synthetic” index funds, which purely used cash and derivatives as underlying investments, be incorporated into the provisions. It said that synthetic products would broaden the choice of benchmarks which would otherwise not be accessible to investors.

The SFC’s views

25. At present, all SFC authorised index funds are equity index linked and the proposed provisions therefore focus on equity or debt indices. The investment restrictions have been modeled on Chapter 7 requirements of the Code. Market practitioners may apply for waivers of certain requirements, which would be considered on the merits of the application.
26. Where the constituents of an index are themselves derivatives (as opposed to using derivatives to substitute constituent securities), it may be necessary that the applicable investment restrictions should be appropriately based on those for specialised schemes in Chapter 8 of the Code. Since these products might utilise a wide range of financial instruments or involve special investment techniques, it would be impractical for the SFC to anticipate all the possible issues that might arise and to prescribe corresponding requirements. Interested parties are welcome to consult the SFC at an early opportunity, while such applications would have to be considered on a case by case basis for the time being.

Paragraph (d) – acceptable index

Comments

27. There was concern from some respondents that the SFC would exercise the right to withdraw authorisation of an index fund if the underlying index ceased to be acceptable for various reasons.
28. One respondent suggested that the SFC should advise the actions the fund manager should take within a certain timeframe in order to ensure continued authorisation of the fund. Another said the SFC should permit the fund manager to work with the index provider to make any necessary adjustments or to seek a replacement index. It further

suggested that Chapter 7.23¹ of the Code should be applied under such circumstances.

The SFC's views

29. The SFC wishes to take this opportunity to clarify the applicability of paragraph (d). The board of directors and/or management company should immediately bring to the SFC's attention if for any reasons the index might likely cease or has ceased to be acceptable. Management should as a priority objective propose and discuss with the SFC remedial actions or alternatives that are acceptable to the SFC and in the interests of the holders. An explanatory note has been inserted into the final provisions.
30. It should also be noted that since the circumstances might vary greatly, it would not be appropriate to pre-determine a rigid timeframe for addressing the issue. However, the SFC would be pragmatic when considering such matter, taking into account the interests of the holders.

Comments

31. One respondent suggested the publication of a list of accepted indices on the SFC's website for future reference.

The SFC's views

32. The SFC welcomes the suggestion and will consider publishing a list of "accepted indices". These would be the underlying indices of index funds that have been authorised by the SFC. For the avoidance of doubt, the SFC does not intend to pro-actively assess the acceptability of indices that are not associated with fund applications or publish a list of "pre-approved" indices.
33. It should also be noted that the fact that an index has previously been accepted by the SFC does not necessarily mean the same index would be considered acceptable in a subsequent fund application with the same underlying index, or that authorisation would necessarily be given to the application.
34. In addition, the fact that an index is acceptable to the SFC does not imply official approval or endorsement of the index or the corresponding index provider.

¹ Chapter 7.23 of the Code states that: If the investment limits in Chapter 7 and 8 are breached, the management company should take as a priority objective all steps as necessary within a reasonable period of time to remedy the situation, taking due account of the interests of the holders.

Paragraph (e) – criteria for acceptable indices

35. There were mixed responses to the proposed criteria for assessing the acceptability of an index. For example, there was essentially unanimous support that the index should have a clearly defined objective (paragraph (e)(i)). On the other hand, several respondents were concerned that the weighting caps could be overly restrictive. The views of the commentators and the SFC's conclusions are set out below.

Paragraph (e)(ii) – index should be broadly based

Comments

36. Although the respondents generally recognised the importance of risk spreading, some said the weighting caps would be too restrictive for funds tracking highly concentrated indices, e.g. a small country market index or a fixed income index. Under these circumstances, the index might have an unusually large concentration on one security or only a few to accurately reflect the market. They said full disclosure should be the right approach.
37. One respondent did not agree weighting caps should be set at all. It said that some indices should be deemed to be acceptable as long as prominent risk warnings were disclosed in the offering documents so that investors could understand the risks involved. It said the SFC should let investors decide whether they wanted to take on the concentration risks.
38. One respondent said that while the weighting cap on the top five constituent securities (75%) was reasonable, the same could not be said of that for a single constituent (40%). Such restriction would in particular make it difficult to develop ETFs on affected indices. It was suggested that if a single issuer weighting cap were to be introduced, the SFC should ensure that waivers could be granted efficiently and timely.
39. However, another commented that both caps were reasonable since the weightings of the constituent securities of most of the indices tended to fall within the limits.

The SFC's views

40. As expected, the proposal has attracted diverse views. The SFC seeks to strike a balance between merit and disclosure based regulation in this regard.

41. On the whole, the SFC considers it necessary to retain the weighting caps as general regulatory guidance. However, the fact that the weightings of the constituents should exceed the caps does not necessarily mean that the fund would not be authorised.
42. From experience, the indices of the majority of the index funds already authorised could satisfy the weighting cap requirements if they had been in place already. It is noted that index weightings are sometimes capped at lower levels because of regulatory restrictions in other jurisdictions where the funds are domiciled or distributed. Given that the SFC has the power to grant waivers, the SFC believes that the imposition of weighting caps would not be an impediment to development of index funds. Provided that there are justifications for exceeding the caps, the SFC will consider the case pragmatically and waivers can be granted.

Paragraph (e)(iii) – index should be investible

Comments

43. Many respondents agreed that the constituents of the underlying index should be investible, but some found the proposed provision too restrictive or wanting in explanation.
44. One respondent suggested that if a certain percentage of the constituents of an index failed an investibility test based on prescribed criteria, authorisation should be denied. For instance, it suggested there should be a minimum free float for any stock which comprised more than 10% of the index weighting. The respondent acknowledged that it would be difficult to set general standards and the SFC should therefore analyse the investibility of each index and consider its acceptability on a case by case basis.
45. One respondent suggested that one method to determine investibility was to review the trading and liquidity of each security, taking into account of its turnover, typical price movements and the ratio of dollar-value traded annually to total market capitalisation.
46. Another said the SFC should not concern itself about the investibility of the underlying index. It would be the fund manager's responsibility to ensure investibility of the index in order to manage the fund. It wanted paragraph (e)(iii) to be deleted. Instead, the investibility of the index should be fully disclosed with reference to the nature and constituents of the index, and market capitalisation of its constituents etc.

The SFC's views

47. The SFC considers it important to set down investibility as a criterion, as tracking errors or price squeezes might occur as a result of the selection of an uninvestible index. The SFC also agrees that it is primarily the responsibility of the fund manager to choose an index that is investible and to demonstrate that to the SFC.
48. Following the two rounds of consultation, the SFC has concluded that there is no one single standard or method to determine investibility of an index. It would not be appropriate or practicable for the SFC to dictate any formula to determine investibility. The SFC therefore sees it fit to only set out the broad principle on this subject as general guidance.
49. The SFC expects that the constituent securities to be sufficiently liquid and that they may be readily acquired or disposed of under normal market circumstances and in the absence of trading restrictions. There may be questions on the investibility of an index if, for instance, its constituents are not available to certain investors.
50. The SFC has taken on board the comment that stock market condition, fund size, and the respective weightings of the constituents should also be considered. The note to the provision has been amended.

Comments

51. One respondent suggested that the SFC should, on an ongoing basis, regularly review and assess the investibility of accepted indices. If an index ceases to be acceptable, the authorised fund should not be allowed to sell additional units.

The SFC's views

52. The SFC would like to stress that it should be the manager's general responsibility to monitor the investibility of the underlying index so that the fund's objective can be achieved on an ongoing basis.
53. In the event that the underlying index ceases to be investible, thus affecting the acceptability of the index, the fund manager should adopt the measures as mentioned in paragraph (d).

Paragraph (e)(iv) – index should be transparent and published in an appropriate manner

Comments

54. In general, the respondents did not object to paragraph (e)(iv). However, one respondent said that the note under the paragraph should be deleted since only index providers could decide whether to publish index levels in newspapers or other media.

The SFC's views

55. The SFC considers that the manager of an index fund has a general responsibility to ensure that information relating to the underlying index is reasonably accessible by investors. The SFC, however, does not intend to make it compulsory for the manager to provide such information.
56. As suggested in the note to the paragraph, the SFC is prepared to accept means that may achieve the objective of the requirement. For example, the Hong Kong Representative of the fund may answer enquiries or direct holders to the appropriate sources of information such as the website of the index provider.
57. In this connection, a paragraph (j)(ix) has been added in the Disclosure section of the final provisions. This requires disclosure in the offering document the means by which investors may obtain the latest index information.

Paragraph (e)(v) – index construction, maintenance and review methodology

Comments

58. One respondent said it should be the responsibility of the index providers to ensure that index rules were well documented, consistent and transparent.
59. Another submitted that it would be unreasonable and unnecessary to require fund managers to publish the index rules because index providers would publicise the index construction and maintenance methodology through their own websites. The respondent said it would also not be possible for fund managers to distribute more than what had been made available publicly by the index providers. It said the requirement of accurate and timely data for index calculation was problematic as index providers would be reluctant to publicly release data.

60. The same respondent further said that transparency could not be guaranteed when a committee-based methodology, or a mix of rule-based and committee-based methodology was adopted. Certain index vendors were “absolutely secretive” about their construction methodologies, it said.

The SFC’s views

61. First, the SFC would like to clarify that the proposal does not require a fund to publish the methodology or rules on behalf of the index provider. The requirement is that the manager must be satisfied that the methodology or rules of the index that the fund is tracking are consistently applied and transparent. Transparency is an important issue as investors have the right to know. Attention is drawn to paragraph (j)(viii) in the final provisions, which allows flexibility in the provision of index methodology/rule information.
62. Second, it has never been the intention of the SFC to require a fund manager to obtain and publicly release data for the calculation of indices. However, the manager must be satisfied that the index provider can competently fulfil the role of accurately compiling and calculating the index. For the avoidance of doubt, the sentence “Accurate and timely data must be available for the calculation of the index” has been deleted from the paragraph.
63. The SFC notes the argument that decisions made by a committee may not be as transparent as those based entirely on rules. However, this should be mitigated by the fact that even committees are expected to work within clear and objective principles or guidelines. A committee-based methodology therefore is not necessarily unacceptable.
64. It should be noted that paragraph (v) has also been amended to refer to “methodology/rules” instead of “rules” to broaden the general purpose of the provision.

Comments

65. One respondent said it would be unreasonable of the SFC to request the resumes of the directors and key personnel of the index provider.

The SFC’s views

66. The note to the paragraph has been amended. The paragraph has also been clarified to require the index providers to possess the expertise and resources to construct, maintain and review the methodology/rules of the index. The SFC maintains that it is important the index provider must be

able to ensure the integrity and continuity of the index, and the fund manager must exercise diligence and be satisfied that is the case when selecting the underlying index. The SFC is likely to pay special attention to the expertise and resources of the index provider if its primary business is not compilation of indices, or if the business is newly established.

Paragraph (f) – reporting requirements

Comments

67. In general, respondents accepted the purpose of the proposed provisions was to ensure adequate and ongoing disclosure to investors. However, many cautioned that any excessive and cumbersome reporting and notification obligations would increase operating costs and impose additional administrative burdens that would lead to tracking errors.
68. Some respondents considered that a change in the methodology for compiling and calculating the index was material and could affect the objective of the index. There was no fundamental objection to the requirement in paragraph (f)(i) to report such matters to the SFC and notify unitholders.
69. As to the proposed reportable events in (f)(ii) and (f)(iii), the general concern was that the costs of compliance would be prohibitive for index funds. It was submitted that those events – changes in index composition, and changes in the weightings of constituents due to corporate activities or market movements – would generally be expected by investors to occur. Some indices were reviewed quarterly, meaning possible reporting at least every three months under the proposal. It was submitted that corporate actions and routine maintenance should not be classified as reportable events since the index provider would make public announcements of those changes, which in turn would normally be well analysed by market participants. One respondent also noted that active managers were not subject to any similar obligation to notify investors of corporate actions that could have a significant impact on their portfolios.
70. In the consultation paper, the SFC invited comments whether the reporting obligation under (f)(iii) should be subject to a materiality test. Certain respondents said that if the obligation were to be imposed, it would be desirable to have a test.
71. A second round of consultation was carried out with parties which had commented on the above, with a view to determining if a meaningful and appropriate materiality level can be established. The respondents

were specifically invited to comment on two options, either of which would limit the reporting and notification obligations to only certain events².

72. One respondent said to impose a uniform threshold might not be appropriate in light of the diverse characteristics and composition of different indices. It said the SFC should consider and require notification to holders on a case by case basis.
73. Another said the options were still onerous and would accept only if the scope were further limited³.
74. A third respondent said the use of optimisation strategy and indices that were well diversified would make the threshold “ineffective”. Optimisation would inevitably exclude certain securities in an index from a portfolio. A change in the composition of the index might be irrelevant to such a portfolio if the securities concerned were excluded securities, but the proposed requirements would still place a burden on the fund manager to track constituents that were not even in the portfolio. Whereas for well diversified indices, the number of reportable events that would be irrelevant was likely to be high. The SFC was also cautioned against “the danger of overwhelming investors with information”.
75. In addition to the above, there were suggestions as to the means of notification. One respondent suggested only “after-the-event” disclosure in the semi-annual and annual financial reports. There was a general call for permission of more cost-effective means of notification. For more timely notification, for example, the SFC should permit notification via websites or newspaper instead of individual notices to holders.

The SFC’s views

76. The SFC is mindful of the need to strike a balance between adequate and relevant information disclosure, and the burden on fund managers and cost implications for the funds.
77. In view of the general support, the SFC has largely retained the original (f)(i) proposal and had it modified. It is stipulated in the final provision (paragraph (f)) that the SFC should be consulted on any events that may affect the acceptability of the index. The paragraph has been broadened

² The first option requires notification to holders when the composition of the top 20 largest constituent securities changes due to inclusion or deletion of any security. The second option requires notification when there is an inclusion or deletion of any constituent security that accounts for 1% or more of the weighting of the index. Under either option, the notification obligation also arises when the weighting of any constituent security changes by a certain amount due to corporate activities.

³ For example, limiting reportable events to only changes affecting the top five constituent stocks.

to include situations where there are changes to the objective or characteristics of the index as notifiable events. It also requires that notices to holders be submitted for the SFC's prior approval.

78. The SFC has considered the comments on the likely compliance burden on funds and the difficulty in arriving at or implementing an appropriate materiality threshold. Given that paragraph (f) has been broadened, it is considered no longer necessary to retain the remainder of paragraph (f) in the proposed provisions. The SFC is confident that the objective of ensuring relevant and material disclosure to unitholders is not compromised.
79. It should be noted that notification to holders should be made as soon as practicable. The industry should consult the SFC when in doubt.

Paragraph (h)(ii) – investment restrictions

Comments

80. Several respondents felt that paragraph (h)(ii) was impractical and restrictive. It was submitted that a fund's exposure to a particular security might vary due to market movement, and that a small overweight of a constituent in the portfolio relative to its index weighting might occur from time to time, especially in the case of corporate actions. It was also submitted that due to possible built-in lag time and execution limitations on a fund's purchases and sales in order to track its underlying index, the fund might be caught temporarily out of compliance. In addition, the strict application of the condition would be problematic for managers adopting an optimisation strategy.
81. Some respondents suggested allowing reasonable margins for a fund's exposure to the constituent securities to exceed their respective weightings in the index⁴. Nevertheless, one respondent said the matter was not critical for funds fully replicating the underlying indices. It was concerned that the introduction of "excess margin" could open opportunities for abuse.

The SFC's views

82. The SFC would like to clarify the rationale for the proposal. Paragraph (h)(ii) imposes a condition on the relaxation of the Chapter 7.1

⁴ One respondent called for a "tolerance level" of half a percentage point to one percentage point in weighting for each constituent, while another supported an excess limit of 10 percentage points on an aggregate basis. The Commission sought further comments from a number of respondents in the second round of consultation. One proposed a two-tiered margin of two percentage points for securities accounting for 20% or more in the index and one percentage point for those between 10% and 20%.

investment restriction⁵, so that the fund's investment in any single issuer is capped. It is considered necessary to minimise the risk of undue over concentration beyond what is expected by unitholders when investing in the fund. Fund managers are therefore not expected to make investments which may result in a breach of the condition.

83. The SFC is sympathetic to the industry's concern about inadvertent and temporary breaches due to external factors. The paragraph has been amended to state that the fund's holding of securities may not exceed their respective index weightings, except where weightings are exceeded as a result of changes in the composition of the index and the excess is only transitional and temporary in nature.
84. The SFC also acknowledges that the restriction may be at odds with the legitimate use of optimisation strategy. It is considered that paragraph (h)(ii) should be administered with flexibility. A note has been added to the paragraph to provide guidance for application for a waiver. The applicant must submit detailed justifications, including any proposed "excess margins" that are considered necessary for the fund. In view of the absence of a consensus on appropriate margins, and because the characteristics of different indices vary, the SFC would determine each case on its merits.
85. It should be noted that the final provision begins with "the fund's holding of...", instead of "the fund's exposure to...". This reflects a comment that "exposure" was not defined in the Code. The paragraph has been amended for clarity and consistency only, and there is no change of meaning.

Paragraph (j) - disclosure

86. The disclosure requirements were generally received positively, although individual respondents had reservations to certain proposed provisions.

Paragraph (j)(iii) – disclosure of top 10 constituent securities

Comments

87. One respondent suggested deleting this provision, since the "latest weightings" of the top 10 largest constituent securities would be outdated easily. It said such information should be disclosed in the financial reports. In contrast, another respondent said the requirement could help investors assess the suitability of an index fund.

⁵ Chapter 7.1 of the Code stipulates that the value of a scheme's holding of securities issued by any single issuer may not exceed 10% of its total net asset value.

The SFC's views

88. The SFC considers that the disclosure is useful for investors and can be performed without much difficulty. Its limitation is noted, but does not outweigh its usefulness. Disclosure in the financial reports does not fully address the issue of dated information. Instead, as a good practice, the disclosure should be updated when the offering document is revised.
89. It should be noted that the provision has been slightly amended to indicate the expectation of the reference date of the information. Nevertheless, information that is more recent may be necessary if it is significantly different.

Paragraphs (j)(xiii) and (j)(xiv) – exchange traded funds

90. The above paragraphs in the proposed provisions have been deleted. While the requirements are important for ETFs – which at present are mostly index based – they represent issues more pertaining to ETFs rather than index funds. The SFC also does not wish to give any impression that they are the only disclosure requirements for ETFs.

Paragraph (m) – name of fund

Comments

91. An enquiry was received as to whether the incorporation of the word “tracker” in the name of an index fund might confuse investors with the “Tracker Fund of Hong Kong”.

The SFC's views

92. In authorising a new fund, the SFC must be satisfied that the name of the fund does not cause any confusion to investors with other existing funds. Amendment is considered not necessary.

Implementation and Transitional Arrangements

93. The final provisions will have immediate effect upon publication. New applications will have to comply with the provisions in full immediately. For new applications of funds tracking indices which are underlying indices of previously authorised index funds, the acceptability of the underlying indices will be examined again. It is not envisaged that there would be major issues arising.
94. Existing authorised index funds will have to comply with the provisions in full immediately, subject to the following:
- The underlying indices will not be subject to an initial re-examination of their acceptability in accordance with paragraph (e). However, managers are reminded of their continuing obligation to notify holders of significant events relating to the indices, as required by paragraph (f). The managers should consult the SFC on any events that may affect the acceptability of the index or whenever in doubt. Moreover, the SFC reserves the right to review the acceptability of an index.
 - Offering documents must meet the Disclosure requirements, as set out in paragraph (j), within six months.
 - With respect to Reporting Requirements (paragraph (f)) and Investment Restrictions (paragraph (h)), fund managers are given a grace period of six months to make any necessary system enhancement and administrative preparation in order to comply with the new requirements.
95. The SFC will be pragmatic in the implementation of the new provisions. In particular, managers of existing authorised funds with difficulties meeting the compliance timetable should consult the SFC at the earliest opportunity.
96. The SFC welcomes further comments from the industry. It will continue to review the provisions and publish any necessary amendments or guidance notes, so that a balance can be achieved at all times between investor protection and market facilitation.

Annex 1

A list of respondents by alphabetical order is as follows:

1. Barclays Global Investors North Asia Limited
2. Charles Schwab, Hong Kong, Limited
3. Clifford Chance
4. Deacons
5. Eagle Star
6. HSBC Asset Management (Hong Kong) Limited
7. Lloyds TSB Pacific Limited
8. Standard & Poor's
9. State Street Global Advisor
10. Vanguard Investments Australia Limited

Annex 2

Provisions for Index Funds for insertion into Chapter 8 of the Code on Unit Trusts and Mutual Funds

(This version has been marked up for changes from the consultation version. Additions are underlined while deletions are struck through.)

8.6 Index Funds

The following criteria apply to index funds.

General

- (a) An index fund is a collective investment scheme, the principal objective of which is to track, replicate or correspond to an index on equities, ~~or~~ debts or other securities, with an aim of providing or achieving investment results or returns that closely match or correspond to the performance of the index.
- (b) An index fund may seek to track an index by investing all or substantially all of its assets in the constituent securities of the underlying index, broadly in proportion to the respective weightings of the securities, ~~or it may invest in a representative sample of constituent securities of the index.~~ Where the fund invests in a representative sample of constituent securities of the index, this should closely reflect the overall characteristics of the index.

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

- (c) In achieving its investment objective, the fund may invest in other appropriate investment instruments, such as derivatives permitted under the Code or otherwise accepted by the Commission, in accordance with the fund's disclosed investment strategies and restrictions.
- (d) In general, the Commission will consider authorising an index fund only if the underlying index is acceptable to the Commission. Such acceptance does not imply official approval or endorsement of the index. The Commission reserves the right to withdraw the authorisation if the index is no longer considered acceptable.

Note: The management company should immediately consult the Commission if for any reasons the index might likely cease or has

ceased to be acceptable. The management company should as a priority objective propose remedial actions or alternatives that are acceptable to the Commission.

Acceptable Indices

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

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

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

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

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

- (iii) The index should be investible.

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

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

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

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

(v) The index provider is expected to possess the necessary expertise and technical resources to construct, maintain and review the methodology/rules of the index. The methodology/rules should be well documented, consistent and transparent.

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

Reporting Requirements

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

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

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

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

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

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

- (f) The Commission should be consulted on any events that may affect the acceptability of the index. Significant events relating to the index should be notified to the holders as soon as practicable. These may include a change in the methodology/rules for compiling or calculating the index, or a change in the objective or characteristics of the index. Notices to holders should be submitted to the Commission for prior approval.

Investment Restrictions

- (g) The core requirements in Chapter 7 will apply with the following exceptions (h) and (i).
- (h) ~~Despite Notwithstanding Chapter 7.1, more than 10% of the net asset value of an index fund may acquire and hold be invested in constituent securities issued by a single issuer even if the value of the fund's holding in the securities exceeds 10% of its net asset value, provided that:~~
- (i) it is limited to any constituent securities that each accounts for more than 10% of the weighting of the index; and
 - (ii) that the fund's exposure to holding of any such constituent securities may not exceed their respective weightings in the index, except where weightings are exceeded as a result of changes in the composition of the index and the excess is only transitional and temporary in nature.

Note: A waiver of (h)(ii) may be granted on a case-by-case basis, after considering factors including whether the waiver is necessary for the fund to achieve its objective to track the index.

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

Disclosure

- (j) In addition to the requirements under Appendix C, the offering document of an index fund must make the following disclosure and warnings:-
- (i) a description of the market or sector the index aims to represent;

- (ii) the characteristics and general composition of the index and, where applicable, concentration in any economic sectors and/or issuers;
- (iii) the ~~latest~~ weightings of the top 10 largest constituent securities of the index as of a date within a month of the date of the offering document;
- (iv) where necessary, a statement to the effect that the investment of the fund may be concentrated in the securities of a single issuer or several issuers;
- (v) a warning of lack of discretion to adapt to market changes due to the inherent investment nature of index funds and that falls in the index are expected to result in corresponding falls in the value of the fund;
- (vi) a statement to the effect that there is no guarantee or assurance of exact or identical replication at any time of the performance of the index;
- (vii) circumstances that may lead to tracking errors and the related risks, and strategies employed in minimising such errors;
- (viii) a brief description of the index methodology/rules and/or ~~an indication of the~~ means by which investors may obtain such information (for example, by providing the website address of the index provider);
- (ix) the means by which investors may obtain the latest index information and other important news of the index;
- ~~(ix)~~ (x) a warning that index composition may change and securities may be delisted;
- ~~(x)~~ (xi) any circumstances that may affect the accuracy and completeness in the calculation of the index;
- ~~(xi)~~ (xii) a warning in relation to any licensing conditions (including indemnity given to the index provider, if any) for using the index, and the contingency plan in the event of cessation of the availability of the index;
- ~~(xii)~~ (xiii) a statement on whether the index provider and the management company of the fund (or its connected persons) are independent of

each other. If not, the means by which possible conflicts of interests may be addressed;

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

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

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

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

Replacement of the Underlying Index

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

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

Financial Statements

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

Name of Fund

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

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