



**THE LAW SOCIETY OF HONG KONG'S RESPONSE TO THE SFC'S
CONSULTATION PAPER ON THE DRAFT GUIDELINES FOR REGULATING
INDEX TRACKING EXCHANGE TRADED FUNDS UNDER THE CODE ON UNIT
TRUSTS AND MUTUAL FUNDS**

This submission is made on behalf of the Law Society of Hong Kong.

Our responses to each of the questions posed by the SFC are outlined below. While the Law Society broadly supports many of the key initiatives proposed by the SFC in respect of ETFs, we consider that the successful launch of a sustainable ETF market in Hong Kong depends on the resolution of several key issues, which we highlight below.

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

Feedback received from clients indicates that there may be strong interest in investing in, or launching ETFs on the HKEx, provided a streamlined and efficient regime is introduced to regulate such investment structures.

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

The Law Society supports the initiatives sought to be introduced by the Commission, subject to the comments as detailed below.

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

We refer to our responses provided below in relation to specific aspects of the draft Guidelines.

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

We support the grant of general relief in the manner proposed by the Commission. It is anticipated that this will further streamline the authorisation process by removing the cumbersome requirement of applying for specific waivers and exemptions from the Commission in order to facilitate authorisation.

We have the following specific comments in relation to paragraphs 8 to 12 (inclusive) of the draft Guidelines:

- (a) **Paragraph 9.1(f) and paragraph 9.1(g):** Instances of non-compliance with investment limits should be subject to the requirement that all steps as are necessary should be taken, as a priority objective, within a reasonable period of time to remedy the situation, taking into account the interests of investors in the ETF. This is consistent with existing regulatory policy and practice as provided under chapter 7.23 of the Code on Unit Trusts and Mutual Funds (“Code”). A departure from this policy and practice is considered unwarranted in relation to ETFs.
- (b) **Paragraph 11:** The concept of what is considered “misleading or deceptive” by the Commission is not entirely clear. This often gives rise to problems when ETF providers, and other fund managers more generally, produce marketing material and determine names for investment products. Such material is often produced at great time, effort and expense only to be rejected by the Commission, often in what may be considered to be an arbitrary and subjective manner. Such decisions lack uniformity.

The concept of what is considered “misleading or deceptive” in relation to the use of product names and marketing material is essentially a legal question that requires the introduction by the Commission of carefully deliberated and detailed Guidelines. The advertising guidelines which currently appear in the Code do not provide sufficient guidance and information concerning the Commission’s policy in this regard.

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

Please refer to our response to Question 4 above.

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

We note that the principles underpinning the introduction of the “Acceptable ETF Regime” are broadly comparable to those that apply in relation to “recognised jurisdiction schemes” under the Code. These principles are consistent with existing regulatory policy and procedure in this regard. The Law Society supports the extension of the operation of these principles under the proposed “Acceptable ETF Regime”.

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

We support the broad initiatives proposed under paragraphs 13 to 16. However, we consider that ETFs that prepare semi-annual and annual financial reports in accordance with the requirements of an Acceptable ETF Regime should not be required to produce additional information in a Key Features Summary, as currently proposed under paragraph 16(d). This measure is likely to increase the costs of administration and act as a further disincentive to the development and sustainability of ETFs in Hong Kong.

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

We agree with the general proposition that standardised disclosure can, in appropriate circumstances, assist investors in comparing the key features of investment products. However, we have concerns in relation to the proposed introduction of the Key Features Summary:

- (a) It is considered that, as is the practice in several major ETF markets, the information that is proposed to be contained in the Key Features Summary can be included in a fact sheet that can be published via the SEHK's website. Consistent with international practice, it is also recommended that the preparation of this information should be on a voluntary basis.
- (b) The requirement to produce a Key Features Summary that must be updated, regulated and approved by the SFC, and continually produced in bilingual form, will significantly increase the cost of administration of ETFs.
- (c) The production of a specific Key Features Summary is inconsistent with general policy and specific disclosure requirements that apply in respect of other publicly offered investment arrangements in Hong Kong. While a high standard of disclosure for ETFs is required in the interests of the investing public, it is submitted that this can be achieved through the means of a comprehensive Product Description Document/Hong Kong Offering Document, together with the issue of summary factsheets by providers on a voluntary basis.
- (d) The overseas experience of Key Features Summary for investment products is not universally positive. It is often argued that such standardisation stifles the flexibility that otherwise exists to disclose information in a creative and marketable manner, and that "best practice" in regulation prescribes substance and not the form of disclosure.

Q9: What is your view on the contents of the proposed Key Features Summary as stated in Annex 1 to this Paper?

Some of the information requirements of the Key Features Summary appear to be unduly technical and overly prescriptive. As outlined above in respect of Question 8, we consider that the information that is required to be outlined in the Key Features Summary should appear in the master Product Description Document or Hong Kong Offering Document, as the case may be.

In particular, ETF-specific product information can be prepared on the basis of a term sheet or annexure that is produced in connection with a more generic Product Description Document or Hong Kong Offering Document. It is not necessary, or even desirable, for ETF providers to be compulsorily required to produce an additional Key Features Summary. ETF providers should be afforded flexibility in determining the form in which information will be prepared, provided the Commission's minimum disclosure requirements are observed. It is unnecessary, in this context, to prescribe the specific form (as opposed to the substance) in which information is delivered to investors. We do not consider that there is any appreciable net regulatory advantage that can be achieved, either for investors or the Commission, in doing so.

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?

If Key Features Summaries are to be introduced, these should be updated on a semi-annual basis in order to coincide with the required production of key financial reports, and otherwise when material changes require that key data should be updated.

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**

This is acceptable.

- **Their real-time RUPV**

No problem for local ETFs but costly for overseas listed ETFs as the calculation would have to be performed by one of the information vendors, such as Bloomberg or Reuters.

- **Their performance against the benchmark index**

There are really two different aspects of performance with an ETF. The first being how closely the ETF tracks the benchmark index (NAV Vs. Index Level). However, even this is confusing as NAV often contains dividend accruals and depending on specific indices, they may or may not contain any dividend. So, by simply looking at the difference between the NAV and the Index Level may not give an accurate representation how well the fund manager is performing. The second being that investors buy and sell their ETF shares on the stock exchange. When measuring the performance of these particular investments, the actual transaction prices should be used. The transaction prices depend on how well these ETFs are supported and how efficient they trade. Both of which are important factors but more of a direct result of the market infrastructure. Comparing the difference in performance of the index and the NAVs could still be muddled by the inclusion of dividend accruals. Hence, we think that this requirement is not as meaningful as originally intended.

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

The HKEx website and teletext screen for local ETFs and a combination of the HKEx website, teletext screen and other information vendor for the overseas listed ones.

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?

For local ETFs, the RUPV and the index level if available should be published on a real-time basis. However, for foreign-listed ETFs, the information may not be very useful or relevant as markets outside the regional time zone would have been closed and the only variables are the exchange rates.

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?

For local ETFs, information should be made available via the teletext screen but cost and practicality may prevent all information appearing on the teletext screen for foreign-listed ETFs.

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?

The requirement of posting a Chinese version or a Chinese summary of the notices and public announcements of an overseas listed ETF could be impractical and costly for overseas-based fund management companies. Having said that, relevant web sites addresses and links containing notices and public announcements should be provided on the Key Features Summary for easy reference.

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?

First of all, it is another burden placed on the Manager. Secondly, we do need a better definition of what "prices" to use when compiling the statistics. Should the last "bid", "ask" or "last traded price" be used? Our concern is that in a market characterized by low liquidity, no arbitrage mechanism and inefficient securities lending, these statistics are not meaningful and in some cases may even get amplified, further discouraging investing from the public.

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?

Substantial holdings in an ETF should be discloseable, not because of the imminence of a takeover offer, but because a substantial holding may give the holder the ability to move the price of the ETF and it is therefore relevant for the market to know the identity of the substantial holders.

**The Law Society of Hong Kong
The Securities Law Committee
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