

MANDATORY PROVIDENT FUND SCHEMES AUTHORITY

III.10 Guidelines on Index-Tracking Collective Investment Schemes

INTRODUCTION

Section 1(1) of Schedule 1 to the Mandatory Provident Fund Schemes (General) Regulation (“the Regulation”) defines an index-tracking collective investment scheme (“ITCIS”) to mean a collective investment scheme which has the sole investment objective of tracking a particular market index.

2. Section 2(4) of Schedule 1 to the Regulation provides that, where a constituent fund has the sole investment objective of tracking a particular market index, section 2(1) and (2) of Schedule 1 to the Regulation shall not apply to the constituent fund if the approved trustee has the prior approval of the Mandatory Provident Fund Schemes Authority (“the Authority”).

3. Section 6A of Schedule 1 to the Regulation provides that the funds of a constituent fund may be invested in an index-tracking collective investment scheme which is –

- (a) either –
 - (i) authorized by the Securities and Futures Commission (“SFC”), within the meaning of the Securities and Futures Ordinance (Cap 571); or
 - (ii) listed on a stock exchange approved by the Authority for the purposes of this section; and
- (b) approved by the Authority for the purposes of this section.

4. Section 6H of the Mandatory Provident Fund Schemes Ordinance (“the Ordinance”) provides that the Authority may issue guidelines for the guidance of approved trustees, service providers, participating employers and their employees, self-employed persons, regulated persons and other persons concerned with the Ordinance.

5. The Authority hereby issues guidelines to specify:

- (a) the Authority’s criteria for granting approval under section 2(4) of Schedule 1 to the Regulation that section 2(1) and (2) of Schedule 1 to the Regulation shall not apply to a particular constituent fund;
- (b) the Authority’s criteria for granting approval to ITCIS which are authorized by the Securities and Futures Commission (“SFC authorized ITCIS”);
- (c) the Authority’s criteria for granting approval to ITCIS which are listed on stock exchanges (“listed ITCIS”);
- (d) the list of stock exchanges approved by the Authority for the purposes of section 6A(a)(ii) of Schedule 1 to the Regulation; and
- (e) the information that needs to be submitted by an applicant when seeking approval under (a), (b) and (c).

GENERAL APPROVAL CRITERIA

6. A number of common criteria are applied by the Authority for approval under section 2(4) of Schedule 1 to the Regulation and under section 6A of Schedule 1 to the Regulation. The general criteria that the Authority will apply in determining whether to grant approval under either section 2(4) or section 6A of Schedule 1 to the Regulation are as follows:

- (a) the fund must be a collective investment scheme or constituent fund with the sole investment objective of tracking a particular market index;

- (b) the fund should seek to track an index by investing all or substantially all of its assets in the constituent securities of the market index being tracked (the “reference index”), broadly in proportion to the respective weightings of the securities. Where the fund invests in a representative sample of constituent securities of the index, this should closely reflect the overall characteristics of the index;
- (c) the reference index must comprise securities which are appropriate for MPF investments. The suitability of a reference index will be assessed on the following criteria:
 - (i) the reference index should be broadly based, that is, the weighting of the largest constituent security in the index does not exceed 40% and the aggregate weighting of the top five constituent securities does not exceed 75%;
 - (ii) for equity indices, the relevant reference index should not have a significant portion of the constituent securities listed on exchanges other than approved stock exchanges set out in Guidelines III.4. For bond indices, the relevant reference index should not have a significant portion of the constituent securities that do not meet the requirements of section 7(2) of Schedule 1 to the Regulation;
 - (iii) the reference index should have a clearly defined objective and/or the market it aims to represent should be clear. The Authority must be satisfied that the reference index appropriately reflects the characteristics of the market;
 - (iv) the reference index should be investible. 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;
- (v) the reference index should be transparent and published in an appropriate manner. The latest reference index level and other important news should be either published in Hong Kong daily newspapers or conveniently accessible by investors (for example, by enquiring the Hong Kong Representative or through relevant websites); and
 - (vi) the reference 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; and
- (d) the fund should not engage in borrowings, security lending facilities or derivatives in a way inconsistent with the objectives of the MPF System.

7. The Authority may waive any of the approval criteria on a case-by-case basis, after considering whether such waiver furthers the objective of the MPF System, including whether the waiver is necessary for the fund to achieve its objective of tracking the reference index.

8. An ITCIS approved by the Authority under section 6A of Schedule 1 to the Regulation is available for investment by all constituent funds of registered schemes and approved pooled investment funds. Approval does not however mean that an investment in an ITCIS is appropriate or suitable for any given fund. Trustees and their delegates should assess the suitability of an investment in an ITCIS by reference to the nature and investment profile of the fund and the investment profile of the ITCIS. In carrying out their duties with respect to the administration of the scheme, trustees and their delegates should ensure that an

investment in an ITCIS would not render the fund overly concentrated in any economic sector or country.

ADDITIONAL CRITERIA FOR APPROVAL UNDER SECTION 2(4)

9. Other than the general approval criteria in paragraph 6 above, additional criteria for approval are applied to index-tracking constituent funds maintaining an internal portfolio structure. Under section 2(4) of Schedule 1 to the Regulation, such funds are required to adhere closely to the reference index weightings when making investments. Any holdings of constituent securities may not vary from their respective weightings in the reference index, except where weightings are varied due to:

- (a) changes in the composition of the index where the excess is only transitional and temporary in nature, or
- (b) purchase of board lots, or
- (c) implementation of a documented sampling or optimization technique the purpose of which is for the fund to achieve its objective of tracking the reference index.

10. The requirement of the fund to closely adhere to the reference index weightings must be stated clearly in the constitutive documents of the index-tracking constituent fund.

11. In addition to obtaining an approval of the ITCIS from the Authority under section 2(4) of Schedule 1 to the Regulation, an approved trustee seeking to establish an index-tracking constituent fund would need to seek the Authority's approval of the constituent fund under section 36(2) of the Regulation. The Authority would not approve a constituent fund that has the sole investment objective of tracking a particular market index, if the relevant reference index is too narrowly concentrated for the investment of MPF funds. A reference index

would be too narrowly concentrated if, for example, it is related to one market sector or it is related to a single country/market other than Hong Kong and the larger markets such as the United States of America, the United Kingdom and Japan.

ADDITIONAL CRITERIA FOR APPROVAL OF SFC AUTHORIZED ITCIS UNDER SECTION 6A

12. An ITCIS which is authorized by the SFC within the meaning of the Securities and Futures Ordinance may be approved by the Authority for the purposes of section 6A of Schedule 1 to the Regulation.

13. The general approval criteria in paragraph 6 above are generally consistent with the SFC criteria for the authorization of index funds as set out in Chapter 8.6 of the SFC Code on Unit Trusts and Mutual Funds (“SFC Code”) and accordingly most of those criteria will be satisfied for those ITCIS which have been authorized by the SFC. Some criteria, such as paragraph 6(d) above, will need to be separately considered. In addition, the Authority will also need to be satisfied that any waivers granted by the SFC pursuant to Chapter 8.6 of the SFC Code in relation to the ITCIS do not adversely impact on the suitability of the ITCIS as an MPF investment.

ADDITIONAL CRITERIA FOR APPROVAL OF LISTED ITCIS UNDER SECTION 6A

14. In addition to meeting the general approval criteria in paragraph 6 above, a listed ITCIS is required to meet the following criteria:

- (a) the ITCIS must be listed on a stock exchange set out in paragraph 15 below; and
- (b) the following information must be readily available to professional investors such as approved trustees or their delegates:

- (i) the legal structure of the ITCIS;
- (ii) a description of the market the ITCIS aims to represent;
- (iii) the characteristics and general composition of the ITCIS and, where applicable, concentration in any economic sectors and/or issuers;
- (iv) the general composition of the reference index;
- (v) the investment methodology adopted by the ITCIS to track the reference index;
- (vi) a comparison of the ITCIS's performance and the actual index performance since inception of the ITCIS; and
- (vii) any other information which is relevant and material for investors to make an informed investment decision.

LIST OF STOCK EXCHANGES

15. A listed ITCIS must be listed on a stock exchange which has rules and regulations governing the operation and disclosure of exchange traded funds. The list of stock exchanges approved by the Authority for the purposes of section 6A(a)(ii) of Schedule 1 to the Regulation is set out below:

| Country | Name of Stock Exchanges |
|------------------|--------------------------------|
| Australia | Australian Securities Exchange |
| Canada | Toronto Stock Exchange |
| Hong Kong, China | Stock Exchange of Hong Kong |
| France | Euronext Paris |
| Germany | Frankfurt Stock Exchange |
| Ireland | Irish Stock Exchange |
| Japan | Tokyo Stock Exchange |
| Netherlands | Euronext Amsterdam |
| United Kingdom | London Stock Exchange |

| Country | Name of Stock Exchanges |
|--------------------------|-------------------------|
| United States of America | NYSE MKT |
| | NASDAQ Stock Market |
| | New York Stock Exchange |
| | NYSE Arca |

APPLICATION FOR APPROVAL

16. In seeking the approval of the Authority of a SFC authorized ITCIS or a listed ITCIS under section 2(4) of Schedule 1 to the Regulation, an application containing the following information should be submitted to the Authority:

- (a) the full name of the constituent fund/SFC authorized ITCIS/listed ITCIS;
- (b) the name of the stock exchange(s) on which the ITCIS is currently listed and/or evidence showing that the ITCIS has obtained authorization from SFC as an authorized index fund as appropriate;
- (c) the name of the reference index, and information about the composition and weightings of the top 10 largest constituent securities of the index as of the latest month end or quarter end;
- (d) the names of the investment manager/custodian/trustee (as appropriate) of the constituent fund or ITCIS;
- (e) for both SFC authorized ITCIS and listed ITCIS, evidence that the disclosure required in paragraph 14(b) is available;
- (f) details of the policies of the constituent fund or ITCIS regarding borrowing, securities lending and the use of derivatives;
- (g) a copy of the offering document and the latest financial statements of the constituent fund or ITCIS, if any;
- (h) an undertaking by either the approved trustee of the index-tracking constituent fund or the sponsor of the ITCIS or its local

representative as relevant that it will advise the Authority of any events that may result in the approval criteria no longer being satisfied;

- (i) for SFC authorized ITCIS only, details of any waivers granted by SFC pursuant to Chapter 8.6 of the SFC Code and reasons why the waivers do not adversely impact on the suitability of the ITCIS as an MPF investment; and
- (j) any other information which is relevant and material for consideration by the Authority in considering approval.

APPLICATION PROCEDURES

17. Approved trustees may apply in writing to the Authority for approval that section 2(1) and (2) of Schedule 1 to the Regulation do not apply to an index-tracking constituent fund. Approved trustees or the sponsor/trustee/investment manager of an ITCIS may apply to the Authority in writing for the approval of an ITCIS. Such applications, together with all the relevant application documents, should be submitted to the Authority at the following address:

Mandatory Provident Fund Schemes Authority
Level 16, International Commerce Centre
1 Austin Road West, Kowloon
Hong Kong

DEFINITION OF TERMS

18. Where a term used in the Guidelines is defined in the Ordinance or the subsidiary legislation then, except where specified in the Guidelines, that term carries the meaning as defined in the Ordinance or the subsidiary legislation.