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COMMENTS ON THE SFC PROPOSED REGULATIONS OF ETFS REFERENCE: 225/IP/6118

GLOBAL COMMENTS

In making my comments I note that the Commission has referred to the ETF as an "Index" product. In reality, the basic design of the ETF does not require it to be based on an index. Instead, the requirements essential for the proper operation of the instrument is that component securities to be held by the fund and the exchange's trading and clearing systems must have the following characteristics:

The outstanding dollar amounts of the fund securities in the market must be substantial, and each security must trade actively and continuously in size. There must be transparency of the Fund's holdings published daily in the form of creation/redemption baskets and the Exchange's trading system and the clearing system used to settle trades must permit fast execution of multiple component fund securities essentially simultaneously, including the sale of the ETF in the process of being created. Trading and clearing systems, which do not permit such transactions, will not be able to support trading in ETFs.

A further reason for not restricting the ETFs to index instruments is that most mutual funds (85% in the US) are managed funds. There appears to be no basic reason why investors in managed funds should not have available to them the inherent benefits of lower operating costs and daily transparency of the portfolio holdings as do index investors. It is of course possible that many managers of managed funds will not wish to expose their holdings daily but it should at least be possible for those who are willing.

It is also very likely that new ETFs based on combinations of different types of securities will be proposed to the Commission. Hedge funds are already using ETFs in such combination. The Commission should be looking ahead in anticipation of such proposals so that Regulations will not have to be rewritten if the Commission approves such instruments.

MARKET MAKING

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Thus far only the Hang Seng Tracker ETF has been successful in Hong Kong. This instrument has not operated as a true ETF but has succeeded primarily because of the attractive discounts offered by the Government. While it may not be the responsibility of the SFC or HKEx to be concerned with the success of investment instruments listed on the exchange, still, neither the SFC nor HKEx should be happy with listing non-performing instruments.

The ETF was designed for the facilities available in the securities markets in the US and it is my opinion that the US specialist system has been a large part of the success of the SPDR and others of its like. It will be noted that while there are a large number of

ETFs listed in Euro land, the dollar value of the assets in these securities is still quite limited. There are a number of reasons why this is so but the lack of assigned market makers is certainly one of them. In Japan where there is no official assigned type of specialist system but where there is a benefit to organizations permitted to launch the ETFS, assets under management of these instruments has grown much more rapidly than in Euro land.

Possibly, the management of HKEx has been concerned that giving significant special privileges to "specialists" would be severely criticized by Exchange members. I believe that if all members are given the same opportunity to compete for the specialist assignment as they are in the US there should be no reason for complaint especially if such a system is limited to ETFs.

30 **DRAFT GUIDE LINES**
Foreign Origin ETFs from an Acceptable ETF Regime

Virtually every stock Exchange in political entities with overlapping time zones are interested in developing their own ETFs. Thus far, the only source of importation of ETFs from a foreign country with facilities for transferring their ETFs to the HKEx for trading, is the US through their DTC. In this case it certainly makes sense to place strong reliance on the countries regulatory organization. The Sydney Exchange in Australia does have a system of sorts linking to Singapore but I haven't looked at this system closely enough to judge how well it works.

For an ETF to succeed it is important to have institutional interest. Payment of the operating costs of an ETF is basically through a basis point fee against assets under management. Since ETFs are listed and launched for trading on the Exchange without an underwriting which assures sales, it is important to have institutional interest in the product to provide assets to bear the operating costs.

Experience has shown that Hong Kong institutional investors do most of their investing in non Hong Kong time zone securities during the time that trading is active on the home exchange. Such being the case, they have little interest in trading US ETFs on HKEx. Accordingly, while the concept of relying on the SEC's regulatory oversight on imported ETFs from the US, there will in all probability not be many.

The most successful Hong Kong ETFs are more likely to be based on securities traded on Exchanges in the same time zone as Hong Kong where institutions both foreign and domestic can rely on the facilities available in Hong Kong. Accordingly, in my view, maximum attention in developing new specific regulations should placed on ETFs based on securities of foreign stock exchanges in over lapping time zone.

Hong Kong Mutual Fund governing regulations place maximum responsibility for the operation of the Fund on the Trust Company. The US system places more reliance on an investment company structure with a board of directors and corporate officers, which can contract out various parts of the operations to the most efficient providers. The trust company primarily holds the securities and is responsible for them but not for the fund management, accounting, financial control. For ETFs based on securities traded on stock exchanges of nearby countries it may make sense to modify the assignment of responsibilities to place them more strongly on the sponsoring organization formed as a corporate entity. In making this suggestion I of course recognize that this would not be a simple change to make.

75. **REPORTING COMPARISON DATA OF FUND NAV VERSUS ETF TRADED PRICES**

This paragraph makes reference to measurement of tracking of the ETF traded instrument and the NAV of the Fund at that moment in time. In my experience, most of the so called “tracking error” arise because market makers are not relying on last sale prices unless the transaction has occurred very closely in time but rather to the current bid/ask offers available for the securities which could differ substantially from last sale data in a volatile market. One solution to this problem is to have the Exchange calculate the theoretical momentary NAV of the Fund to be based the current bid/ask prices available rather than last sale. I have seen an enormous amount of time spent studying so called tracking error data, which was completely meaningless.

SUMMARY

I recognize that in submitting these comments to the Commission, I have only skimmed the surface of the kinds of comments, which would be appropriate in offering assistance to the Commission in its task of determining the most efficient and effective means of regulating the ETF marketplace. Unfortunately, available time does not permit me to offer the kind of assistance I would otherwise be more than willing to provide. I believe that the Commission is doing an excellent job of developing a regulatory basis for what appears to be a continuously growing acceptance of the ETF as a next stage for mutual fund type instruments. I will look forward to seeing the final outcome of this work.

Nathan Most