

Legislative Council Panel on Financial Affairs

Information Note on Government Share Disposal Programme Launch of TraHK

INTRODUCTION

1. This note updates Members on the plans of Exchange Fund Investment Limited (EFIL) for the launch of the disposal programme for the shares acquired by the Government in the form of a unit trust; the “Tracker Fund of Hong Kong” (TraHK).

2. As Members will recall from the earlier paper submitted to the Panel on this subject at the end of June 1999, a unit trust tracking the Hang Seng Index (HSI) was selected over other disposal methods because it offered the following advantages: -

- i) it can cater for the needs of both retail and institutional investors;
- ii) it does not involve the selection of individual stocks and is therefore “market neutral”; and
- iii) it is likely to cause the least disruption to the market.

Over the past four months we have been working on the structure of TraHK and on the legal documentation. The offer of TraHK was launched on 25 October 1999.

3. The initial offer of TraHK will consist of an offer to the public in Hong Kong (the Retail Offer) together with an offering of units to institutional, professional and other qualifying investors in Hong Kong and overseas through a bookbuilding process (the Institutional Offer). The proceeds of both offers will be used by TraHK to buy a “basket” of shares from the Exchange Fund reflecting the composition of the HSI. The offer for TraHK will close at noon on 4 November 1999 (for the Retail Offer) and on 5 November 1999 (for the Institutional Offer). The price of the units in TraHK will be announced on 9 November 1999 and dealings in the units on the Stock Exchange are expected to commence on 12 November 1999.

DETAILS

TraHK - *Structure*

4. TraHK is a unit trust which has been authorized by the Securities and Futures Commission (SFC) for sale to the public in Hong Kong and which will be listed on the Stock Exchange of Hong Kong.

5. State Street Global Advisors (HK) Limited has been appointed as the fund manager of TraHK and State Street Bank and Trust Company will be its Trustee. Both entities have been approved by the SFC for this purpose. A Supervisory Committee has been appointed to oversee the Trustee and Manager in relation to the administration and management of TraHK.

6. TraHK is designed to provide investment results that closely correspond to the performance of the HSI. To achieve this, TraHK will hold a portfolio of stocks reflecting the composition and weighting from time to time of all of the shares in the HSI.

7. TraHK is further designed to help keep the trading price of its units on the Stock Exchange close to its net asset value per unit. Units in TraHK must be created (unless the Tap Facility is used – please see below) and redeemed “in kind” in exchange for baskets of HSI shares. Arbitrageurs will therefore be incentivised to create and redeem units to exploit any price differential which may arise between the trading price of the units and the value of the underlying stocks. This arbitrage activity will tend to cause the trading price and net asset value to converge.

8. The ongoing creation/redemption features of TraHK are primarily designed for use by arbitrageurs and large professional players. Creations and redemptions can only be made in “wholesale” lot sizes of 1 million units. This size achieves tracking efficiency and a lower threshold would be too costly to administer.

9. Small retail investors will be able to acquire units and realize their investments by buying and selling units on the Stock Exchange like any other stock. The overall size of the offering through the Retail and Institutional Offers should be sufficiently large to ensure liquidity in the secondary market, with a diversified investor base split between professional institutional investors, local corporates and local retail investors. The arbitrage activities referred to above should also contribute to liquidity in the market.

10. In addition to the in-kind creation procedure, units can also be created by tendering cash under the “Tap Facility”. The Tap Facility is a means for the Government passively to sell more shares into TraHK on a continuous basis in response to investor demand. Under the Tap Facility, HSI shares will be sold from the Exchange Fund’s portfolio to TraHK to fulfil orders for the creation of new units at an average price calculated by reference to the price of HSI shares at five-minute intervals during the trading day. There will be no discount on units acquired through the tap. The use of an “averaged price” for sales under the tap is designed to minimize potential for price manipulation. Further, the Government will announce a limit on the Tap Facility in each quarter to avoid the perception of any market overhang. The tap limit is not expected to be more than HK\$3 billion for the first (shortened) quarter commencing on 12 November 1999 and ending on 31 December 1999.

11. TraHK can offer investors the following benefits:-

- a) Diversification across the companies currently comprised within the HSI in a single investment;
- b) Units can be traded like a normal share listed on the Stock Exchange;
- c) TraHK intends to pay twice yearly dividends;
- d) The minimum investment size for TraHK will be substantially lower than the amount required to buy minimum board lots of shares in all the companies comprised in the HSI;
- e) As constituent companies of the HSI change over time the investments in TraHK’s portfolio will also change, thus the investors will gain exposure to these companies without having to make any additional investment; and
- f) TraHK offers relatively low annual fees. The annual fees for TraHK including the trustees’ and managers’ fee, registrar’s fees, licence fees and legal and audit costs are expected to be around 0.20% per year. Investors will however also have to pay registrar charges of HK\$80 per year for so long as they hold their units in scrip form.

Terms of the Initial Offer

12. The indicative size of the initial offer quoted in the Prospectus is HK\$10 billion although the actual size of the offer may be higher or lower than this, depending on actual investor demand and prevailing market conditions.

13. Under the Retail Offer applicants must subscribe for a minimum of 1,000 units. The maximum number of units which may be applied for under the Retail Offer is 300,000 units. It is necessary to cap the size of applications in the Retail Offer as the incentive package (see below) for Hong Kong retail investors will differ from that to be offered to institutional investors.

14. The issue price under the Retail Offer will be at a minimum 5% discount to a “reference market price” which will be calculated on the basis of a three day average price for the HSI shares (taken at five minute intervals during the trading day). The institutional issue price will be at, or at a discount to, the reference market price. Indications of interest will be sought from institutional investors on the basis of a discount range of 5-8%. Further, the retail issue price will be at, or below, the “maximum retail issue price” of HK\$13.80 stated on, and payable upon submission of, TraHK’s application form. This maximum retail issue price was set having regard to the HSI closing level on 22 October 1999. The setting of a maximum price is designed as an additional benefit to retail investors and offers protection to them in the event that the market rises sharply before the pricing date. If the retail issue price is set at a level below the maximum retail issue price the difference will be refunded to the investor.

15. Individual applicants applying under the Retail Offer who hold a Hong Kong identity card, have a Hong Kong address, are aged 18 or over and whose applications are successful will also be entitled to receive loyalty bonus units from the Exchange Fund, if they hold the units for which they have subscribed in the Retail Offer continuously for one year (when they will receive 1 unit for every 20 held) and two years (when they will receive 1 unit for every 15 held). This Loyalty Bonus Scheme is not available to institutional investors.

Offer Arrangements

16. As in the case of other Initial Public Offerings (IPOs) in Hong Kong, the units will be sold through “selling syndicates”. These

comprise Joint Global Coordinators and Joint-Lead Managers selected by EFIL and Co-Lead Managers selected by the Joint Global Coordinators in consultation with EFIL. The members of the syndicates are selected having regard to their reputation, client outreach and distribution capabilities as well as their ability to work with the Joint-Lead Managers and other members of the syndicate to ensure a successful execution for the IPO.

17. The offer of units in TraHK will not be underwritten. Unlike issues of shares, there is no requirement under the Stock Exchange's Listing Rules for the offer of units in a unit trust to be underwritten. Further, the Government wishes to retain control over all aspects of the offering process including pricing and allocation, in order to ensure a balanced investor base encompassing genuine long term retail and institutional investors and to minimize any potentially adverse impact on the market. This level of control would be unlikely to be achievable by an issuer in an underwritten structure.

CONCLUSION

18. TraHK is the first fund of its kind to be launched and listed in Hong Kong or in Asia (outside of Japan). In the US, a similar product "SPDRs", took three years to develop before its launch in 1993 and has taken a further six years to become what is now a liquid and popular financial product traded on the American Stock Exchange. The creation of TraHK (with the unique features described above) within a 4 month timeframe and its launch in the form of an IPO with the continuous Tap Facility have presented very significant challenges. Complex legal issues have had to be resolved and the processing of what may potentially be a very large IPO combined with TraHK's automated creation and redemption features have posed challenges for Hong Kong's market, clearing and settlement infrastructure. A comprehensive marketing campaign has been undertaken to raise public awareness and understanding of TraHK. Although such campaigns are standard practice for most privatizations undertaken by overseas governments, this is the first time that the HKSARG has engaged in this kind of marketing campaign for an IPO in Hong Kong. TraHK is a unique product and as it gains increasing familiarity and popularity amongst investors and market participants following its launch it will contribute to the long term development of Hong Kong's capital market.