



EXCHANGE TRADED FUNDS GUIDANCE NOTE

About this Note

This Policy Guidance Note (PGN) is to be used in Kenya as a guide on the operational environment of ETFs, and to inform the ultimate design of a comprehensive legal and regulatory framework.

CAPITAL MARKETS AUTHORITY – KENYA

SEPTEMBER 2015

Introduction

This note is a precursor to a comprehensive regulatory framework to allow for the operationalization of Exchange Traded Funds (ETFs) in Kenya. As such it has limits on use and application.

- i. ETFs are a type of listed open-ended index/unit instrument bought or sold on a securities exchange. The index or unit may be composed of ordinary stocks, bonds, commodities, futures or a combination of real assets with the objective of allowing for exposure to a portfolio of securities, assets or indices whose price movement is in tandem with the price movement of the constituent underlying securities or commodities. An ETF can be a domestic or offshore product.
- ii. In case of any doubt, it is advised that direction be sought from the Capital Markets Authority (CMA).
- iii. This PGN aims to provide a guide to listing ETFs in Kenya, whilst identifying and mitigating the likely regulatory risks arising from ETF transactions in Kenya, to promote market confidence and integrity, key planks of fair and efficient capital markets in Kenya.
- iv. The introduction of an ETFs market in Kenya is aimed at offering investors another option of investing in capital markets through pooled securities or indirectly in commodities in a formal securities exchange environment.
- v. As is the case with any other listed security, investors shall buy and sell their ETFs through a securities exchange and clear or settle through existing Clearing and Settlement Infrastructure.
- vi. Just as is the case with trading in other securities, the value of an investment in an ETF may go up or down as the market conditions change. Also, ETFs are not capital protected; there is therefore no guarantee that on selling after purchase, investors would get back the whole amount invested.
- vii. Investors should view ETFs as long-term investments designed to not only diversify investment horizons but also reduce exposure to significant price fluctuations that sometimes characterize buying and selling of securities and thus minimize their risk exposure.

Issuance of ETFs in Kenya

1. ETFs shall have their own market sub-segment – to be created by a relevant listing exchange.
2. ETFs shall have their own international security identification numbers and codes.
3. Domestic ETFs¹ shall be subject to intra-day price fluctuation limits on trading like shares. However, off-shore ETFs² intra-day price limits shall be based on the limits that have been imposed in their home jurisdiction and forex fluctuations. Domestic ETFs shall at the minimum, comply with internationally accepted principles of issuance and trading of ETFs.
4. Units in an exchange traded fund shall be listed and traded in Kenya Shillings.
5. For a start, the maximum ETFs' fees charged shall not be more than that charged in the equities markets subject to revision by CMA notification. All fees shall be fully disclosed in the issuance or introduction documentation.
6. Where the ETF issuer is not a local entity, it shall meet the following minimum requirements:

¹ Domestic ETFs refer to ETFs whose prices shall be determined by prices of domestic constituent underlying assets or securities only,

² Offshore ETFs shall be those ETFs whose prices shall be determined by prices of the foreign constituent underlying assets or securities denominated in domestic currency and the forex fluctuation component

- 6.1 comply with the requirements of this PGN on ETFs to the extent practicable.
 - 6.2 be listed on an exchange upon receiving CMA's approval which shall be subject to such conditions as may be imposed by CMA including obtaining a No Objection letter from a competent Authority in the home jurisdiction of the issuer.
 - 6.3 appoint a person licensed by CMA as its authorized representative in Kenya for purposes of regulation and oversight;
 - 6.4 in addition to complying with the corporate actions in the home jurisdiction in respect of Kenyan investors and regulators disclose and comply with continuing obligations observed in the home jurisdiction.
7. The issuer may be exempted from Kenya's capital adequacy requirements, subject to being in compliance with requirements in the home jurisdiction. The Authority (CMA) may require a copy of rating reports or other documentation as submitted to a regulator in the home jurisdiction (if applicable).
 8. Where an issuer is seeking a secondary listing for ETF units listed on another exchange, the said issuer shall be in compliance with the requirements of the regulatory regime in its home jurisdiction that meet minimum internationally acceptable principles and standards.
 9. Exchange traded funds in Kenya shall have one or more Market Makers (MMs), licensed by CMA and admitted by the listing exchange. MMs, shall at all times give a binding two-way (bid and offer) quote for the ETF units for which they are MMs.
 10. ETFs listed in Kenya shall be open-ended unless an exemption is granted.
 11. ETFs in Kenya shall be issued on the basis of an index or be structured on a combination of securities, commodities or financial instruments based on a clearly defined and approved ratio and price.
 12. Calculation of an ETFs per unit value (whether an index or a commodity ETF unit) shall be done by a competent institution that shall either be an approved exchange or an outsourced organization that shall also provide error tracking services. An exchange shall also establish an Index Review Committee whose role shall be to:
 - 12.1 Semi-annually and within the first two months after the end of the six months, review the ETF's value to give an objective view on its historical reliability
 - 12.2 Evaluate the ETF's transparency and fair computation
 - 12.3 Communicate its findings on the ETF's evaluation to CMA
 13. The methodology of computation of the ETF's Net Asset Value (NAV) shall be clearly spelt out and be easily understandable as shall be outlined in the ETF's constitutive documents and any relevant information memorandum and marketing materials.
 14. The constituent assets or securities shall be housed in a trust arrangement with a trustee being appointed, subject to approval by CMA.
 15. ETFs listed in Kenya shall be fully backed by an underlying asset of an equivalent value at all times.
 16. Trading in ETFs shall be open to all investors seeking to participate in a formal exchange and shall be subject to this PGN and any other rules as issued by a listing exchange or CMA.

17. If circumstances are such that the ETF has to be delisted or wound up, this shall be done based on the ETFs' NAV on the basis of the average price of the last traded month. This process shall be clearly provided for and outlined in the Trust Deed.
18. Minimum securities or asset blocks in the case of creation, redemption or cancellation shall be agreed upon with CMA and clearly indicated in the information memorandum, while minimum trading lots shall be equivalent to those in the listing exchange.

Approval of ETF

19. A person who intends to issue an ETF shall make an application to CMA for approval to list or introduce the ETF in accordance with this PGN.
An ETF Issuer shall be notified of the decision of the Authority in writing. If the application is rejected, the reason for rejection shall be stated in the notification, as well as the procedure and time limit for resolution.
20. An ETF Issuer shall be a legal person.³
21. On approval of the ETF by CMA, the ETF shall be listed on a securities exchange subject to:
 - 21.1 The ETF being in compliance with the approved exchange Listing and Trading Rules. The ETF Listing and Trading rules shall clearly and comprehensively outline procedures, processes, frequency and content of reporting, clearly highlighting the disclosures to be made daily, weekly, monthly, quarterly or annually;
 - 21.2 The ETF units being freely transferable;
 - 21.3 The establishment of adequate infrastructural arrangements for the clearing and settlement of trades in ETF units through an approved Central Securities Depository;
 - 21.4 Minimum free float of the ETF in terms of Assets under Management, being at 25 per cent of the issued share capital in underlying assets subject to such changes as may be prescribed from time to time and
 - 21.5 Compliance with the process and indicated timelines for issuance and listing of ETFs set out in a listing exchange's rules.

³ This may be an individual or company

Pre-listing Requirements

22. A potential issuer of ETFs shall submit an Information Memorandum complying with the disclosures under **‘Requirements on the specific details of the ETF’** of this note, together with the information, documents or Annexes highlighted below:

- 22.1 Full name and profile of promoter, manager (where applicable) and trustee;
- 22.2 Place and date of incorporation of promoter, manager (where applicable) and trustee;
- 22.3 The full names, details and addresses of directors of the issuer, manager (where applicable) and trustee;
- 22.4 Details of the financials, corporate governance structures and key personnel of the issuer;
- 22.5 Copies of all necessary authorizations, licenses and agreements;
- 22.6 Constitutive documents including the Trust Deed or Memorandum and Articles of Association as applicable;
- 22.7 The fund’s key contact person to CMA;
- 22.8 A certified copy of the minutes of the board meeting or meeting of the promoter(s) at which the resolution to establish an ETF was passed;
- 22.9 Where the promoter of the ETF is a company, a resolution to apply for admission to a securities exchange listing shall have been passed by the board of directors of the promoter, and the application shall be signed by the board of directors or by a party duly authorized by the board of directors. If the application is signed pursuant to a power of attorney, a copy of the signed power of attorney shall be attached.

Requirements on the specific details of the ETF

23. The following specific details shall be outlined in the Information Memorandum submitted to CMA:

- 23.1 The type of ETF(s) to be issued;
- 23.2 A description of the ETF, including the name of the promoter of the ETF, its date of establishment and how it shall be compiled or constituted;
- 23.3 Information on the computation(s) behind the number of block or portfolio securities to make up ETF units and the targeted unit holder category;
- 23.4 A justification (reasons for establishment, reasons for selection of assets or portfolio of assets, reasons for choice of jurisdiction, benefits to investors and the issuer etc.) for issuance of the stated type of ETF(s);
- 23.5 A description of the constituent assets and the ratio of their combination;
- 23.6 The ETF units’ creation and cancellation process;
- 23.7 A detailed explanation of the anticipated institutional, human resource and infrastructural arrangements to be used in the ETF units’ creation, trading and cancellation process;
- 23.8 The identity and competence of the party or parties that shall be involved in sponsoring or calculating the ETF;
- 23.9 The frequency with which the ETF shall be updated or reconstituted and circumstances instigating reconstitution;
- 23.10 The names and addresses of the advisors to the issue at a minimum being fund manager, market maker, trustee, custodian or administrator, index provider and external auditor;

- 23.11 Net Asset Value (NAV) of the said fund as at the date of application, in cases where a mutual fund for an underlying portfolio of securities is already in existence and is seeking to convert to an ETF, or where an ETF is seeking secondary listing in Kenya;
- 23.12 Pricing, dividend distribution and tracking approach. Specifically:
 - 23.12.1 The dividend distribution policy in terms of timeliness, retention, distribution costs, re-investment and preferred mode (bank, phone, cheque etc.);
 - 23.12.2 If the ETF has already been established elsewhere, its past performance measured through its realized tracking difference and tracking error and
 - 23.12.3 The issues anticipated to affect the ETF's ability to fully replicate its target index, the level of tracking error that may be reasonably expected and a policy to minimize tracking error.
- 23.13 The fund or portfolio's constituent assets/securities on which the ETF shall be structured (where applicable);
- 23.14 Liquidity ratio - turnover/market capitalization of each of the underlying securities & basket of securities as a whole over the past year in jurisdictions where the ETF trades (where applicable);
- 23.15 The volatility of the NAV of the underlying basket of securities for the previous four (4) months on a daily basis (in cases where the securities are listed elsewhere);
- 23.16 In cases where the ETF is new, the volatility of the NAV of the constituent assets that would constitute the underlying securities portfolio or assets shall be disclosed;
- 23.17 The course of action that shall be taken by the issuer where an underlying security is suspended or delisted and the repercussions on the computation of NAV;
- 23.18 The Issuer/Promoter shall prove to have relevant expertise and experience to issue ETFs or prove to have access to such expertise.
- 23.19 Satisfy CMA that a secondary market for the ETF shall be established and maintained;
- 23.20 Undertake to compute the Net Asset Value (NAV) of the ETF on a daily basis and make the NAV public to all market participants at the same time through a listing exchange.
- 23.21 Commit to computing NAV, while taking into account any corporate actions for instance better than anticipated performance of the underlying asset(s).
- 23.22 Commit to providing linkage with CMA's surveillance infrastructure; and
- 23.23 Highlight the anticipated fees to be charged by service providers and their justification.

Requirements on risk and risk mitigation

- 24. Before ETF issuance, CMA shall satisfy itself that the issuer has addressed most of the potential risks associated with early-stage ETF markets, in line with established international standards. In this respect the issuer shall be required to:
 - 24.1 Detail within the Information Memorandum, a comprehensive report on the likely risks, including:
 - 24.1.1 Continuing (financial, computational, risk management and/or reporting) obligations of key stakeholders (e.g. the promoter, market maker(s), listing exchange, trustee, custodian, brokers/investment banks, investors etc.)
 - 24.1.2 Disclose potential conflict of interest, for instance, in situations where a custom index is created by an affiliate of the issuer, CMA may:

- a. Require the issuer to make publicly available, all the rules that would govern the composition, and weighting of assets or securities in each commodity or index;
 - b. Limit the ability to change the rules for asset or index compilation and require public notice before any changes are made; and
 - c. Where appropriate, require the establishment of firewalls between the staff responsible for the portfolio and management staff.
- 24.2 Sufficiently address Counterparty credit risk either in an OTC (primary market) transaction or in a formal securities trading arrangement. This shall involve putting in place:
- 24.2.1 Appropriate risk management procedures;
 - 24.2.2 Limits with respect to an ETF's net exposure to counterparty risk posed by a specific issuer;
 - 24.2.3 Appropriate procedures for management of tracking error.
 - 24.2.4 Other safeguards to mitigate potential operational and legal risks arising from ETF units trading (e.g. conditions governing pledging).
 - 24.2.5 Appropriate actions to be taken by the issuer to shield investors particularly if an ETF issuer fails for whatever reason (e.g. fraud, loss of liquidity) as investors 'rush for the exits', a bad business model or poor risk management).
 - 24.2.6 A comprehensive and exhaustive complaints handling procedure and recourse (penalty, transaction recall etc.) process.
 - 24.2.7 Fully outline embedded risks which include general market risks, interest rate risks, exchange rate risks, inflationary risks, liquidity risks and legal and regulatory risks and clearly link them to transactions in ETFs.
- 24.3 Detail the risk mitigation measures to minimize risk exposure to the identified potential risks in ETFs trading.
- 24.4 Intermediaries shall be required to use existing compliance function infrastructure and internal control policies and procedures for ETFs trading.

Appointment of Market Makers

25. A market maker in Kenya's ETF market shall play the role of creating liquidity through two-way price quotes in order to eradicate substantial price gaps and ensure a liquid market for all.
- 25.1 An issuer shall, prior to the listing of the ETF, be required to appoint a market maker and such duly appointed market maker shall undertake to quote buy and sell price(s) in respect of units in the ETF on a daily basis.
 - 25.2 The issuer and market maker shall sign a written agreement on clear terms of market making for an ETF. The market maker shall submit to CMA and the listing exchange a copy of the market making agreement concluded with the issuer prior to commencement of market making.
 - 25.3 Prior to the approval for listing, the issuer and the Market Maker shall communicate the date of commencement and termination (if applicable) of an undertaking regarding the market making activity for the ETF.
 - 25.4 A listing exchange may establish an incentive mechanism for the most active Market Makers in the market, on the basis of a clear formula that may be independently verified.

Appointment and Responsibilities of the Manager

26. The issuer may appoint a Fund Manager to act on its behalf for the purpose of managing the ETF or undertake to manage the ETF.
27. Subject to the Listing Rules and ETF rules, the manager may in its absolute discretion:
- 27.1 Act and enter into all arrangements as necessary for the administration of the scheme so as to achieve the investment objective(s) of the ETF;
 - 27.2 On receiving the necessary approvals, select, purchase, sell, exchange or change any of the assets of the underlying securities in the ETF;
 - 27.3 Appoint persons to exercise powers and perform duties on its behalf;
 - 27.4 Act on the advice or information obtained from professional advisers and others considered by it to be experts;
28. The manager may, with the written approval of the trustee and the listing exchange, appoint any company qualified to act on its behalf, and may assign to such appointee all its rights and duties as manager.
29. Where it is imminent that the manager will be liquidated, the trustee shall take immediate steps to ensure the appointment of a new manager before the commencement of the liquidation process of the exiting manager.

Appointment and Responsibilities of the Trustee

30. Prior to ETF issuance, the Issuer shall appoint a trustee licensed by CMA, who shall have the primary responsibility of protecting the interests of investors.
31. The powers, authority, obligations and responsibilities of the trustee shall be detailed in the trust deed and shall include the following among others:
- 31.1 The trustee's powers necessary to protect the interests of investors and to perform its functions.
 - 31.2 The trustee's liability in making distributions to unit holders only out of funds held by or paid to it for the purpose under the ETF rules.
 - 31.3 The trustee's obligation to take delivery of and retain in safe custody and under its supervision and control, the documents of title to the underlying assets.
 - 31.4 The trustee's duty to prepare a detailed delisting or winding-up process that shall be underpinned by a distribution of redemption funds mechanism guided by the ETF's NAV on an average price in the last trading month of the ETF.
32. A trustee shall be deemed to have resigned if its certificate of registration is revoked or suspended and the issuer shall in that event immediately appoint another legal person qualified to act as trustee.

Corporate actions

33. In the case of ETFs, the execution of any corporate action shall follow already existing regulations on such corporate actions.
34. Continuous creation or cancellation of ETF units shall be allowed, subject to the relevant institution (issuer or Market Maker) effecting the process through an account that shall be readily accessible in real time by both the listing exchange and CMA
35. Where corporate actions, including but not limited to mergers, takeovers, ETF creation, ETF cancellation, rights issues, capital reductions etc. occur in a constituent security of the ETF, the issuer of the ETF shall immediately publicly disclose the corporate event and take steps to rebalance its portfolio while complying with the rules pertaining to the ETF's reconstitution.

Information and Information dissemination

36. There shall be a clear set of policies and procedures on ETF market data disclosure and circulation by relevant information and data stakeholders (a listing Exchange, intermediaries, trustees, data vendors etc.)
37. CMA shall require that further information is included in the Information Memorandum if it considers this necessary in view of the interests of investors or for the purpose of evaluating whether an ETF is suitable for a securities exchange listing.
38. Intra-day ETF value information dissemination by a listing exchange shall be real-time.
39. The CMA may in special circumstances grant exemptions from the requirements of this guidance note where it deems it necessary or appropriate for the listing of ETFs to be done.

Continuing Obligations

40. All ETF issuers shall:
 - 40.1 Publicly disclose all material changes and developments likely to affect their valuation and operations immediately;
 - 40.2 Submit a notification and seek approval from CMA for alterations to capital structure including but not limited to; new issues of debt securities, changes of rights attached to listed units or issues affecting conversion rights;
 - 40.3 Notify the Authority on how tracking error shall be measured;
 - 40.4 Ensure equality of treatment of unit holders;
 - 40.5 Notify the Authority on any Board changes;
 - 40.6 Notify the Authority of any interests of directors and their associates in the ETF;
 - 40.7 Notify the Authority on Board decisions that could have an impact on an ETF's valuation;
 - 40.8 Notify the Authority and secure approval of applicable Annual fees (Administration, Management etc.) and changes thereto if any;

- 40.9 Submit Interim (Semi-annual) financial statements within two months after the end of the six months period and audited annual financial statements within four months of the end of the financial year ;
- 40.10 Continuously notify unit holders on Net Asset Value (NAV) of units;
- 40.11 Publicly disclose any changes to the terms and conditions for trading in fund units, including any changes to market making arrangements;
- 40.12 Publicly disclose information on distributions by the fund to unit holders of dividends, realized gains and effective dates;
- 40.13 Publicly disclose changes to the fund's investment strategy;
- 40.14 Publicly disclose changes to the manager(s) responsible for the fund;
- 40.15 Disseminate any announcement on the underlying securities to a listing exchange, at the earliest opportunity, but at the very latest, on or before the expiry of 1(One) market day subsequent to such announcement in respect of the constituent security and
- 40.16 Disseminate through the listing exchange, the NAV of the ETF to participants based on the last traded price on a daily basis before the commencement of trading.

The role of a Listing Exchange

- 41. A listing exchange shall provide the first-line supervision and surveillance.
- 42. A listing exchange shall have the right to require the issuer, its Trustee, its officers or its employees to provide it with all the information necessary for it to carry out its legal duties.
- 43. Any supervisory request or action by a listing exchange shall be in writing. In special circumstances, a listing exchange may make a demand orally. However, such oral demand shall be confirmed in writing as soon as possible.
- 44. A listing exchange shall submit to CMA, for approval, listing and trading rules for ETFs.

The Role of CMA

- 45. CMA shall from time to time issue revisions to this PGN as and when necessary.
- 46. The ETF issuer and other key stakeholders may be subjected to either existing or reasonable financial requirements by the Authority.
- 47. CMA may at any time require that the fund, its trustees/managers, its officers and/or its employees provide it with information.
- 48. CMA shall require to be satisfied that end-to-end ETF data transmission and sharing between the various players (Issuer/Market Maker, listing exchange, CSD, Vendors, CMA, etc.) is seamless, before giving approval for the listing of the ETF.
- 49. CMA may at any time take enforcement action on any party where it finds that such party has not complied with the provisions of this PGN.
- 50. The CMA and relevant listing exchange shall establish mechanisms for cooperation and coordination of the oversight of ETF products with other ETF exchanges and regulatory entities in order to cater for sharing of information relating to material events, market data and transaction records in addition to the effective oversight of cross-market events.