

MEMO# 31524

December 18, 2018

Hong Kong SFC Issues Conclusions on Amendments to the Code on Unit Trusts and Mutual Funds

[31524]

December 18, 2018 TO: ICI Members

ICI Global Members

Derivatives Markets Advisory Committee

ICI Global Pacific Chapter

ICI Global Regulated Funds Committee

ICI Global Trading & Markets Committee SUBJECTS: Derivatives

International/Global

MiFID, EMIR, AIFMD, UCITS V RE: Hong Kong SFC Issues Conclusions on Amendments to the Code on Unit Trusts and Mutual Funds

On 6 December the Hong Kong Securities and Futures Commission's (SFC) issued its conclusions on proposed amendments to the Code on Unit Trusts and Mutual Funds (UT Code).[\[1\]](#) The SFC is adopting substantial changes to the UT Code in order to ensure that Hong Kong's regulatory regime for SFC-authorized unit trusts and mutual funds is up-to-date and appropriately addresses the opportunities and risks presented by financial innovation and market developments.[\[2\]](#) Such an updated UT Code will benefit investors, fund managers, and the Hong Kong financial services industry as a whole by, among other things, increasing trust and confidence in the regulatory framework.

The SFC's conclusions follow its December 2017 consultation paper and subsequent engagement with industry stakeholders to better understand the impact of the proposed changes.[\[3\]](#) ICI Global, in coordination with interested member firms, has engaged extensively with the SFC regarding the proposed amendments, particularly on those related to the classification of funds based on the use of derivatives.[\[4\]](#) We summarize below the SFC's conclusions on the issues we raised in our comment letters.

Implementation Date

The revised UT Code will become effective, tentatively on 1 January 2019, following its gazettal. It will apply to new funds with new operators with immediate effect as of the effective date. Existing funds and existing operators have a 12-month transition period from the effective date unless otherwise specified.[\[5\]](#) We recommended a 24-month transition period, but this recommendation was not adopted.

Application to UCITS Funds

Over the years, the SFC has been adopting a streamlined approach to the authorization of UCITS funds from specified jurisdictions. To provide better transparency and clarity, the SFC in Appendix B of the Conclusions Paper specifies which Chapters of the UT Code apply to UCITS funds not falling or authorized under the applicable mutual recognition of funds arrangements with relevant jurisdictions.^[6] The SFC also notes that, notwithstanding this streamlined approach, the SFC may impose or vary the requirements applicable to UCITS funds as it may deem fit. We are pleased that, as we recommended, the SFC has specified clearly the provisions that will apply to UCITS funds.

Derivatives Investments

The SFC's final amendments retain the general classification system and distribution restrictions on derivatives that the initial consultation proposed. The classification system would impose differing fund distribution requirements based on a fund's derivatives use under an adjusted gross notional exposure test that classifies funds into three categories: "plain vanilla" funds; derivatives-based funds; and retail hedge funds. "Plain vanilla" funds could invest up to 50 percent of their net assets in derivatives. Derivatives-based funds could invest more than 50 percent and up to 100 percent of their net assets in derivatives, while retail hedge funds could invest more than 100 percent of their net assets in derivatives. Both derivatives-based funds and retail hedge funds would be subject to additional "know your customer" assessments, and retail hedge funds would be required to have a minimum initial subscription of at least \$50,000 US.

Funds would determine how much of their portfolio is invested in derivatives based on an adjusted gross notional exposure test that aggregates the notional exposures of a fund's derivatives, exclusive of certain derivatives transactions. The SFC did not take our comments to use a different classification system or our concerns that using aggregated gross notional exposures could overstate the riskiness of funds. Instead, the SFC stated that there is no consensus on a single consistent measure of leverage and that various recommended approaches are not related to the SFC's goal of identifying or imposing limits on leverage for public funds.^[7] Consistent with our comments, however, the SFC did expand the types of derivatives that could be excluded from the exposure calculation to include not only derivatives acquired for hedging purposes^[8] (as proposed) but also derivatives for: netting, risk mitigation, cash flow management, market access or exposure replication (without incremental leverage at the fund portfolio level), and investment in conventional convertible bonds.^[9] In this regard, the SFC indicated that it will publish further guidance on these additional exclusions and the calculation of net derivative exposures, along with examples, which may be updated from time to time.^[10]

In terms of disclosure, funds now must provide in their Key Fact Statement the expected maximum leverage arising from derivatives investments.^[11] Consistent with our concerns, the SFC noted that these thresholds should not be exceeded "under normal market conditions," thus implicitly acknowledging that funds could exceed the thresholds, if necessary, under abnormal market conditions.^[12]

Investment Experience and Expertise. The SFC did not adopt our requested change that would permit fund managers to effect an investment manager change without prior SFC approval so long as certain conditions are met.

Diversification Requirements. We requested that the proposed diversification provision limiting the value of a fund's cash deposits with the same entity to 20 percent include

additional exemptions for unusual circumstances to make the exemptions useful and practically workable. The SFC revised the proposed Code amendments to make the exemptions broader and more workable.

Investment in Other Schemes. We requested that the Note on investments in other schemes clearly state that a determination of how an exchange traded fund (ETF) is treated (whether considered a listed security or a collective investment scheme) is to be made at an individual fund level. The SFC did not revise this Note as we requested.

Counterparties. We requested that the SFC delete the requirement for a counterparty to a securities financing transaction to be a “substantial financial institution” as defined in the UT Code and instead allow the fund manager to have discretion to determine the appropriateness of a fund’s counterparty. The SFC did not adopt our requested change, but instead revised the provision to require that the counterparty to a securities financing transaction be a financial institution that is subject to ongoing prudential regulation and supervision.

Securities Financing Transactions Indemnification. We requested that the SFC delete the proposed requirement for securities lending agents to indemnify a fund against counterparty default. The SFC has deleted this provision.

Collateral Requirements. We requested that the SFC confirm that the fund manager may determine that, for certain assets, it would be appropriate not to take any haircut based on the fund manager’s assessment of the market risks of those assets. The SFC did not revise the provision as we requested.

Money Market Funds. We requested that the SFC clarify and expand the guidelines regarding reverse repurchase agreement collateral to include specifically government securities. Although the SFC did not make the specific change we requested, the SFC revised the provision to permit as collateral for reverse repurchase transactions government securities receiving a favourable assessment on credit quality. Additionally, we requested that the liquid asset definitions be expanded to include government securities. The SFC did not make this change. However, it did revise the provision to require a fund to hold at least 7.5% (rather than 10%) of its total net asset value in daily liquid assets and at least 15% (rather than 30%) of its total net asset value in weekly liquid assets.

Valuation and Pricing. The SFC proposed to require that the trustee/custodian be informed of any error in the pricing of shares. We requested that the SFC confirm that the requirement to notify the fund’s trustee/custodian of any pricing error applies only to a material error that would impact the price as published to the public. The SFC declined to make the requested confirmation.

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endnotes

[\[1\]](#) Consultation Conclusions on Proposed Amendments to the Code on Unit Trusts and Mutual Funds (Conclusions Paper), available

at <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=17CP8>

[2] Funds offered to the retail public in Hong Kong, whether domiciled in Hong Kong or elsewhere, are required to be authorized by the SFC.

[3] The Hong Kong Securities and Futures Commission Consultation on Proposed amendments to the Code on Unit Trusts and Mutual Funds is available at <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=17CP8>. Corresponding amendments are also proposed to relevant provisions of various SFC product codes.

[4] See ICI Global memorandum (linking to comment letter) on the SFC UT Code consultation, dated 23 March 2018, available at <https://www.iciglobal.org/vgn-ext-templating/v/index.jsp?vgnextoid=55aef71f58352610VgnVCM100000650210acRCRD&vgnnextchannel=36566702fa782310VgnVCM1000005b0210acRCRD&vgnnextfmt=default>; and ICI Global memorandum (linking to comment letter) on revised proposed derivatives amendments to the SFC UT Code, dated 27 August 2018, available at <https://www.iciglobal.org/iciglobal/pubs/memos/memo31347>

[5] The UT Code contains a table specifying the effective dates of the specific UT Code Chapters to new and existing funds and operators.

[6] In the Conclusions Paper UCITS funds refers to UCITS funds domiciled in France, Luxembourg, Ireland, and the United Kingdom.

[7] Conclusions Paper at paragraphs 71-73. See also IOSCO Report: Leverage (November 2018) (proposing approaches to measuring and comparing leverage in funds), available at <https://www.iosco.org/library/pubdocs/pdf/IOSCOPD615.pdf>.

[8] Derivatives positions typically acquired for investment (i.e., non-hedging purposes) would be converted into the equivalent prevailing market values in their underlying assets and aggregated. The SFC, per its initial consultation, would exclude derivatives acquired for “hedging purposes” if they meet all the following criteria: (a) they are not aimed at generating any investment return; (b) they are solely intended for the purpose of limiting, offsetting, or eliminating the probability of loss or risks arising from the investments being hedged; (c) although they may not necessarily reference the same underlying assets, they should relate to the same asset class with high correlation in terms of risk and return, and involve taking opposite positions, in respect of the investments being hedged; and (d) they exhibit price movements with high negative correlation with the investments being hedged under normal market conditions. Chapter 7.25 of the UT Code.

[9] Conclusions Paper at paragraph 79. The SFC notes, however, that passively managed index funds (including ETFs) or structured funds could not exclude derivatives used for market access or exposure replication, even if the derivatives do not create incremental leverage at the fund portfolio level. Conclusions Paper at note 11. Other funds would be able to exclude derivatives used for market access or exposure replication so long as the derivatives do not create incremental leverage at the fund portfolio level.

[10] Conclusions Paper at paragraph 81.

[11] The SFC provides sample disclosure that could read: “The fund will not use derivatives for any purposes” or “The fund’s net derivative exposure may be [up to 50%] / [more than 50% but up to 100%] / [more than 100%] of the fund’s NAV.”

[\[12\]](#) Conclusions Paper at paragraphs 85-87. If a fund exceeds its disclosed threshold, the management company is expected to take all necessary steps to reduce the fund's leverage within a reasonable period to ensure that the disclosure is not misleading, while taking into account the fund's investors. Conclusions Paper at paragraph 87.

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