

MEMO# 31332

August 15, 2018

Draft Comment Letter on the SFC's "Soft Consultation" Revising Proposed Derivatives Amendments to the Code on Unit Trusts and Mutual Funds

[31332]

August 15, 2018 TO: ICI Members

ICI Global Members

Derivatives Markets Advisory Committee

ICI Global Pacific Chapter

ICI Global Trading & Markets Committee SUBJECTS: Derivatives

International/Global RE: Draft Comment Letter on the SFC's "Soft Consultation" Revising Proposed Derivatives Amendments to the Code on Unit Trusts and Mutual Funds

Attached for your review is a draft comment letter to a Hong Kong Securities and Futures Commission ("SFC") "soft consultation" revising proposed amendments to derivatives regulations in its Code on Unit Trusts and Mutual Funds.[\[1\]](#) The original proposed amendments would impose additional distribution requirements and restrictions on funds based on their derivatives exposure.[\[2\]](#) The comment letter generally supports the SFC's revisions that would expand the types of derivatives that would be excluded from the derivatives exposure determinations[\[3\]](#) and that would create exemptions for certain other types of derivatives.[\[4\]](#) To make the proposed amendments more workable for and reflective of the actual practice of global asset managers, the letter recommends that the SFC:

- Except the "exempted circumstances" for derivatives exposures that exceed 100 percent of the fund's NAV;
- Revise the "exempted circumstances" exception to require that exposure in excess of 50 percent of the fund's NAV be primarily, not solely, attributable to the exempted circumstances;
- Add fixed-income scenarios to the "exempted circumstances" examples in the Appendix;
- Permit funds using interest-rate derivatives to scale notional exposures; and
- Confirm that the "expected maximum leverage" disclosure does not impose a

hardwired limit on a fund's investment in derivatives.

Given the abbreviated comment period, final comments on the "soft consultation" are due to the SFC by Wednesday, August 22. If you have any comments on the draft letter, please provide them in writing to Ken Fang at kenneth.fang@ici.org **by 9 am (Eastern Time) on Monday, August 20.**

Kenneth Fang
Assistant General Counsel

[Attachment](#)

endnotes

[1] For a summary of the soft consultation, please see ICI Memorandum No. 31300 (July 26, 2018), available at https://www.ici.org/my_ici/memorandum/memo31300.

[2] In particular, the SFC proposes to impose differing requirements on three categories of funds: plain vanilla funds; derivatives-based funds; and retail hedge funds. The SFC proposes to permit "plain vanilla funds" to invest up to 50 percent of their net asset value ("NAV") in derivatives (exclusive of derivatives used for hedging purposes). The SFC would permit other funds known as "derivatives-based funds" to invest up to 100 percent of their net asset value in derivatives (exclusive of derivatives used for hedging purposes), provided they provide additional risk disclosures. Finally, the SFC would permit retail hedge funds to invest in derivatives without any limit, subject to enhanced requirements, including a minimum initial subscription of at least \$50,000 US.

The SFC would impose additional requirements on derivatives-based funds and retail hedge funds. Specifically, the SFC would treat derivatives-based funds and retail hedge funds as "derivative products" subject to enhanced distribution requirements under 5.1A and 5.3 of the Code of Conduct for Persons Licensed by or Registered with the SFC. Those provisions would impose additional know-your-client assessments when selling those products on persons licensed by or registered with the SFC. In addition, the SFC would require both derivatives-based funds and retail hedge funds to provide additional plain language disclosure about the risks associated with derivatives and the risk management policy and methods employed to measure and manage derivatives risks.

[3] Although the initial consultation paper only would have excluded derivatives for hedging purposes from this determination, the soft consultation also would exclude derivatives for cash flow management or downside risk mitigation purposes.

[4] The exemptions would apply if the portion of derivatives exposure in excess of 50 percent of the fund's NAV (but only up to 100 percent of the fund's NAV) is solely attributable to one of several "exempted circumstances." These "exempted circumstances" are for: (i) hedging purposes; (ii) cash flow management or downside risk mitigation; (iii) market access or exposure replication (without incremental leverage at the fund portfolio level); (iv) interest rate strategies qualifying for duration netting rules; or (v) investment in convertible bonds (without stripping out the embedded derivatives).

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