MEMO# 31577

January 25, 2019

Hong Kong SFC Briefs Industry and Issues Guidance on Implementing Amendments to the Code on Unit Trusts and Mutual Funds

[31577]

January 25, 2019 TO: 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 RE: Hong Kong SFC Briefs Industry and Issues Guidance on Implementing Amendments to the Code on Unit Trusts and Mutual Funds

The Hong Kong Securities and Futures Commission ("SFC") recently held industry-wide briefing sessions for managers of SFC-authorized funds ("funds") to provide a high-level overview of recent amendments to its Code on Unit Trusts and Mutual Funds ("UT Code").[1] The briefing sessions focused on implementation and transition issues associated with the revised UT Code. As part of the sessions, the SFC distributed a presentation deck and highlighted recently issued Frequently Asked Questions on implementation and transition arrangements ("FAQs"), which will be updated from time to time.[2] This memo highlights key points from the briefing sessions on transition periods, changes to constitutive or offering documents, and derivatives.

I. Transition Periods

The effective date of the revised UT Code was 1 January 2019. Existing funds, management companies (fund managers), and trustees/custodians have a 12-month transition period from the effective date, ending on 31 December 2019, to comply with the requirements in the revised UT Code. New funds with new key operators (*i.e.* new management companies and new trustees/custodians) that apply or applied for SFC authorization on or after the effective date must comply immediately with the revised UT Code.[3]

II. Changes to Constitutive or Offering Documents

The revised UT Code typically requires funds to receive prior approval from the SFC and to notify investors when there are changes to the funds' constitutive and/or offering documents.[4] Funds, however, generally do not need prior SFC approval and do not need to provide advance notice to investors when: (i) existing funds make changes to their constitutive and/or offering documents to comply with the revised UT Code; and (ii) there are no material changes to the funds' investment objectives, policies, or strategies.

III. Derivatives

The briefing sessions focused on four items related to derivatives: (a) disclosures relating to expected maximum derivatives use; (b) changes in anticipated derivatives use; (c) a list designating "derivative funds;" and (d) information about to-be-announced transactions ("TBAs").[5]

a. *Disclosure about Expected Maximum Derivatives Use*

The revised UT Code requires all funds (including UCITS funds) that are offered publicly in Hong Kong to provide enhanced disclosure about their expected maximum "net derivative exposure" in their Key Facts Statement ("KFS").[6] Existing funds must update their KFS with the enhanced disclosure by 1 January 2020 (*i.e.* the expiry of the 12-month transition period), but management companies are encouraged to produce the updated KFS for their existing funds as soon as reasonably practicable. The SFC also confirmed that the expected maximum net derivative exposure should be derived from an assessment made under normal market conditions based on the fund's investment objective and strategy.

b. *Changes in Anticipated Derivatives Use*

The SFC emphasized that prior SFC approval and advance notice to investors (generally 1-month prior notice) is required for changes to the fund's anticipated "net derivative exposure" under the following circumstances:

- A fund's net derivative exposure will change from not more the 50 percent of the fund's NAV to exceeding 50 percent of the fund's NAV (or vice versa);
- A fund's net derivative exposure will change from not more than 100 percent of the fund's NAV to exceeding 100 percent of the fund's NAV (or vice versa); or
- *(For UCITs funds during the 12-month transition period, if applicable)* A fund proposes to effect a change whereby the fund may use derivatives for investment purposes extensively (from non-extensive use of derivatives for investment purposes, or vice versa).[7]

c. *List of "Derivative Funds"*

The SFC has added a new column to the list of SFC-authorized funds available on the SFC's website to indicate whether a fund is a "derivative fund."[8] During the 12-month transition period, the SFC will not post on its website any classification for a fund unless the fund has advised the SFC of its classification. On the expiry of the 12-month transition period (*i.e.* 1 January 2020), management companies must calculate a fund's "net derivative exposure" and disclose it in the fund's KFS. The SFC also clarified that management companies are not expected to take active positions in derivatives that exceed the disclosed net derivative exposure. Thus, management companies should be prudent in determining their funds' net derivative exposure and making the disclosure in the KFS accordingly.

d. *To-Be-Announced Transactions (TBAs)*

Under the revised UT Code, the SFC believes TBAs are, by nature, considered derivatives.[9] The SFC clarified, however, that TBAs may fall under the "market access/exposure replication" exclusion and be excluded from the net derivative exposure calculation if the use of the TBAs does not create incremental leverage at the fund portfolio level.[10]

Irene Leung
Regional Lead, Member Relations and Research, Asia Pacific
ICI Global

Kenneth Fang
Assistant General Counsel

endnotes

[1] The SFC issued a consultation conclusion adopting the recent amendments in December. *See* SFC, Consultation Conclusions on Proposed Amendments to the Code on Unit Trusts and Mutual Funds (6 December 2018) ("Conclusions Paper"), *available at* https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=17CP8. For a summary of the Conclusions Paper, please see ICI Global Memorandum No. 31524 (18 December 2018), available at https://www.iciglobal.org/iciglobal/pubs/memos/ci.memo31524.global.

[2] The presentation deck and FAQs are available on the SFC's website. See SFC Investment Products Division, Consultation Conclusions on Proposed Amendments to the Code on Unit Trusts and Mutual Funds (UT Code) (17 and 18 January 2019), *available at* https://www.sfc.hk/web/files/PCIP/FAQ-PDFS/Consultation%20Conclusions%20on%20Proposed%20Amendments%20to%20the%20UT%20Code_20190118.pdf; SFC, Frequently Asked Questions on the Implementation and Transition Arrangements of the Code on Unit Trusts and Mutual Funds (Effective 1 January 2019) (First Published: 17 December 2018), available at https://www.sfc.hk/web/files/PCIP/FAQ-PDFS/FAQ_Code_on_Implementation%20and%20Transition%20Arrangements_20181217.pdf.

[3] A detailed implementation timetable of the revised UT Code is available in the Conclusions Paper. *See* Conclusions Paper, *supra* note 1, at pages 39-42.

[4] *See* revised UT Code at Chapter 11.

[5] As previously reported, under the revised UT Code, the SFC will classify and impose restrictions on a fund's use of derivatives based on the fund's "net derivative exposure" under an adjusted gross notional exposure test that aggregates the notional exposures of a fund's derivatives, exclusive of certain derivatives transactions. The test 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 ("derivative funds") will be subject to additional "know your customer" assessments, and retail hedge funds will be required to have a minimum initial subscription of at least $50,000 US. See, e.g., Conclusions Paper, supra note 1, at pages 15-16.

[6] *See* Conclusions Paper, *supra* note 1, at page 17. Specifically, funds will note that they do not use derivatives for any purpose or provide their expected maximum "net derivative exposure." The SFC provides an illustrative template to provide the expected maximum net derivative exposure suggesting that funds state that such exposure "may be [up to 50%] / [more than 50% but up to 100%] / [more than 100%] of the fund's net asset value [("NAV")]." *Id*. *See* also SFC, Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds (18 December 2018) ("Derivatives Guidance"), available at https://www.sfc.hk/web/files/PCIP/FAQ-PDFS/Guidance%20on%20the%20use%20of%20FDI%20for%20unit%20trusts%20and%20mutual%20funds_20181217.pdf. For a summary of the Derivatives Guidance, please see ICI Global Memorandum No. 31541 (3 January 2019), *available at* https://www.iciglobal.org/iciglobal/pubs/memos/ci.memo31541.global.

[7] The SFC also clarified that a fund must provide advance notice to investors (generally 1-month prior notice) if its net derivative exposure will change from not using derivative to up to 50 percent of the fund's NAV, but that the fund does not need to obtain prior SFC approval to make the change.

[8] *See* SFC, List of Investment Products, *available at* https://www.sfc.hk/productlistWeb/searchProduct/UTMF.do. *See also supra* note 5 (describing "derivative fund").

[9] *See* revised UT Code at Chapter 3.7A.

[10] *See* Derivatives Guidance, *supra* note 6, at paragraph 22. The Derivatives Guidance, among other things, sets forth certain types of derivatives that could be excluded from the "net derivative exposure" calculation. One type of derivative, derivatives that provide market access or exposure replication (without incremental leverage), may be excluded if:

(a) The arrangement swaps the performance of financial asset(s) held in the fund for the performance of other reference financial asset(s), and the derivative:

(i) totally offsets the market risk of the swapped asset(s) held in the fund, so that the fund's performance does not depend on the performance of the asset(s) swapped out; and

(ii) does not include additional optional features, leverage, or risks as compared to a direct holding of the reference financial asset(s); or

(b) The combined positions of the derivative relating to the financial asset(s) and the cash or cash equivalents the fund holds for the derivative is equivalent to holding a cash position in the reference financial asset(s) (*i.e*. the relevant amount of cash and cash equivalents should equal the total underlying market value of the derivative involved); and the derivative does not generate any incremental leverage or market risk. *Id*.