The Asset Management Industry
SERVING INDIVIDUAL INVESTORS
INVESTMENT COMPANY INSTITUTE

MEMO# 31347

August 27, 2018

ICI Global Files Comment Letter on the SFC's "Soft Consultation" Proposing Refinements to Proposed Derivatives Amendments in the Code on Unit Trusts and Mutual Funds

[31347]

August 27, 2018 TO: ICI Members
ICI Global Members SUBJECTS: Derivatives
International/Global RE: ICI Global Files Comment Letter on the SFC's "Soft Consultation" Proposing Refinements to Proposed Derivatives Amendments in the Code on Unit Trusts and Mutual Funds

ICI Global recently filed the attached comment letter responding to a Hong Kong Securities and Futures Commission ("SFC") "soft consultation" paper proposing refinements to proposed amendments to derivatives regulations in its Code on Unit Trusts and Mutual Funds.[1] The proposed amendments would impose additional distribution requirements and restrictions on funds based on their derivatives exposure.[2] The soft consultation would expand the types of derivatives that could be excluded from the calculation of derivatives exposure for determining which restrictions apply.[3] In addition, the soft consultation would provide that funds with derivatives exposure exceeding 50 percent of the fund's NAV (but not more than 100%) not be deemed to be "derivative products" subject to enhanced distribution requirements, if the portion of derivatives investments in excess of 50 percent is solely attributable to one of five "exempted circumstances."[4]

The comment letter welcomes the SFC's proposed changes and generally supports the proposed exclusions and "exempted circumstances." 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" when classifying *all* funds, not just those funds with derivatives exposures in excess of 50 and up to 100 percent of the fund's net asset value;
- Revise the "exempted circumstances" exception to require that exposure in excess of 50 percent of the fund's net asset value be attributable, not *solely* attributable, to the

exempted circumstances;
- Permit Hong Kong-domiciled funds to net offsetting positions in limited circumstances;
- Add fixed-income and other 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.

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. The proposed amendments were set forth in an initial consultation paper issued in December. *See* SFC, Consultation Paper on Proposed Amendments to the Code on Unit Trusts and Mutual Funds (December 2017), *available at* http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=17CP8. For a summary of the consultation paper, *please see* ICI Memorandum No. 31065 (Feb. 1, 2018), *available at* https://www.iciglobal.org/iciglobal/pubs/memos/memo31065.

[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 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] 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).