

MEMO# 31065

February 1, 2018

Hong Kong Securities and Futures Commission Proposes Amendments to the Code on Unit Trusts and Mutual Funds; Details on Member Calls

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February 1, 2018 TO: ICI Global Pacific Chapter
ICI Global Regulated Funds Committee RE: Hong Kong Securities and Futures Commission Proposes Amendments to the Code on Unit Trusts and Mutual Funds; Details on Member Calls

In late December, the Hong Kong Securities and Futures Commission (SFC) published a [consultation](#) (Consultation)^[1] on proposed amendments to the Code on Unit Trusts and Mutual Funds (UT Code). The SFC is seeking to update the UT Code 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. Funds offered to the retail public in Hong Kong, whether domiciled in Hong Kong or elsewhere, are required to be authorized by the SFC. ICI Global intends to comment on the Consultation; comments are due by 19 March 2018.

We will hold two member calls next week to discuss the Consultation, one at a time convenient for participants in Asia, one at a time convenient for participants in the United States and Europe. Please let us know whether you intend to participate by emailing Ruth Tadesse at rtadesse@ici.org. If you are unable to participate in either call, we welcome you reaching out to us by email or phone to provide your feedback.

Call 1 (convenient for Asia): Tuesday, February 6 at 10 am Hong Kong time / Monday, February 5 at 9 pm US Eastern time Dial in details:

Hong Kong Toll Free: 800-930-445
International: 1-210-795-1099
USA Toll Free: 866-803-2145
Participants Passcode: 7881946

Call 2 (convenient for US and EU): Thursday, February 8 at 3 pm London time / Thursday, February 8 at 10 am US Eastern time Dial in details:

USA Toll Free: 866-803-2145
International: 1-210-795-1099
UK Toll Free: 0800-376-8334
Participants Passcode: 3607824

Overview

The main changes proposed by the SFC include:

- strengthening requirements for key operators (such as management companies, trustees and custodians);
- providing greater flexibility and enhanced safeguards for funds' investment activities (such as restrictions related to derivatives and securities lending, and repo and reverse repo transactions; and
- new chapters for certain specialised fund types (such as active exchange-traded funds).

The key proposals are described in more below.

Application of the UT Code to UCITS

The SFC currently authorizes UCITS under a streamlined approach^[2] and deems UCITS from relevant jurisdictions as having complied in substance with the relevant provisions of the UT Code. In order to provide transparency and clarity to the industry, the SFC is proposing to include in the revised UT Code a separate Appendix that would explicitly specify the provisions of the UT Code that are applicable to UCITS.^[3] We note below whether the relevant provisions would apply to UCITS.

We are pleased that the SFC's proposed approach is in line with the recommendation contained in our June 2017 letter responding to the SFC's soft consultation on the UT Code that the SFC explicitly state which provisions would apply to UCITS.

Key Operators Requirements

Minimum Capital Requirement for Management Companies (Chapter 5.2)

Currently, a management company must have minimum issued and paid-up capital and capital reserves of HK\$1 million or its equivalent. The SFC is proposing to increase the minimum capital requirement for management companies to HK\$10 million or its equivalent. This requirement would apply to UCITS.

In our soft consultation response we encouraged the SFC to consider the requirements in other key jurisdictions, as well as the prior experiences of asset managers in Hong Kong when they have ceased operations to determine whether any adjustments to the capital requirements were warranted. The SFC has proposed the higher capital requirement "to better reflect the expected financial standing and commitment of management companies for SFC-authorized funds."

Management Company Investment Expertise and Experience (Chapter 5.5)

Currently, key personnel of a management company (at least two) must be dedicated full-time staff and possess at least five years investment experience in managing public funds with reputable institutions. The current key personnel relevant experience requirement must be satisfied by staff of the applicant management company, and at that level only. The SFC now proposes to grant well-established fund management groups more flexibility

in meeting this requirement by allowing them to leverage the group's investment expertise and experience. This provision would apply to UCITS. *The precise flexibility provided by the amended language, however, is not clear; we are seeking to better understand the proposed change.*

Management Company Liquidity Risk Management Policies (Chapter 5.10)

The SFC is proposing to codify existing requirements on general obligations of management companies, requiring them to put in place proper risk management systems to ensure funds are designed fairly and operate as designed. These requirements include an obligation to put in place effective liquidity risk management policies and procedures to monitor the liquidity risk of funds. These provisions would apply to UCITS.

Trustees and Custodians (Chapter 4)

The SFC is proposing changes to align the obligations of trustees and custodians with the recently adopted International Organization of Securities Commissions (IOSCO) standards on the custody of collective investment scheme assets (these provisions generally would not apply to UCITS). Additionally, the SFC proposes to include a provision stating that while the trustee/custodian and the management company of a fund may be subsidiaries, they must meet specified conditions regarding functional independence (this provision would apply to UCITS).

Core Investment Requirements Amendments

The SFC is proposing significant amendments to the core requirements of the investment limitations and prohibitions, which are specified in Chapter 7 of the UT Code.

Diversification Requirements (Chapters 7.1, 7.1A, 7.1B, and 7.2)

The SFC currently restricts a fund's investment in a single issuer to 10% of the fund's net asset value (NAV), but does not include a group limit. The SFC now proposes to impose stricter investment diversification requirements by introducing: (1) a group limit where the aggregate value of a fund's investments in or exposure to entities within the same group may not exceed 20% of the fund's NAV; and (2) a separate diversification limit on cash deposits where the value of a fund's cash deposits made with the same entity or entities within the same group may not exceed 20% of the fund's NAV. These proposed changes would not apply to UCITS.

The SFC has included a provision in the UT Code specifying which entities would be considered to be in the same group, which was a suggestion we made in our response to the soft consultation.

Limitation on Illiquid Assets (Chapter 7.3)

Currently, the UT Code provides that the value of a scheme's holding of securities neither listed, quoted nor dealt in on a market may not exceed 15% of its NAV. To provide additional clarity regarding which assets should be considered illiquid, the SFC has revised this provision to state that "the value of a scheme's investments in securities that cannot be readily converted into cash at limited cost in an adequately short timeframe thereby impairing the scheme's ability in satisfying its redemption and other payment obligations (including securities that are neither listed, quoted nor dealt in on a market) may not exceed 15% of its total net asset value." This provision would not apply to UCITS.

Loans and Borrowings (Chapters 7.17 and 7.21)

The SFC proposes several changes to the provisions on loans and borrowings, including: (1) prohibiting funds from engaging in lending (excluding permitted reverse repo transactions and investments in fixed income securities), guaranteeing or other activities that may lead to direct or contingent liabilities or obligations; and (2) lowering a fund's borrowing limit from 25% to 10% of its NAV (excluding permitted securities lending transactions and sale and repurchase transactions). These provisions would not apply to UCITS.

Derivatives (Chapter 7)

Recognizing that advancements in financial innovation and changing investment needs have led to an increased use of derivatives by funds, the SFC has proposed a number of amendments to funds' use of derivatives. Funds are subject to different limits on investments in derivatives based on the type of fund: plain vanilla funds (covered in Chapter 7), funds with extensive derivatives investments (covered in Section 8.9), and retail hedge funds (covered in Section 8.7). The provisions regarding use of derivatives contained in Chapter 7, described below, would not apply to UCITS, with the exception of required disclosure in the key facts statement (KFS).

Expanded Derivatives. Currently, plain vanilla funds may invest only in futures, options and warrants for non-hedging purposes. The SFC now proposes to permit plain vanilla funds to invest in any type of derivative up to the proposed limits.

Limits on Derivatives Use. With the limitation on the types of derivatives in which a plain vanilla fund may invest proposed to be removed, the SFC proposes to permit plain vanilla funds to acquire derivatives for non-hedging purposes, subject to the limit that the fund's global exposure relating to the derivative instruments does not exceed 50% of the fund's NAV, calculated according to the commitment approach. Other funds – deemed “funds with extensive derivatives investments” – that have a principal objective of investing in derivatives or which seek to acquire derivatives extensively for investment purposes could invest up to 100% of the fund's NAV in derivatives under the commitment approach, provided they provide additional risk disclosures (covered in Chapter 8.9).

Counterparties. The SFC proposes to limit net derivatives exposure from a single counterparty to no more than 10% of the fund's NAV or 20% of the fund's NAV for entities within the same group (except for retail hedge funds).

Coverage. The SFC proposes to require funds to ensure that derivatives transactions are adequately covered on an ongoing basis with qualifying collateral.

Increased Disclosure - KFS. To enhance transparency and facilitate comparison by investors, the SFC proposes that all SFC-authorized funds (domiciled in Hong Kong or overseas, including UCITS) disclose in the KFS the purpose of, and expected maximum leverage arising from, derivatives investments based on the commitment approach. Prescribed disclosure in the KFS is set out in paragraph 47 of the Consultation.

Minimum Initial Subscription for Certain UCITS (Section 8.7). Under the existing UT Code, Hong Kong domiciled funds that invest in derivatives exceeding 100% of the fund's NAV under the commitment approach (classified as retail hedge funds) are subject to a minimum initial subscription by an investor of not less than US\$50,000 or its equivalent. The SFC is proposing to apply the same minimum initial subscription requirement to UCITS

funds authorized by the SFC that have derivatives investments of more than 100% of their NAV based on the commitment approach.

Securities Financing Transactions (Chapters 7.32 - 7.35)

The SFC proposes to implement provisions on securities lending, sale and repurchase and reverse repurchase transactions (collectively, securities financing transactions) that are in line with Financial Stability Board requirements and to introduce additional investor protection measures. Specifically, the SFC proposes the following new requirements for funds (other than UCITS funds):

- Funds may engage in securities financing transactions if it is in fund holders' best interest.
- Securities financing transactions counterparties must be substantial financial institutions.
- Securities financing transactions must be fully collateralized.
- All securities financing transactions revenues must be returned to the fund (other than reasonable compensation).
- Funds should be able to recall all securities or the full amount of the cash and terminate securities financing transactions at any time and securities lending agents should indemnify funds against a counterparty default.

Collateral (Chapter 7.36)

The SFC is proposing that the collateral requirements have general application (currently collateral provisions are in the section governing structured funds), as well as four noteworthy enhancements to the collateral requirements: (1) a prudent haircut policy, (2) restrictions on the re-investment of collateral, (3) a list of prohibited assets as collateral, and (4) disclosure to investors about the fund's collateral policy and a description of collateral holdings in the interim and annual reports.

Specialised Funds

Money Market Funds (Chapter 8.2)

The SFC has proposed to amend the provisions of the UT Code regarding money market funds (MMFs) to align the requirements with the IOSCO recommendations on MMF. The key proposals are described below.

The MMF provisions generally would not apply to UCITS, except for the provisions on offering document disclosure, the name of the fund, and filing requirements (regarding total funds subscribed and total funds under management).

Definition of a MMF. The SFC proposes to clarify the definition of a MMF to mean "a fund which invests in short-term, high quality money market instruments and which seeks to offer returns in line with money market rates." Under this revised definition, funds that present the characteristics of a MMF or that are presented as having similar investment objectives (for example, funds named as liquid funds or cash funds) would also be subject to the applicable requirements, even if the funds are not marketed as MMF.

Permitted Investments. The SFC proposes to limit MMF investments to short-term deposits, high quality money market instruments and other MMFs that are authorized by the SFC or regulated in a manner generally comparable with the authorization requirements of the

SFC. Under this proposal, “money market instruments” will refer to securities normally dealt on the money market, for example, government bills, certificates of deposit, commercial papers, short-term notes and bankers’ acceptances. The SFC also proposes to allow MMF to invest in asset-backed securities so long as they do not exceed 15% of the fund’s NAV.

Repo Transactions and Safeguards. The SFC is proposing the following limits on MMFs (in addition to those applicable to other funds): (1) the amount of cash received under a repo transaction may only be up to 10% of the fund’s NAV; and (2) the aggregate amount of cash provided to the same counterparty in reverse repo agreements may not exceed 15% of the fund’s NAV.

Portfolio Maturity Limits and Minimum Liquid Asset Level. The SFC is proposing to require a MMF to maintain a portfolio with a weighted average maturity which does not exceed 60 days and a weighted average life which does not exceed 120 days. Additionally, the SFC proposes to require MMFs to hold at least 10% of their NAV in daily liquid assets and at least 30% of their NAV in weekly liquid assets.

MMF with Stable/Constant NAV. The SFC proposes that a MMF offering a stable or constant NAV will be approved by the SFC on a case-by-case basis, provided that the SFC is satisfied with the measures and safeguards put in place to address the risks associated with these features. This provision would apply to UCITS.

Unlisted Index Funds and Index Tracking Exchange Traded Funds (Passive ETFs) (Chapter 8.6)

The SFC is proposing to modernize the requirements for index funds and passive ETFs, as well as clarify existing requirements and codify existing practices. The key changes are described below.

Broad-Based Requirement for Underlying Index. The SFC is proposing that an index with a single constituent security that constitutes more than 20% of the fund’s index (or 35% of the fund’s index during exceptional market environments where certain securities are highly dominant) or which otherwise has “few constituent securities” would generally be considered too concentrated. The existing limit is 40% for a single constituent security or the top five constituent securities weighing more than 75%. This provision would apply to UCITS.

Enhanced Disclosure for Passive ETFs. If a passive ETF’s global exposure relating to financial derivative instruments for investment purposes exceeds 50% of its total NAV or if the securities financing transactions undertaken by a passive ETF exceed 50% of its total NAV, the SFC is proposing to require such fund to make information regarding these instruments or transactions available on the fund’s website or other channels on an ongoing basis. These provisions would apply to UCITS.

Market Maker Requirement for Passive ETFs. The SFC proposes to require the management company of a passive ETFs to use its best endeavors to ensure that there is at least one market maker for the shares (traded in each counter) of the passive ETF, who will give not less than three months-notice prior to terminating its market making arrangement. This provision would apply to UCITS.

Listed Open-Ended Funds (Active ETFs) (Chapter 8.10)

The UT Code currently only covers passive ETFs. The SFC is proposing a new section that would apply to active ETFs. Among other provisions, SFC is proposing to require active ETFs to publish full portfolio information to the public on a monthly basis (with no more than a one-month delay); however, active ETFs would be allowed to selectively provide portfolio information to participating dealers and market makers to facilitate the provision of liquidity and the performance of effective arbitrage for the active ETF. These provisions would apply to UCITS.

Closed-Ended Funds (Chapter 8.11)

The SFC is proposing to include a new section on closed-ended fund which would codify the existing requirements applicable to closed-ended funds. Among other things, the provisions would require a closed-ended fund to have procedures to ensure that it is widely held and to have in place measures to address any prolonged significant discount of its secondary trading price on the Hong Kong Stock Exchange to its NAV. These provisions would not apply to UCITS.

Operational Matters

Valuation and Pricing Errors (Chapters 10.2, 10.2A, and 10.2B)

Currently, any incorrect pricing of 0.5% or more of a fund's NAV per share must be corrected as soon as possible and the trustee/custodian must be informed. The SFC is proposing to require that the trustee or custodian must be informed of any pricing error in a timely manner. A pricing error (individually or in aggregate resulting from incidences which occur in a simultaneous or successive manner) amounting to 0.5% or more of the fund's NAV must be reported to the SFC. These provisions apply to UCITS.

Withdrawal of Fund Authorization (Chapter 11.4)

Currently, if the management company does not wish to maintain a fund's SFC authorization, an application may be made for withdrawal. The SFC now propose that, in cases where the withdrawal of authorization is not due to a merger or the termination of the fund, the SFC must be satisfied that the interests of investors will be safeguarded before granting its approval for withdrawal. This provision applies to UCITS.

Implementation Timeline

The SFC has included a proposed implementation table, with different implementation dates depending on whether the schemes and/or key operators are new and/or whether the scheme is existing or new. Generally, new funds with new key operators would have to comply with the UT Code amendments on the effective date (*i.e.*, immediately). For others schemes and key operators there is generally a 12-month transition period.

Eva M. Mykolenko
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endnotes

[1] 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.

[2] In accordance with interim measures published in March 2005 and March 2007.

[3] The UCITS included in these provisions are those domiciled in Luxembourg, Ireland, and the United Kingdom.

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