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Hong Kong SFC issues Consultation Conclusions on the regulation of fund managers

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On November 16, 2017, the Hong Kong Securities and Futures Commission issued its *Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts* incorporating proposals for changes to the regulation of fund managers in Hong Kong under the Commission's *Fund Manager Code of Conduct* and *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.*

Background

After a year-long period of consultation, the Hong Kong Securities and Futures Commission (SFC) has issued *its Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts* (Conclusions).

Below, we provide a summary of the key changes contained in the SFC's original November 2016 Consultation Paper (Consultation Paper) as amended by the post-consultation Conclusions.

The changes are intended to bring existing regulation of fund managers in Hong Kong in line with international regulatory developments—notably policy reforms promulgated by the International Organization of Securities Commissions (IOSCO) and the Financial Stability Board (FSB). The changes fall into three parts, as follows.

Part I sets out the enhancements to be made in the SFC's *Fund Manager Code of Conduct* (FMCC) relating to the key areas of securities lending and repurchase agreements (repos), safe custody of fund assets, liquidity risk management and disclosure of leverage. It also clarifies how the FMCC applies to different types of fund managers.

Part II sets out amendments to be made to the SFC's *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (Code of Conduct) to enhance point-of-sale transparency and to deal more effectively with the potential conflicts of interest in the sale of investment products, following principles aimed at:

- governing the conduct of intermediaries when representing themselves as "independent" or as providing "independent advice" and
- enhancing the disclosure of monetary benefits received or receivable that are not quantifiable prior to or at the point of entering into a transaction.

The changes to the FMCC are targeted to come into effect in November 2018 and changes to the Code of Conduct are targeted to come into effect in August 2018. Clarifications will be given in *Frequently Asked Questions* (FAQs) yet to be issued by the SFC.

Part III, as set out in the Conclusions, contains a further consultation on the disclosure requirements that will be applicable to discretionary accounts under the Code of Conduct.

What do intermediaries need to do now?

Where necessary, intermediaries will need to take action during the transitional period to make changes to their operations, and to amend counterparty contracts, client agreements and marketing materials. In doing so, they will need to take account of points of elaboration in the Consultation Paper and Conclusions that are not specifically contained in the revised FMCC or Code of Conduct, and review relevant FAQs when these are issued.

FUND MANAGER CODE OF CONDUCT

Major issues

Changes are being made to the Fund Manager Code of Conduct across a wide range of issues. Key issues highlighted by the SFC are set out below.

Persons to whom the FMCC applies
The FMCC will apply as follows:

- **Fund managers responsible for the overall operation of a fund.** Certain principles and standards (referred to below) will apply to a fund manager where it is in substance "responsible for the overall operation of the fund." Several points are noteworthy:
  - The SFC has dropped the earlier additional reference to fund managers who have "de facto control of the oversight or operation of the fund." The exclusion of this wording does not in practice appear to have much effect, as managers caught by this wording would almost always still be treated as responsible for the overall operation of the fund.
  - Despite criticism of the approach in the consultation period, the SFC has stood firm and proposes to apply such principles and standards even where legally it is the board of directors of the fund (or trustees of a unit trust) that would be responsible for making certain decisions relating to the fund such as appointing the custodian and issuing offering documents. The SFC cites as an example that where representatives of a fund manager or its subsidiaries constitute a majority of the fund board, then the fund manager may be considered to be responsible for the overall operation of the fund, but this would appear not to be the only circumstance. The SFC also refers to cases where fund managers are heavily involved in a fund's set up, where among other things they may choose the directors of the

fund. Despite the discussion, the Conclusions leave a significant degree of uncertainty as to when a fund manager would be considered to be responsible for the overall operation of the fund. This may be clarified in FAQs on this issue, which will be published at a later date.

- **Public and Private Funds.** The FMCC will apply to all Hong Kong licensed managers involved in the discretionary management of collective investment schemes, regardless of whether they are public (i.e., retail) funds (which are also regulated by the SFC at the fund level) or private funds, and whether the funds are domiciled in Hong Kong or offshore. The requirements of the FMCC are principles-based, as compared with the specific fund level requirements set out in the SFC's Codes and Handbooks relating to public retail funds.
- **Managers of Discretionary Accounts.** The SFC has clarified that the FMCC applies in principle to all managers of discretionary accounts (subject to a carve-out for certain brokers providing management services). Notably, such discretionary managers will need to observe the requirements regarding liquidity management. Provisions on custodians may not, however, apply if the client has selected and appointed its own custodian. Clarification on which requirements do and do not apply to managers of discretionary accounts are set out in Appendix 1 to the revised FMCC.

Securities lending and repurchase agreements (repos)

Responding to reports from the FSB, to address shadow banking risks the revised FMCC will place express obligations on a Hong Kong licensed fund manager where a fund under its management "engages" in securities lending, repo and reverse repo transactions. The Conclusions clarify that a fund manager would be engaging in such transactions if it decides that securities lending should be a fund activity, or is materially involved in determining a securities lending mandate or in actual lending activities. Except where the FMCC provides otherwise, these proposals apply to all fund managers, not only those responsible for the overall operation of a fund. They also apply to managers of private as well as public funds. Specifically, the fund manager will need to:

- put in place a **collateral valuation and management policy** that should include certain minimum valuation and margin requirements.
- put in place an **eligible collateral and haircut policy** that should cover the types of acceptable collateral and the methodology to calculate haircuts on collateral received in connection with these transactions. Comments on the design of haircut methodologies (meeting FSB recommendations) are set out in Appendix C of the original Consultation Paper, and this may be supplemented by FAQs in due course.
- where the fund manager reinvests cash collateral received by a fund, it should put in place a **cash collateral reinvestment policy** that seeks to ensure that assets held in the cash collateral reinvestment portfolio are sufficiently liquid with transparent pricing and low risk to meet reasonably foreseeable recalls of cash collateral. A fund manager of a fund that is a securities lender should stress test the ability of a cash collateral reinvestment portfolio to meet foreseeable and unexpected calls for the return of cash collateral on an ongoing basis.

Where a fund manager outsources its functions to a third party (such as a prime broker), the fund manager is expected to act with due skill, care and diligence in the selection, appointment and ongoing monitoring of the third party. This would include checking that the service provider's policies and procedures are consistent with the FMCC.

In addition, where a fund manager is responsible for the overall operation of a fund, it will need to disclose to fund investors a summary of the securities lending, repo and reverse repo transactions policy and the risk management policy, but there is now no requirement for this to be set out in the fund's offering document. Fund managers responsible for the overall operation of a fund will also need to provide certain reports on an annual basis as to such transactions, including at a minimum certain specified global data, concentration data, aggregate transaction data, re-use and re-hypothecation data and data as to returns, as well as information as to custodians used and the proportion of collateral posted by funds held in various types of accounts.

To meet the disclosure requirements, the fund manager will need to ensure that mechanisms are put in place to allow it to obtain the information for such reports where the fund appoints a third-party agent to conduct securities lending and repo activities on its behalf.

Custodian/safe custody of fund assets

In the Conclusions, the SFC has clarified that the changes regarding custodians and safe custody only apply to fund managers who are responsible for the overall operation of the fund. Adopting the latest principles under IOSCO standards, the current FMCC custody requirements are supplemented with respect to:

— **Custody and independence of the custodian.** The FMCC will expressly require segregation of fund assets from those of the fund manager and, unless they are held in an omnibus account, from the assets of the fund manager's affiliates and other clients. Fund assets belonging to each client will need to be appropriately recorded and readily identifiable as belonging to the fund, with frequent reconciliations being undertaken. The fund manager will normally need to arrange for the appointment of, and entrust the fund assets to, a "functionally independent" custodian. Special rules will apply where self-custody is adopted.
— **Selection of custodian, custody agreement and monitoring of custody arrangements.** A fund manager will need to exercise due skill, care and diligence in the selection, arranging for the appointment of, and ongoing monitoring of, the custodian and ensure that a custodian agreement meeting certain criteria is entered into (even though the custodian may formally be appointed by the board of the fund).
— **Disclosure of custody arrangements.** A fund manager will need to ensure that the custody arrangements and any associated material risks are disclosed to investors.

These requirements will similarly apply where the fund is a unit trust, so that the duties of the fund manager will relate to the appointment of the trustee and the ongoing monitoring of the trustee's performance of its custodial functions.

Liquidity risk management

Liquidity risk has been of international concern since the global financial crisis, especially with respect to the meeting of redemption requests. The SFC has already responded to this in a July 2016 circular on liquidity risk management for public funds authorized by the SFC, but is now adopting certain IOSCO principles in the FMCC. These only apply to fund managers who are responsible for the overall operation of the fund, but apply whether the fund is a public or private fund and whether it is open-ended or closed-ended:

— **Liquidity management policy.** A fund manager will need to establish, implement, maintain, review and update effective liquidity management policies and procedures to monitor the liquidity risk of the fund.

- **Stress Testing.** A fund manager will need to conduct regular assessments of liquidity and apply stress testing to assess and monitor the liquidity risk of the fund. The Consultation Paper points out that the SFC expects that stress test results should be reviewed by a committee responsible for liquidity risk management and/or senior management to determine whether further actions are warranted and the fund manager should have in place action plans regarding how it would meet the fund's liquidity needs should any of the stress scenarios materialize.
- **Tools and exceptional measures.** Generally, a fund manager should consider the appropriateness of using specific liquidity risk management tools to aid orderly redemptions, taking into account the nature of assets held by the fund and its investor base, with investors' interests taking priority over a fund manager's own interest. An explanation of any such tools and exceptional measures should be disclosed in the fund offering documents or otherwise be made freely available to investors. Where a fund manager has granted preferential treatment (e.g., side letters) to certain investors, it should disclose such facts and the material terms in relation to redemption in the side letters to all potential and existing fund investors.

Helpfully, the SFC has confirmed that a fund manager will not be deemed to be responsible for the overall operation of a fund (and thus subject to the above provisions) simply by virtue of having responsibility for managing liquidity risk.

Disclosure of leverage

There has been international concern as to the contribution of the use of leverage by funds to the build-up of systemic risk or disorderly markets. In the USA and Europe, managers may now be subject to reporting obligations regarding the use of leverage. The FMCC will require a fund manager responsible for the overall operation of a fund to disclose to fund investors the expected maximum level of leverage that it may employ on behalf of each fund it manages and the basis of calculation of leverage that should be reasonable and prudent.

Other amendments

Supplementing the major issues highlighted above, the original Consultation Paper contained a raft of additional amendments and updates to the FMCC to codify existing requirements or practices and improve clarity. These include:

- Codification of existing requirements and industry practices regarding the independent valuation of fund assets.
- Codification of industry practice requiring the appointment of independent auditors to audit each fund managed by a fund manager responsible for the overall operation of the fund.
- Addition of a new Appendix 2 to the FMCC suggesting risk management control techniques that a fund manager should consider in monitoring fund risks.
- Addition of a new section on side pockets, reflecting the existing requirements from the SFC's *Circular to All Licensed Corporations Engaged in Hedge Funds Management Business* of October 27, 2008.
- Clarification of requirements of fund managers to report to the SFC to allow it to monitor and detect risks arising from asset management activities.

- Clarification of requirements regarding the aggregation of house orders with client orders.
- Removal of the section on electronic trading, which is now dealt with under the general Code of Conduct.

The Conclusions have refined these proposals among other things as follows:

- As regards dealing for house accounts, the existing FMCC requires the fund manager to give priority to client orders, and where client and house orders are aggregated, the client's order must take priority in any subsequent allocation if all orders cannot be fulfilled. This principle has been refined so that allocation may be effected on terms specified by the client where the client is an institutional professional investor.
- The provisions on independent valuation will only apply where a fund manager is responsible for the overall operation of the fund.
- The provisions on general disclosure regarding side pockets only apply to a manager responsible for the overall operation of the fund, whereas the provisions on setting up and managing side pockets apply to all fund managers responsible for that activity.

Intermediaries conducting discretionary accounts management

The FMCC will generally apply to Hong Kong SFC licensed managers of discretionary accounts (Discretionary Account Managers) where (a) the Discretionary Account Manager provides discretionary management services to a client in the form of an investment mandate or a pre-defined model investment portfolio, and (b) the Discretionary Account Manager receives a management fee and/or a performance fee as remuneration for managing discretionary accounts for its clients. It will not apply to brokers providing management services ancillary to brokerage services where there is no investment mandate or pre-defined model investment portfolio and the broker does not receive a management fee and/or performance fee in addition to commission fees.

A new Appendix 1 will be introduced in the FMCC clarifying which FMCC requirements do and do not apply to Discretionary Account Managers. This will include specific requirements that only apply to Discretionary Account Managers.

In the Conclusions, the SFC rejected most of the comments made in the consultation period. Relevant points arising are:

- There will be no grandfathering of existing client agreements, so Discretionary Account Managers will need to amend their existing client agreements during the 12-month transition period to conform with Appendix 1 to the FMCC.
- Where clients wish to negotiate their own form of client agreement, these should nevertheless contain the minimum content requirements in the FMCC.
- Client consent for the receipt of soft commissions or retention of cash rebates will still be required.
- Client agreements will need to reference certain performance benchmarks or indicators.

CODE OF CONDUCT FOR PERSONS LICENSED BY OR REGISTERED WITH THE SECURITIES AND FUTURES COMMISSION

Key changes

Inducements/commissions

Two key regulatory concerns over past years have been the inherent conflict of interest in the receipt of inducements and commissions by financial advisers and distributors and the lack of transparency in the monetary benefits received or receivable that are not quantifiable at the point of sale of an investment product. One solution to alleviate these concerns might be a "pay for advice" model favoured in the UK and Australia, which bans commissions for the sale of fund products. The SFC has confirmed its view that this model is not currently appropriate for Hong Kong but will keep it under review.

The Consultation Paper introduced proposals for new rules supplementing existing protections under the Code of Conduct (which among other things already requires intermediaries to act in the best interests of clients and to disclose affiliations with product issuers and (where applicable) limitations of recommendations to products issued by related companies). Under the revised Code of Conduct, the SFC will apply the following principles:

- **Restriction on Representations of Independence.** Intermediaries will be restricted from representing themselves as "independent" or using similar terms such as "independent financial advisers," "IFA," "impartial," "neutral," "objective" or "unbiased" if (a) they have close links or other economic relationships with product issuers, or receive any non-monetary benefits from any party that are likely to impair their independence to favour a particular investment product, class of investment products or issuer or (b) they receive monetary benefits from other parties including product issuers. "Close links" would require the licensed entity to be in a parent-subsidiary relationship with the product issuer, or be in a controlling entity relationship (as defined in the Securities and Futures Ordinance) with the product issuer. FAQs are to be issued later on the meaning of "other legal or economic relationships." Further, intermediaries will need to make clear disclosure to investors before or when entering into a transaction as to whether or not it is independent and the basis for its determination. Forms of disclosure statement are included in a new Schedule 9 to the Code of Conduct.
- **Point of Sale Transparency.** In addition to the current requirement to disclose the existence and nature of monetary benefits received or receivable that are not quantifiable prior to or at the point of entering into a transaction (such as trailer fees), an intermediary will need to disclose the maximum percentage of such monetary benefits receivable per year. In the Conclusions, the SFC dropped its earlier proposals to require disclosure of the range of such monetary benefits receivable on an annualized basis and the maximum dollar amount of such monetary benefits receivable per year. Disclosure will be required at the point of entering into each transaction and a sample disclosure (using trailer fees) is given in the Conclusions. In addition, various clarifications have been given in the Conclusions as to how the disclosure requirements will apply in different circumstances.

Notably, an exemption from compliance with the proposed disclosure requirements may be available for intermediaries when dealing with corporate professional investors and institutional professional investors under paragraph 15 of the Code of Conduct.

Application of Code of Conduct to all fund managers

The Code of Conduct is also amended to make it clear that it and its general principles will apply to all Hong Kong licensed fund managers.

FURTHER CONSULTATION ON DISCLOSURE REQUIREMENTS APPLICABLE TO DISCRETIONARY ACCOUNTS

In the consultation period, questions were raised as to how the disclosure requirements for point of sale transparency would apply to discretionary accounts. The SFC is now seeking comments on its proposals for the following disclosure options for discretionary accounts:

— **Monetary Benefits (under explicit remuneration arrangements).**

  Option 1—Specific disclosure by type of investment product. Under this model, the intermediary would disclose the maximum percentage of monetary benefits receivable by it and its associates by type of investment product.

  Option 2—Specific disclosure of the aggregate amount in percentage terms. Under this model, the intermediary would disclose the estimated maximum percentage of monetary benefits receivable by it and its associates, calculated by aggregating the maximum monetary benefits receivable from each product type according to the proportion such product type represents in a client's investment portfolio.

— **Monetary benefits (under non-explicit remuneration arrangements) and non-monetary benefits.**

  Where there is no explicit remuneration arrangement between the intermediary and the product issuer, the intermediary would need to make a generic disclosure that it will benefit from purchasing in-house products for a client under a discretionary portfolio. Where the intermediary will receive non-monetary benefits from a product issuer when purchasing an investment product for a client, it would need to make a similar generic disclosure.

These disclosure requirements will apply where the intermediary deals with clients who are "individual" professional investors, but may be exempt where the intermediary deals with "institutional" or "corporate" professional investors.

The SFC has invited comments on these proposals by January 15, 2018.

IMPLICATIONS FOR HONG KONG FUND MANAGERS LICENSED BY THE SFC

Although lengthy transition periods apply before these changes become effective, to the extent they have not already done so Hong Kong fund managers licensed by the SFC will now need to begin a process of reviewing what changes should be made to their operational procedures, counterparty contracts, client agreements and marketing materials to meet these additional compliance obligations. Among other things:

— Fund managers should carefully review those comments from the SFC in the Consultation Paper and Conclusions that are not specifically contained in the revised FMCC or Code of Conduct. They should also review all relevant FAQs when these are issued in due course.

— Fund managers, including managers of private funds, will need to assess whether they are responsible for the overall operation of a fund, and which provisions of the revised FMCC will apply to them. Operational procedures and systems may need to be revised.

- Where necessary, fund managers may need to change their management agreements, sub-management agreements and third-party provider agreements as well as potentially fund level documentation to ensure that they have all necessary contractual rights (or have in place other mechanisms) to require information and to compel performance of obligations by other parties in order to meet the fund manager's obligations under the revised FMCC and Code of Conduct.
- Where relevant, fund managers will need to consider how they will monitor third-party service providers to ensure compliance with revised FMCC, in particular with respect to the securities lending requirements.
- Discretionary Account Managers should review which of the provisions of the FMCC will apply to them, and consider what changes should be made to their client agreements to ensure compliance.
- Where relevant, care will need to be given to updating client documentation to ensure compliance with the requirements regarding representations of independence and enhanced disclosure for point of sale transparency.

Fund managers may also wish to provide comments to the SFC before January 15, 2018 under the further consultation concerning the application of disclosure requirements for point-of-sale transparency to discretionary accounts.

For more information on the content of this alert, please contact your regular Nixon Peabody attorney or:

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