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Submission to the SFC Consultation Paper on Proposed Amendments to the Code on Unit Trusts and Mutual Funds

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Consultation Paper on Proposed Amendments to the Code on Unit Trust and Mutual Funds

Introduction

The Securities and Futures Commission (“the **SFC**”) has issued a Consultation Paper in December 2017 on the Proposed Amendments to the Code on Unit Trusts and Mutual Funds (“**Consultation Paper**”). CompliancePlus is pleased to provide feedback on the Consultation Paper. In general, CompliancePlus welcomes the SFC’s proposals in relation to the Unit Trust Code.

Question 1: Do you have any comments on the proposed increased minimum capital for management companies?

While we agree with the SFC that the paid capital should be increased for SFC-authorized fund management companies considering that the requirement has remained unchanged over the last two decades, however, we do not see sufficient grounds to justify the tenfold increase in the original requirement.

The mere statement “most management companies for SFC-authorized funds have minimum capital of over HK\$10 million” is a rather weak argument to support the proposal. The SFC should provide statistics and justifications from the standpoint of necessity in safeguarding the best interests of investors, instead of simply following common market practices. Furthermore, the SFC should provide transition arrangements for existing management firms that do not currently meet the proposed capital requirement. From these firms’ point of view, they may have been operating the fund smoothly over the years and requiring their shareholders to suddenly commit higher capital may result in financial difficulties and inefficient use of resources.

As per the Consultation Paper, another reason for raising the required capital is to better reflect the expected financial standing of the public funds management companies. It should be noted that financial standing of a company is largely affected by its liquidity (as monitored by the FRR Rules) instead of its paid-up capital.

We agree that an increase in requirement is justified because salaries, marketing and office rental expenses in Hong Kong have increased a lot over the past two decades. To ensure smooth running of the firm in its first 6-12 months, where income may not be generated in time to meet the payment for the increased expenses, committing higher capital is necessary. However, there are no grounds to justify that such expenses has increased by 10 times over the years. Furthermore, as most of these management companies entrust the fund assets with custodians, requiring these management companies to increase capital would not necessarily result in greater commitment in protection of assets and investors interests.

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Should the SFC aim to improve public funds management companies' financial standing and commitment, requesting quarterly submission of FRR documents (currently every 6 months) might be more effective than requiring higher capital.

Question 2: Do you have any comments on the proposals to provide flexibility for well-established fund management groups to leverage group investment expertise and experience?

We welcome the SFC's proposal to provide flexibility for well-established fund management groups to leverage group investment expertise and experience. We believe that such arrangement would enhance Hong Kong's competitiveness in the global fund market.

Question 3: Do you have any comments on the proposals regarding the enhanced obligations of trustees and custodians?

We are supportive of SFC's proposals relating to the enhanced obligations of trustees and custodians. Promoting a higher standard of obligations helps to ensure that standards that are applicable to SFC authorized fund can align with the International Organization of Securities Commissions' standard on the custody of CIS assets and with other major overseas jurisdictions. Such proposed enhancement can also enhance investor protection.

Question 4: Do you have any comments on the proposals to enhance the periodic reviews of the internal controls and systems of trustees and custodians?

CompliancePlus agrees with the SFC's intention in expanding and enhancing the scope and level of review by the trustee/custodian's independent auditor in relation to the internal controls and systems of trustee and custodian, unless the trustees/custodians are prudentially regulated and supervised by overseas supervisory authorities acceptable to the SFC. More stringent review requirements and more detailed review report requirement is believed to be able to better ensure the performance quality of the custodians and trustees.

However, it is doubtful as to how the SFC may lawfully and reasonably ensure the trustees' /custodians' compliance to these guidelines in practice.

The Introduction of Appendix G provides that "the Trustee/custodians" should ensure the adequate policies and procedures instead of the licensed corporation being responsible for enquiring these elements during its custodian due diligence process. We are unsure whether the SFC has the statutory power to issue codes or guidelines binding to the trustee/custodians that are overseas or not licensed/registered with the SFC, let alone the independent auditors appointed by them.

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Furthermore, even if the guideline is written in the way that licensed corporations should include the considerations in Appendix G in its custodian due diligence process, it will be very difficult practically for licensed corporations to inspect and monitor on an ongoing basis, as Appendix G touches upon a lot of internal and confidential information and policies of the trustee/custodian that may not be accessible by the Hong Kong licensed corporation.

Should the SFC intend Appendix G be merely an unenforceable guideline providing suggestions of best practices to be adopted by trustees and custodians, this content should be included in a Code addressed and binding to SFC licensed corporations that intend to or are offering unit trusts and mutual funds in Hong Kong. Nevertheless, we understand that Appendix G will not apply to trustees/custodians that are prudentially regulated and supervised by overseas supervisory authorities acceptable to the SFC, where most assets are currently deposited with, such that the problem should be minimal.

Question 5: What other measures do you think are appropriate to strengthen the regulations for trustees and custodians of public funds in Hong Kong?

Not much incident on the issue of trustees and custodian of public funds in HK has been seen over past years, while the existing regulation standards for public fund trustees and custodians are generally good enough, CompliancePlus do not see the need to impose additional measures to strengthen the existing regulations.

Question 6: Do you have any comments on the proposal to introduce an overall limit on derivatives investments for a plain vanilla public fund? Do you consider the proposed 50% limit appropriate? Please explain your views.

CompliancePlus agrees to remove the current requirement that plain vanilla funds may invest in futures, options and warrants only for non-hedging purpose as nowadays more and more complex financial products are trading on the market, removing the existing requirement may provide more investment opportunities to the plain vanilla funds. While applying a clear overall limit on a fund's derivatives investments (i.e. 50% of the fund's NAV in derivatives) is fair enough to meet retail investors' expectation and at the same time, catch up with the usual practice under local landscape.

Question 7: Do you have any comments on the proposed enhanced disclosures regarding derivatives investments in the fund's KFS and financial reports?

CompliancePlus is supportive of efforts to increase transparency to investors regarding derivatives investments in the fund's KFS and financial reports. CompliancePlus recommends that the leverage disclosure should be made in

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percentage method as illustrated in paragraph 47 of the consultation paper so as to provide a comprehensive and comparable statistics for investors.

Question 8: Do you agree with the proposed framework for Securities Financing Transactions? Please explain your views.

CompliancePlus is cognizant of the fact that more funds are entering into Securities Financing Transactions with the purpose of enhancing yield or managing liquidity. CompliancePlus welcomes SFC's intention to specify requirements for funds that want to engage in Securities Financing Transactions. The proposed framework can help to safeguard the best interests of holders and lower the risks associated with it.

Question 9: Do you consider indemnification by securities lending agents is a necessary and appropriate safeguard? Please explain your views.

CompliancePlus do think that indemnification of the Fund by the securities lending agents is an appropriate measure to safeguard against counterparty default. Given that there are more and more funds entering into securities financing transaction, such indemnification can provide an additional layer of protection to the Fund and investors.

Question 10: Do you consider an overall transaction limit should be imposed on Securities Financing Transactions (other than the additional safeguards proposed)? Please explain your views (with any suggested overall transaction limit, if applicable).

CompliancePlus disagrees to imposing an overall transaction limit to Securities Financing Transactions. One of the main objectives of the amendments proposed in this Consultation is to keep the code and regulations up-to-date to lay down a clear, definite and adequately regulated playing field for financial market development and innovation. Imposing an overall transaction limit, in addition to the already proposed additional safeguards, would severely and unnecessarily limit investors' choices and market development.

The additional safeguards proposed have already provided sufficient and necessary protection to investors. Insofar as the investors are clearly and adequately made known of the risks involved, together with the proper imposition of risk controls, there is no need to sacrifice market development and diversity in favor of imposing transaction limit to Securities Financing Transactions, which would only make problems smaller, but not making the investments safer.

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Question 11: Do you think that the proposed collateral requirements are sufficient to safeguard investor interests? What additional criteria should be considered?

While CompliancePlus is broadly supportive of the proposed collateral requirements such as setting up more prudent haircut policy, introducing requirement on reinvestment of collateral, as well as confining the type of assets that can serve as collateral. Such proposal is believed to help reducing the adverse selection problem and hence reducing the counterparty risk from OTC derivatives investment and Securities Financing Transactions. This in turn can help safeguarding investors' interests. However, CompliancePlus would like to point out that in practice, haircut rate calculation and deciding the haircut can be full of uncertainty and subjective. In this sense, CompliancePlus suggest the SFC to set out more explicit guidance on the determination of haircut policy so that the calculation of haircut can be more objective and of less bias.

Question 12: Do you agree with the proposed disclosure requirements concerning collateral? Please explain your views.

CompliancePlus agrees with the proposed enhanced disclosure requirement that any information in relation to the collateral should be set out in fund's offering documents and financial reports so as to be aligned with the Revised Fund Manager Code of Conduct reporting requirements. The harmonization of disclosure requirements across relevant codes is a commendable goal in view of the considerations of consistency and operation efficiencies.

Question 13: Do you have any comments on the proposals on investment in other funds?

CompliancePlus agrees with the proposed proposals on investments in other funds and particularly, welcome the suggestion to consolidate and streamline the relevant provisions in relation to investment in other funds as this helps to enhance the comprehensiveness of the UT Code and allows it to be more user friendly.

Question 14: Do you agree with the proposal to require a structured fund to be subject to 100% collateralization?

We agree with the proposal to require listed and unlisted structured funds to be subject to 100% collateralization. While unlisted structured funds may not have easy access to capital as opposed to listed structured funds, they may nonetheless be invested by retail investors. From the point of view of protecting assets of investors who may not possess the same experience, risk appetite or portfolio size of professional investors, we agree to provide a level-playing field for all structured funds in regards to degree of collateralization.

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Question 15: Do you agree with the proposed requirements for money market funds? Please explain your views.

Generally speaking, the SFC suggests tightening the UT Code requirement on the money market funds with the hopes to align its requirements with International Organization of Securities Commissions' recommendation. The proposed changes involve the alteration in the definition of money market funds, types of permitted assets, repo transactions, portfolio maturity limits, minimum liquid asset level. Even though money market funds are not very popular in Hong Kong, CompliancePlus still agree with SFC's suggested enhancement on the UT Code regarding money market funds, so that the requirements can live up to international standard.

Question 16: Do you agree with the proposed amendments to the requirements for unlisted index funds and passive ETFs using index tracking strategies which substantially invest in derivatives? Please explain your views.

CompliancePlus welcomes the proposed amendments to the requirements for unlisted index funds and passive ETFs using index tracking strategies. It is believed that with rapid evolvement with the fund markets, modernization and update on current requirements is needed.

Question 17: Do you agree with the proposed enhanced diversification requirements for indices? Please explain your views.

CompliancePlus is supportive of efforts to align with comparable indices requirements with overseas jurisdiction. Requiring the underlying indices to be more diversified helps to lower the unsystematic risks. While taking into consideration practices of comparable jurisdictions, i.e. Singapore and European countries, CompliancePlus perceives that the 20% or 35% requirements can be a reasonable benchmark. Whilst CompliancePlus also agree to set out in the UT Code that an index with few constituent securities will be considered too concentrated.

Question 18: Do you agree with the proposed arrangement for setting up listed and/or unlisted units or share classes for index funds and passive ETFs? Please explain your views.

In general, CompliancePlus agrees with the proposed arrangement for setting up listed and/or unlisted units or share classes for index funds and passive ETFs. While given that the structure of allowing the listed and unlisted share classes to co-exist within a single fund is new to the Hong Kong market and up till present, there is no ETF listed in Hong Kong operates with both listed and unlisted units or shares, we welcome the SFC to conduct a separate consultation focused specifically on this topic and to discuss on the practical issues that may potentially arise from the mentioned structure.

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Question 19: Do you agree with the other proposed amendments related to unlisted index funds and passive ETFs under Chapter 8.6 of the UT Code?

CompliancePlus agrees with other proposed amendments related to unlisted index funds and passive ETFs under Chapter 8.6 of the UT Code. For instances, amendments such as “moving relevant provisions in Appendix I to Chapter 8.6”, “providing a level playing field for trading information disclosure for overseas and local ETFs” etcetera is believed to streamline the existing requirements and is beneficial to the UT Code user in the sense of clarity and conciseness.

Question 20: Do you agree with the proposed requirements for listed open-ended funds? Please explain your views.

Broadly speaking, CompliancePlus supports the proposal of including a new chapter in relation to active EFTs, including key features such as relevant investment restrictions, required portfolio transparency, requirements relating to dissemination of trading information. However, once again, CompliancePlus recommend the SFC to conduct a separate consultation to collect opinions from industry practitioners regarding the treatments of active ETFs.

Question 21: Do you agree with the proposed requirements for closed-ended funds? Please explain your views.

CompliancePlus agrees with the proposed requirements for closed-ended fund. The proposed new provisions help to provide better guidance to the close-ended funds, in particular, measures on trading discount mechanisms, redemption, takeovers and mergers issues, permitted investment excetra. While despite real estate investment trusts, there has only one close-ended authorized fund listed on the SEHK, we do not expect much issues to be arise from the proposed amendments.

Question 22: Do you agree with the proposed amendments to the provisions in the UT Code relating to operational requirements and financial reporting? Please explain your views.

The proposed amendments of provisions in the UT Code regarding the operational requirements and financial reporting are fine given that these amendments help to enhance the existing provisions and lift up the standard to practices published by International Organization of Securities Commissions. However, specifically, CompliancePlus would like to point out an issue regarding the proposed changes in financial reports. The SFC proposes to clarify that annual reports must be prepared in compliance with HKFRS or IFRS, it should be aware that some overseas fund houses may need time to adjust to such changes.

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Question 23: Do you agree with the proposed streamlining of specialized schemes in the UT Code? Please explain your views.

CompliancePlus agrees with the proposal of streamlining the measures for processing scheme changes, CompliancePlus believes that not only this is beneficial to the relevant parties but can also enhance Hong Kong's position in the global fund market.

Question 24: Do you agree with the proposed consequential amendments to the MPF Code? Please explain your views.

CompliancePlus agrees with the proposed consequential amendments to the MPF Code as the proposed amendments are mainly for the sake of consistency.

Question 25: Do you agree with the proposed consequential amendments to the PRF Code? Please explain your views.

CompliancePlus agrees with the proposed consequential changes to the PRF Code as for the sake of consistency.

Question 26: Do you agree with the proposed consequential amendments to the ILAS Code? Please explain your views.

CompliancePlus agrees with the proposed consequential changes to the ILAS Code, CompliancePlus are in the view that proposed changes are made to better align with the amendments proposed for the UT Code.

Question 27: Do you agree that a minimum initial subscription by investors to be consistently applied to all highly leveraged funds? Do you consider the proposed US\$50,000 or the equivalent threshold appropriate? Please explain your views.

CompliancePlus agrees with the imposition of initial subscription by investors to be consistently applied to all highly leveraged funds. CompliancePlus has no objection to the stated threshold.

Question 28: Do you agree that the requirement on disclosure of the purpose of, and expected maximum leverage arising from, derivatives investments should be consistently applied to all SFC-authorized funds? Please explain your views.

CompliancePlus agrees to apply the same KFS disclosure requirement to UCITS funds authorized by the SFC for public offering in Hong Kong. Increasing level of transparency and risk disclosure has been a global trend adopted by regulators around the globe in safeguarding investors' interests. We see no justifiable grounds

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for any type of public funds to not disclosing such information to investors, as the expected degree of leverage is often key to investors' evaluations of the risk profiles of their portfolios.

Question 29: Do you agree with the proposed implementation timetable for the proposed amended UT Code? If not, please set out your reasons and what you think is an appropriate transition period.

CompliancePlus holds a slightly different opinion on the proposed implementation timetable, CompliancePlus think that 18 months transition period should be allowed for the proposed amended UT Code upon gazettal, as quite a lot of new requirements or amendments are proposed and the changes to the Revised Fund Manager Code of Conducts (with effect from November 2018), in order for the industry practitioners to fully enforce and incorporate the new changes to their businesses, a slightly longer transition period should be allowed for the relevant parties to update and amend relevant documents, such as offering documents, key facts statement of various products and parties. Providing more time can also allow SFC to organize workshops or to issue FAQs to provide appropriate guidance to the industry so as to help different stakeholders to better adapt to the changes and allow things to be transitioned in a more smooth way.

Question 30: Do you agree with the proposed implementation timetable for the proposed amended MPF Code? If not, please set out your reasons and what you think is an appropriate transition period.

Once again, CompliancePlus would request a transition period of at least 18 months following gazettal to allow enough time for relevant parties to amend necessary documents or agreements.

Question 31: Do you agree with the proposed implementation timetable for the proposed amended PRF Code? If not, please set out your reasons and what you think is an appropriate transition period.

CompliancePlus suggest to have a 18 months transition period, carrying the same reasoning as above.

Question 32: Do you agree with the proposed implementation timetable for the proposed amended ILAS Code? If not, please set out your reasons and what you think is an appropriate transition period.

CompliancePlus suggest to have a 18 months transition period, carrying the same reasoning as above.

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Additional Comments

In relation to the Product Advisory Committee, despite the annual report it published, not much information can be found on public website, we recommend the Committee to provide more information to the public and enhance its transparency, such as major decisions of the Committee can be disclosed without disclosing specific fund details or client details.

Conclusion

In general, we are supportive of most of the proposed changes and clarifications to be made in relation to the requirements of key operators, permitted investments, money market funds, listed open-ended funds, close-ended funds, ETFs and UCITs funds under the Code on Unit Trusts and Mutual Funds. It is believed that with careful adoption of the proposals set out in the Consultation Paper, Hong Kong's pioneer status as leading Asia financial hub and asset management center can further be strengthened and investors can be better benefited. While given the broad scope of proposed changes, we highly encourage the SFC to prolong the transition period from 12 months to 18 months to ensure smooth transition.

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