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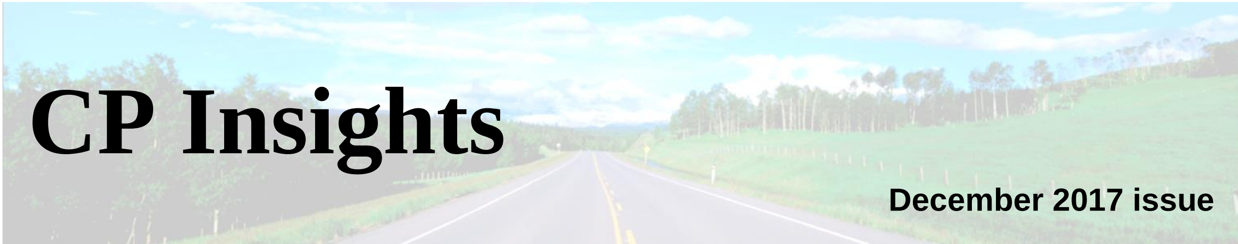

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Revision of HK SFC Fund Manager Code of Conduct - A New Wave of Regulatory Revolution in Hong Kong Asset Management Industry

A discussion on the proposed amendments to the Fund Manager Code of Conduct (the "FMCC") and implications following the release of a recent consultation conclusion from the Securities and Futures Commission of Hong Kong ("HK SFC") on 16 November 2017.

Background

On 16 November 2017, the HK SFC released the 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 (the "Consultation Conclusions"). The Consultation Conclusions can be viewed at:
http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=16CP5.

The Consultation Conclusions largely implement the SFC's proposals of amendments to the FMCC and the new FMCC will become effective on 17 November 2018, exactly 12 months after its recent gazettal. **We urge the industry to start getting prepared in early 2018 by updating the compliance manual and related documents in order to meet the requirements set out in the new FMCC, which will be implemented in the fourth quarter of 2018.**

This article aims to discuss the main proposed changes to the FMCC and their implications to Fund Managers in particular whose managing private funds. At the very least, Fund Managers will be required to revise their offering documents such as private placement memorandum ("PPM") and internal policies such as compliance manual to comply with the proposed amendments.

(1) Responsible for overall operation of the fund

From the Consultation Conclusions, the HK SFC has replaced the term of "de facto control" with "responsible for overall operation of the fund". However, the latter term gives the same meaning of the "de facto control". This involves day-to-day investment management of fund assets. Further, the SFC has indicated that some provisions in the new FMCC will only be applicable to those Fund Managers who are responsible for overall operation of the fund.

Implication: Such revision of FMCC clarifies the duties and responsibilities for Fund Managers who are responsible for overall operation of the fund. However, for those who are not responsible for overall operation of the fund, they should beware of some core provisions of the new FMCC that they still need to comply with, especially risk management policies (paragraph 3.11).

(2) Custodian / Safe Custody of Fund Assets

From the Consultation Conclusions, the HK SFC has revised paragraph 4 of the FMCC to include further requirements on Fund Managers to comply with. Although the custodians of the funds are typically appointed by Fund Board of Director, the Fund Managers still play an important role in terms of advisory of custodian selection and monitoring of the custodian. Therefore, the SFC expects Fund Managers to exercise due skill, care and diligence in the selection and ongoing monitoring of fund's custodian.

The revised paragraph 4 has outlined (i) how Fund Managers safeguard the fund assets, (ii) how Fund Managers select and appoint custodian, (iii) how custodian agreements shall be formed, and (iv) the relevant disclosure requirements of custodian arrangement.

Implication: SFC expects a robust approach in terms of safe custody of assets arrangement. For those Fund Managers who do not have a formal custodian selection review / procedures, they need to start preparing one with constant review of custodian. The SFC is not likely to accept custodian to be appointed without legitimate grounds.

(3) Liquidity Risk Management

In order to align with rules and standards issued by international securities bodies such as International Organization of Securities Commissions ("IOSCO"), the HK SFC has added paragraph 3.14 regarding the liquidity risk management policies and relevant requirements imposed on the Fund Managers responsible for overall operation of the fund.

Paragraph 3.14 of the revised FMCC requires that the Fund Managers shall have appropriate liquidity risk management policies and procedures especially regular stress testing on the fund's liquidity and consider liquidity in investment decision making.

The revised FMCC has provided suggested risk-management controls and procedures for funds including liquidity risk management measures.

Implication: For multi-strategy Fund Managers which have investments in illiquid investments such as long term OTC derivatives, they should further consider the liquidity risk incurred. For boutique private hedge fund managers, it can be a difficult time for them because the HK SFC does not provide clear practices guidance on what they should do to manage fund's liquidity risk such as the frequency of stress testing. Therefore, we recommend the Fund Managers to make reference to industry standards and recommendations in corresponding area. They can also refer to the SFC Circular to management companies of SFC-authorized funds on liquidity risk management for the recommended practices proposed. The circular can be viewed at http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC29.

(4) Enhanced Requirements on Discretionary Account Managers

While the existing FMCC has insignificant coverage of discretionary account managers' conduct, the revised FMCC has further introduced roles and responsibilities of the discretionary account managers by (i) listing out which provisions of the revised FMCC are not applicable to them and (ii) additional requirements for the discretionary account managers.

For point (i), the Appendix 1 of the revised FMCC clarified that the following provisions would apply to funds only but not to managed accounts: (i) liquidity management (partly), (ii) termination, (iii) side pocket, (iv) auditors and audited accounts, (v) valuation frequency (partly), (vi) net asset value calculation and pricing, (vii) offers of investments.

For point (ii), the SFC has elaborated the minimum content requirements for discretionary account client agreement which covers the requirements as set in paragraph 6.2 of the SFC Code of Conduct in addition to those covered in Appendix 1 of the revised FMCC.

Implication: The discretionary account managers will be under radar screen of the HK SFC, which will be subject to a higher expectation towards their internal controls. Instead of having a separate "Discretionary Account Manager Code of Conduct", the SFC chooses to indicate the Sections inapplicable to them and additional requirements to them. The discretionary account managers shall not overlook any provisions as set in the revised FMCC because some provisions in the revised FMCC are still applicable to them such as liquidity risk management in paragraphs 3.14.1 (a) - 3.14.1 (e) of the revised FMCC.

(5) Disclosure of Leverage

According to paragraph 3.12 of the revised FMCC, Fund Managers will have to disclose the expected maximum level of leverage it may employ for a fund as well as the basis of calculation to the investors. Although the SFC did not prescribe any particular leverage calculation method due to absence of general consensus in the industry, the wordings in the revised FMCC indicate that the basis of calculation should be reasonable and prudent.

Implication: Fund Managers will need to revise their offering documents (e.g. PPMs) to include disclosure of the expected maximum level of leverage and the basis of calculation.

(6) Securities Lending and Repos

As paragraph 3.13 of the revised FMCC provides, Fund Managers will be required to have in place a Collateral Valuation and Management Policy, an Eligible Collateral and Haircut Policy and a Cash Collateral Reinvestment Policy that governs securities lending, repo and reverse repo transactions and any cash collateral reinvestments in respect of collateral received by the funds managed by the Fund Manager.

Implication: Fund Managers will be required to disclose a summary of the above policies to fund investors at least annually or upon request. However, the SFC clarifies that it need be in the fund's PPM.

(7) What else?

Other changes to the FMCC include:

(i) Fund Valuation: valuation of portfolio required to be done by a functionally independent party.
(ii) Auditors: Fund Managers must appoint an independent auditor even if it is not required by the fund's jurisdiction of domicile.
(iii) Side Pockets: Fund Managers need to disclose to fund investors the structure and operation of side pockets, including the fees, before side pockets are created. Fund Managers should also notify fund investors whenever illiquid assets are allocated to a side pocket in addition to disclosure in the PPM.
(iv) Reporting to the SFC: it is expressly stated that Fund Managers must provide appropriate information to the SFC on an ongoing basis.

Conclusion

The proposed amendments serve the objective of aligning the FMCC with current international standards such as IOSCO and Financial Stability Board ("FSB") principles. The revised FMCC also reflects the SFC's intent to enhance market transparency by imposing additional investor disclosure requirements.

Fund Managers will need to check their offering documents (e.g. PPM), internal policies (e.g. compliance manual) and managed account agreements, where applicable, to ensure coverage over the proposed amendments of the FMCC by 17 November 2018 the latest.

CompliancePlus will continue to keep in view any updates from the SFC with regard to the present Consultation Conclusions and will send out further materials to our Monthly Ongoing clients in January 2018.

If you have any further questions regarding this issue of CP insights or have any topic you would like us to cover, please submit your response here https://goo.gl/forms/gDLVThTmxGvMl4r12.

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