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SFC Proposes to Enhance Asset Management Regulation, for better or worse?

A discussion on Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency issued by the SFC in November 2016 and its impacts on asset management industry in Hong Kong.

To maintain Hong Kong as a leading asset management center in Asia, the Hong Kong Securities and Futures Commission (“SFC”) launched a three-month consultation into proposals to amend the Fund Manager Code of Conduct (“FMCC”) and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code”). The Consultation period has ended on 22 February 2017. CompliancePlus has submitted detailed response to the SFC that can be downloaded at <http://www.complianceplus.hk/wp-content/uploads/2013/06/FMCC-Consultation-SubmissionFeb2017.pdf>.

The FMCC originates from personal account dealing guidelines that was developed by the Hong Kong Investment Funds Association (“HKIFA”), an industry organization in Hong Kong, in February 1997 for the industry to follow.

Subsequently, in September 1997, the SFC issued consultation paper on developing a formal fund manager-specific code of conduct. The first version of the FMCC drew together references from some 14 pieces of legislation, codes and guidelines and was a collaborative effort with HKIFA. Since its introduction in 1997, the FMCC was amended twice in 2003 and 2013 respectively without major or significant amendment.

Hong Kong asset management business has been growing rapidly over the past twenty years. Based on SFC’s information, the combined fund management business in Hong Kong as of 2015 was over HK\$17,000 billion, taking into account asset under management and advisory by fund managers, private bankers and insurers.

As of 2015, more than 500 licensed corporations were engaging in asset management and/ or advisory business on funds or portfolios with over 34,000 staffs involving in business management, dealing and/or trading, research/ analysis, fund administration and sales and marketing.

Nowadays, asset management companies offer various types of investment products to investing public and retail investors in Hong Kong. The list includes SFC authorized funds, REITS, Mandatory Provident Funds and mainland funds through the Mainland – Hong Kong Mutual Recognition of Funds (“MRF”) scheme, ranging from investment products to retirement/ pension plan. It is time to review the FMCC in light of major international regulatory developments to bring it in line with the evolving international standards.

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The Scope of the SFC Proposal

Under the SFC Proposal, all SFC Type 9 licensed/ registered fund managers (managing either SFC authorized funds, i.e. public funds, or non-authorized funds, private funds, or discretionary accounts in the form of an investment mandate or a pre-defined model portfolio) and the SFC licensed representatives will be subject to the FMCC.

It also clarifies that management of discretionary accounts such as those who act as External Asset Managers (“EAM”) or Segregation Accounts/ Portfolios managers will also be subject to the FMCC.

Fund Manager hereafter refers to the parties that are subject to the FMCC.

The details of the SFC Proposal

The SFC Proposal contains two parts. Part I sets out the SFC’s proposed enhancements to be made in respect of the following key areas in the FMCC with the purpose to codify existing requirements and industry best practices:

➤ Part I – Fund Manager Conduct

(a) Securities lending and repurchase agreements (repos)

It is proposed that a summary of the securities lending, repo and similar OTC transactions policy and the risk management policy (including haircut policy, selection criteria of securities lending counterparties, collateral policy and the relevant provisions in the securities lending arrangements) should be disclosed in the offering documents of a fund.

It is further proposed that a Fund Manager should provide, at least on an annual basis and upon request, information relating to securities lending, repo and similar OTC transactions to clients (and, where the Fund Manager is responsible for the overall operation of a fund (or has de facto control of the fund's oversight and operations), to fund investors).

As a minimum, on an annual basis and upon request, fund managers also need to provide relevant information on securities lending, repos and OTC transactions in a prescribed form by the SFC of global data, concentration data, aggregate transaction data, reinvestment and re-hypothecation data etc.

(b) Custodian / safe custody of fund assets

It is proposed that a Fund Manager responsible for the overall operation of a fund (or who has de facto control of the fund’s oversight and operations) should ensure that the custody arrangements in respect of assets of the fund and any material risks associated with the arrangements (including additional safeguards to mitigate any potential conflicts of interest that have been put in place where self-custody is adopted) are properly disclosed to the fund’s investors and that fund investors are updated about any significant changes.

(c) Liquidity risk management

It is proposed that the Fund Manager should maintain and implement effective liquidity management

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policies and procedures to monitor the liquidity risk of the fund, taking into account the investment strategy, liquidity profile, underlying obligations and redemption policy of the fund, and should ensure that the effectiveness of its liquidity management policies and procedures is periodically reviewed and updated as appropriate.

On liquidity risk management policy proposal, whilst SFC noting that the relevant International Organization of Securities Commissions (“IOSCO”) principles appear to be more relevant to open-ended funds, the SFC is of the view that fund manager of any type of fund (public or private fund) should still consider the extent of the applicability of the requirement on liquidity risk management as proposed by the SFC in this Proposal.

(d) Disclosure of leverage

It is proposed that a Fund Manager should disclose the maximum level of leverage which it may employ on behalf of each fund it manages and should take into account financial leverage arising from borrowings and synthetic leverage arising from the use of derivatives in calculating leverage and disclose the basis of calculation it has adopted, which should be reasonable and prudent, having due regard to international best practices, in the fund’s offering document.

➤ Part II – Intermediaries Conduct

Part II discusses the proposed amendments to be made to the Code. These amendments mainly aim to enhance point-of-sale transparency and to better address the potential conflicts of interest in the sale of investment products by adopting a two-pronged approach:

- (a) governing the conduct of intermediaries when representing themselves as “independent” or as providing “independent advice” that the term “independent” can only be used if the intermediary does not receive any direct or indirect monetary or non-monetary benefits from other parties in the distribution of an investment product to clients; and
- (b) enhancing the disclosure of monetary benefits received or receivable that are not quantifiable including the existence and nature of any such benefits, the annualised range of monetary benefits received and the maximum annual dollar amount of monetary benefits receivable in a prescribed form by the SFC prior to or at the point of sale.

The impact of the Proposals

The Proposals imply that, going forward, SFC will seek to apply the same regulatory and compliance standard to both public funds and private funds that private fund managers must beef up its legal and compliance budget to get prepared for changes that will bring under the SFC Proposals to ensure ongoing compliance in future. If this Proposal is fully adopted, we are concerned that private fund management business will be impacted and burdened with tightening compliance obligations that may discourage private fund managers to choose Hong Kong as their place of operation.

It is expected that once the Proposals are adopted, fund managers (whether public or private funds managers) will need to amend to fund’s offering document to include a summary of the securities lending, repos and similar OTC transactions policy, risk management policy and maximum level of leverage.

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On the enhanced disclosure of monetary benefits received or receivable that are not quantifiable prior to or at the point of sale (for example, trailer fees), it is correct that the proposal can facilitate easy comparison of fees received by different intermediaries and competition. In the short run, fees may go down because of possible cutthroat competitive that may benefit investors.

However, in the long run, this can potentially impact the sustainable development of financial advisory business in Hong Kong. They may lose financial talents and their competitiveness in products offering and pricing. Risks will be posed on internal controls, human resources, compliance and risk management to financial firms who face resources issues and business decline.

The SFC proposes a 6-month transition period for implementation of the Proposals. Nevertheless, in light of the broad scope of the Proposals, we are of the view that at least 12-month transition period should be needed so that fund managers can get ready for compliance. The SFC should consult industry organizations and lawyers, compliance consultants to assess the readiness of the industry once the Proposals are adopted and what assistance the SFC can offer to the industry to facilitate implementation.

What to do next?

This SFC Proposal is highly relevant to SFC Type 9 licensed corporations and the asset management industry of Hong Kong that we recommend the following actions:

- Voice out any feedback or concerns you may have to relevant industry organization such as HKIFA or AIMA even the Consultation is closed now
- Keep track of the development of the Consultation and any SFC Consultation Conclusions are issued
- Keep in contact with your fund lawyer to assess the timing for updating or amending the fund offering document
- Seek advice from your compliance consultant to review the existing compliance framework and/or compliance manual to ensure ongoing compliance

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/gDLVThTmxGvMI4r12>.

CompliancePlus is an independent consulting firm focused on providing a complete range of proven and reliable compliance solutions to fund management companies and hedge fund managers in Asia. Our dedicated team of compliance officers has years of professional experience equipped with in-depth knowledge of both functional and compliance experience in managing and minimizing regulatory, operational and reputational risks.

We have been providing real time compliance support and proactive recommendations to start-up hedge funds, fund of hedge funds and multi-strategies hedge funds with our solid compliance knowledge.

By partnering with **CompliancePlus**, our clients gain access to compliance solutions that they can trust and the latest knowledge of regulatory policies and procedures. Through building up strong relationships with our clients and by ensuring our availability to them, we are trusted advisors helping clients to navigate a challenging and changing regulatory environment.

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