CHARLTONS

SOLICITORS

Hong Kong **December** 2016

SFC Consults on Proposals to Tighten Regulation of Fund Managers and Point-of-sale Disclosure

Introduction

The Securities and Futures Commission (**SFC**) is consulting on proposals to tighten regulation of Hong Kong's asset management industry as set out in its November 2016 Consultation Paper (the **Consultation Paper**). The aim of the reforms is the alignment of Hong Kong's regulatory framework with international regulatory reforms affecting the asset management industry implemented in the wake of the global financial crisis to enhance financial stability and improve investor protection.

In formulating the proposed reforms, the SFC has sought to balance the need to facilitate market development and competitiveness on the one hand with the need to ensure investor protection and market integrity on the other.

The SFC proposes to make amendments to:

a) **The SFC's Fund Manager Code of Conduc**t in 4 key areas:

- securities lending and repurchase agreements (**repos**);
- provisions for custodians and the safe custody of fund assets;
- liquidity risk management; and
- disclosure of leverage.

The proposed changes are set out in Part I of the Consultation Paper.

b) **The Code of Conduct for Persons Licensed by or Registered with the SFC.**

The SFC is proposing amendments to improve point-of-sale transparency and address potential conflicts of interest through:

- the regulation of intermediaries' representing themselves as "independent" or as providing "independent advice"; and
- enhancing the disclosure of monetary benefits received or receivable that are not quantifiable before or at the point of entering into a transaction.

The SFC has invited responses to the Consultation Paper[1] which should be submitted by 22 February 2017.

Proposed Amendments to the Fund Manager Code of Conduct (FMCC)

The key proposed changes to the FMCC relate to: (i) securities lending and repurchase agreements; (ii) safe custody of fund assets; (iii) liquidity risk management; and (iv) Fund Managers' disclosure of leverage.

1 The Securities and Futures Commission "Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency" of November 2016 available at http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=16CP5.

1. Persons covered by the FMCC

1.1 Fund managers responsible for the overall operation of a fund

The SFC is proposing that certain FMCC requirements (and proposed requirements), such as the settling of liquidity management policy and the appointment of a qualified custodian, should only apply to fund managers who are responsible for the overall operation of a fund or have *de facto* control of its oversight or operation. This proposal stems from the SFC's recognition that notwithstanding that the board of directors of a fund is legally responsible for formal decision-making in relation to a fund (e.g. the issue of an offering document in relation to the fund), in practice, it is often the fund manager who is substantially responsible for the fund's overall operation and may in fact have *de facto* control of the fund.[2] It also reflects the position under the principles adopted by the International Organization of Securities Commissioners (**IOSCO**).

If the proposal is implemented, an example of a fund manager who would be considered to have *de facto* control of the oversight or operation of a fund would be where the representatives of the fund manager and/or its affiliate(s) make up a majority of the fund's board of directors. Conversely, a Hong Kong fund manager who is appointed as a sub-manager to manage only an allocated portion of the fund, would not be required to comply with certain FMCC principles and requirements.

All fund managers will however be required to comply with the generally applicable FMCC principles and requirements, such as organisation and management structure, staff ethics, record keeping and conflicts of interest requirements.

1.2 Application to SFC licensed/registered entities managing CIS and/or discretionary accounts

The proposed amendments to the FMCC will govern the conduct of entities licensed by or registered with the SFC (and their relevant representatives) where the entity's business involves:

a) the discretionary management of collective investment schemes (**CIS**), whether authorised or unauthorised;[3] and/or

b) the management of discretionary accounts in the form of an investment mandate or a pre-defined model portfolio (together, **Fund Managers**).

Private funds

The proposed amendments would thus apply to all SFC-licensed/registered fund managers managing public or private funds domiciled in Hong Kong or overseas. SFC regulation at the fund level (i.e. under the SFC's Code on Unit Trusts and Mutual Funds (the **UT Code**) and the Overarching Principles Section of the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (the **SFC Products Handbook**) will continue to focus on public (i.e. authorised) funds and will not extend to privately offered funds. The Consultation Paper's proposed amendments would operate at the fund manager level and apply to the management of both publicly and privately offered funds. This is in line with the comparable IOSCO principles and recommendations of the Financial Stability Board (**FSB**). The proposed new FMCC requirements are generally principles-based (in line with the IOSCO and FSB principles and recommendations): detailed requirements for publicly offered funds are specified in the UT Code.

Discretionary Accounts

The revised FMCC will state that it applies to SFC-licensed or registered entities involved in the business of managing discretionary accounts either in the form of an investment mandate or a pre-defined model portfolio, and their representatives. The specific FMCC requirements that would not apply to managers of discretionary accounts will be set out in Appendix 1 to the FMCC.

1.3 Securities lending and repurchase agreements

SFC-authorised funds can conduct securities lending, repo and similar over-the-counter (**OTC**) transactions subject to compliance with the general requirement that transactions are conducted in the best interests of holders and that associated

2 The SFC views de facto control as where "the representatives of the fund manager and/or its affiliate(s) constitute a majority of the board of directors of the fund".

3 Applicable to discretionary account except for those offering such a service only as an ancillary part of their brokerage services for clients without establishing an investment mandate or a pre-defined model investment portfolio, and who do not receive management fee and/or performance fee as remuneration

risks are properly mitigated and addressed as set out in the UT Code and the SFC Products Handbook. The FMCC does not currently impose obligations on a Fund Manager where the activities are conducted by a fund under its management.

The SFC proposes to adopt certain FSB recommendations to address shadow banking risks in securities lending and repos conducted by fund managers and funds. The key proposals are set out below.

i) Collateral valuation and management policy

A Fund Manager engaging in securities lending, repo and similar OTC transactions on behalf of a fund under its management would be required to put in place a collateral valuation and management policy including certain margin and minimum valuation requirements.

ii) Eligible collateral and haircut policy

Fund Managers would be required to put in place an eligible collateral and haircut policy covering the types of acceptable collateral and the methodology for calculating haircuts on collateral received in relation to these transactions. Fund Managers would have to consider and assess the acceptability of collateral when formulating this policy. The haircut methodology should be formulated on the basis that haircuts will cover the maximum expected decline in the market price of the collateral assets (over a conservative liquidation horizon) before a transaction can be closed out. Fund Managers would be expected to exercise professional judgment and give due consideration to the specific nature of each fund under its management when designing the haircut methodology and take into consideration relevant international regulatory standards and FSB recommendations as set out in its Regulatory framework for haircuts on non-centrally cleared securities financing transactions.[4] Appendix C of the Consultation Paper sets out particular FSB recommendations relating to haircut methodology design of which Fund Managers should be aware:

a) the maximum price decline used to determine the applicable haircut should be calculated using a long time series of price data covering at least one stress period. If such historical data is either unavailable or unreliable, then stress simulations or data for other similar asset types as a proxy (including at least one stress test period and with prudent adjustments made as appropriate) should be used. The assumed liquidation horizon should be conservative, reflect the expected liquidity or illiquidity of the asset in stressed market conditions, and depend on the relevant market characteristics (such as trading volumes and market depth) and other special characteristics of the collateral.

b) haircuts should cover different risk considerations where relevant, including market risk, counterparty risk and foreign exchange risk. Additional factors to be considered in setting the appropriate haircut include the specific characteristics of the collateral and the correlation between securities accepted as collateral and lent securities.

The SFC will issue Frequently Asked Questions providing guidance on the standards applicable to designing haircut methodologies which would meet the standards set by the FSB recommendations.

iii) Reinvestment of cash collateral

A cash collateral reinvestment policy would become a requirement for Fund Managers engaging in securities lending, repo and similar OTC transactions on behalf of funds under their management which reinvest cash collateral received. The aim of the policy should be to ensure that assets held in the cash collateral reinvestment portfolio are sufficiently liquid with transparent pricing and low risk in order to meet reasonably foreseeable recalls of cash collateral. Fund Managers would also be required to stress test the cash collateral reinvestment portfolio's ability to meet foreseeable and unexpected calls for the return of cash collateral on an on-going basis.

In formulating their cash collateral reinvestment policy, Fund Managers should consider establishing specific requirements for the cash reinvestment portfolio and/or liquidity pool maintained to meet cash collateral recalls. These requirements should include a requirement for a minimum portion of the cash collateral to be kept in short-term deposits, held in highly liquid short-term assets, or invested in short tenor transactions; and set specific limits for the weighted average maturity and/or weighted average life.

4 FSB. "Strengthening Oversight and Regulation of Shadow banking - Regulatory framework for haircuts on non-centrally cleared securities financing transactions". 14 October 2014. http://www.fsb.org/wp-content/uploads/r_141013a.pdf.

iv) Rehypothecation of non-cash collateral

Unauthorised funds

Where non-SFC authorised funds (i.e. private funds) re-hypothecate non-cash collateral, the SFC would require Fund Managers to make adequate disclosure to investors of the details of the re-hypothecation, for example, of the non-cash collateral re-use arrangements, and related risks, so that investors can understand the relevant risks and exposures to the fund.

SFC-authorised funds

Authorised funds should not re-hypothecate non-cash collateral and must comply with the relevant requirements of the UT Code and the SFC Products Handbook.

v) Reporting to fund investors

Where a Fund Manager has responsibility for a fund's overall operation or has *de facto* control of it, the fund's offering documents would be required to include a summary of the securities lending, repo and similar OTC transactions policy and the risk management policy including the haircut policy, selection criteria of securities lending counterparties, collateral policy and the relevant provisions in the securities lending arrangements.

There are minimum requirements on the information to be disclosed (as set out in Appendix 3 of the Consultation Paper): Fund Managers will be required to provide the information set out below in relation to securities lending, repo and similar OTC transactions on an annual basis and upon request.

i) Global data

a) the amount of securities on loan as a proportion of total lendable assets and of the fund's assets under management; and

b) the absolute amount of assets engaged in securities lending, repos and similar OTC transactions.

iii) Concentration data

a) top 10 collateral securities received by the issuer; and

b) top 10 counterparties of securities lending, repos and similar OTC transactions.

iii) Aggregate transaction data

a) by type of collateral received;

b) by currency;

c) by maturity tenor;

d) by geography of counterparty;

e) cash versus non-cash collateral;

f) maturity of collateral; and

g) settlement and clearing (tri-party, central counterparty, bilateral).

iv) Reinvestment and re-hypothecation data

a) share of collateral received that is re-invested or re-hypothecated, compared to the maximum authorised amount if any;

b) information on any restrictions on type of collateral received; and

c) aggregate transaction data for collateral re-invested or re-hypothecated by product type.

v) Return data on collateral – including the split between the return from securities lending, repos and similar OTC transactions and the return from cash collateral reinvestment.

vi) Number of custodians and the amount of collateral assets held by each.

vii) The proportion of collateral posted by funds which are held in segregated accounts, pooled accounts, or in any other accounts.

Where funds appoint a third-party agent

Where a fund appoints a third-party agent to conduct securities lending and repo activities on its behalf, the SFC still expects Fund Managers to obtain access to the relevant disclosure information from the third-party agent.

Fund Managers should, for example, ensure that the trustee or Board of Directors of relevant funds can exercise their power to receive information on such transactions from the agent (e.g. under the contract with the agent) and pass on the information to the Fund Manager.

2. Custody/safe custody of fund assets

The SFC is proposing to adopt the latest relevant principles under IOSCO's November 2015 report, "Standards for the Custody of Collective Investment Schemes' Assets" in relation to custody of fund assets. IOSCO defines "custody" as the safekeeping and record-keeping of CIS assets to ensure the assets' physical and legal integrity.

2.1 Safekeeping of fund assets and custodian independence

i) Safekeeping of fund assets

The SFC proposes to amend the FMCC to expressly require the segregation of fund assets from:

a) the assets of the Fund Manager; and

b) the assets of the Fund Manager's affiliates and other clients, unless they are held in an omnibus account.

ii) Fund assets held in omnibus accounts

Where fund assets are held in an omnibus client account, the key principle is that fund assets must be readily identifiable as belonging to the fund in the books and records of the custodian, or in the case of self-custody, the Fund Manager. Fund Managers must also ensure that adequate safeguards exist so that individual clients' assets are properly recorded and frequent reconciliations are performed.

iii) Custodian independence

The SFC proposes to amend the FMCC to specifically require Fund Managers to arrange for the appointment of, and entrust the fund assets to, a custodian that is functionally independent from it. The requirement will apply to Fund Managers who are responsible for a fund's overall management or have *de facto* control of its oversight or operation.

Where a Fund Manager adopts a self-custody arrangement (which is often the case for Fund Managers of private funds), it will be required to have policies, procedures and internal controls in place to ensure that persons fulfilling the custodial function are functionally independent of the persons fulfilling the fund's management or administration functions.

2.2 Selection of the custodian, the custody agreement and monitoring of custody arrangements

The SFC is proposing to impose the following requirements on Fund Managers who are responsible for a fund's overall operation or have *de facto* control of its oversight and operation.

i) Custodian selection and ongoing monitoring

A new explicit requirement on Fund Managers to exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of the custodian is proposed. In the case of funds structured as corporates where the custodian is legally appointed by the fund's board of directors (rather than the Fund Manager), the SFC will still require the Fund Manager to ensure compliance with this requirement.

ii) The Custody Agreement

Fund Managers will be responsible for ensuring that a formal custodian agreement is entered into, and that it properly delineates the custodian's scope of responsibility and liability. Fund Managers must additionally monitor the custody arrangements on an ongoing basis to ensure the custodian's compliance with the custody agreement.

iii) Disclosure of custody arrangements

Fund Managers will be required to ensure proper disclosure to investors of the custody arrangements for fund assets and of any associated material risks. Where Fund Managers adopt self-custody arrangements, they should disclose any additional safeguards adopted to mitigate potential conflicts of interest. Fund investors must also be informed of any significant changes to the custody arrangements.

3. Liquidity risk management

The SFC issued a circular in July 2016 providing guidance to managers of SFC-authorised funds on liquidity risk management.[5]

5 The SFC's Circular to management companies of SFC-authorized funds on liquidity risk management issued on 4 July 2016, http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=16EC29

The SFC is now proposing to adopt in the FMCC the IOSCO principles on liquidity risk management6 for both public and private CIS. The following proposals are put forward for Fund Managers with responsibility for a fund's overall operation or de facto control of its operations and oversight.

3.1 Liquidity management policy

It is proposed that Fund Managers should be required to maintain, implement, and periodically review and update, liquidity management policies and procedures to ensure their effectiveness, taking into account the investment strategy, liquidity profile, underlying obligations and redemption policy of the fund. The SFC stresses that while liquidity risk management is a particular concern for open-ended funds, some principles are also relevant to private funds where liquidity risk may arise in connection with margin calls for derivatives and other financing obligations. All Fund Managers will therefore be expected to consider applying the proposed liquidity management principles to the funds they manage taking into account the liquidity profile of relevant funds and irrespective of the type of fund. The SFC acknowledges however that the extent of the application of the proposed liquidity management principles will vary depending on a fund's nature, liquidity profile and asset-liability management.

3.2 Stress testing

Fund Managers will be required to perform regular liquidity assessments in different scenarios, including stressed situations. Responding to comments that not all types of funds require regular stress-testing, the SFC said that Fund Managers should conduct liquidity stress testing on their funds on a continuing basis to determine the impact of plausible severe adverse changes in market conditions on the liquidity of their funds. The extent or frequency of testing may however be varied according to a fund's particular nature and liquidity profile.

Stress test results should be reviewed to determine what action (if any) needs to be taken by a committee with responsibility for liquidity risk management and/or by senior management. If no immediate actions are required, the SFC still expects Fund Managers to have in place a plan of action to ensure the fund's liquidity needs are met in the event that any of the stress scenarios materialises.

6 IOSCO's principles on liquidity management are set out in its "Principles of Liquidity Risk Management for Collective Investment Schemes" published in March 2013.

3.3 Tools and exceptional measures

The SFC proposes to incorporate a general principle into the FMCC that where a fund's constitutive documents allow the use of specific tools or exceptional measures which could affect investors' redemption rights, the Fund Manager will have to consider the appropriateness of using those specific tools or exceptional measures, taking into account the nature of the fund's assets and its investor base. An explanation of any tools and exceptional measures should be included in the fund offering documents if they form part of the fund's investment strategy. Where side letters are entered into, Fund Managers must disclose this fact and the side letter's material terms in relation to redemption to all potential and existing fund investors.[7]

The SFC also reminds Fund Managers that in using liquidity risk management tools, they must give priority to investors' interests over their own interest, e.g. reputational and competitive concerns.

4. Disclosure of leverage

Leverage within investment funds is perceived by international financial regulators as a potentially important structural vulnerability in the asset management industry. As a result, stricter oversight measures have been introduced internationally. For instance, the Securities and Exchange Commission (**SEC**) requires private funds' investment advisers to report leverage-related information to the SEC on its regulatory form, Form PF, primarily for use by the Financial Stability Oversight Council for monitoring systemic risk. The SEC has set the reporting interval depending on the assets under management (**AUM**) and the type of funds. For AUM attributable to private funds of more than US$150 million, investment advisers are required to report on an annual basis. For AUM attributable to hedge funds of more than US$1.5 billion, hedge fund advisers are required to report on a quarterly basis giving more detailed leverage information. In the European Union, leverage disclosure is required under the Alternative Investment Fund Managers Directives.

7 Circular to all Licensed Corporations Engaged in Hedge Funds Management Business issued by the SFC on 27 October 2008.

Disclosure of maximum leverage to fund investors

The SFC is proposing that Fund Managers responsible for funds' overall operation or having *de facto* control of their oversight or operation should be required to disclose the maximum level of leverage it may employ on behalf of each of the funds it manages.

The SFC is not proposing to prescribe a method for calculating leverage at this stage given the lack of general consensus internationally on how leverage should be calculated. It suggests however that Fund Managers should take into account financial leverage arising from borrowings and synthetic leverage resulting from the use of derivatives in calculating leverage. They should also disclose in the fund's offering document the basis of calculation used, which should be reasonable and prudent and have due regard to international best practices.

This requirement will need to be met by Fund Managers in relation to both private and public funds given the importance investors attach to information regarding leverage.

The SFC will keep international developments under review and will review its regulations if it considers this necessary.

5. Other amendments

The SFC proposes a number of other amendments to the FMCC to codify existing requirements and/or practices and make updates and housekeeping changes aimed at improving clarity.

5.1 Fund portfolio valuation

The SFC proposes to codify existing requirements and industry practices for CIS valuation by reference to relevant principles under IOSCO's May 2013 "Principles for the Valuation of Collective Investment Schemes". These include requirements with respect to the independent valuation of fund assets and periodic review of valuation policies and procedures and fund valuation processes. Independent valuation can be accomplished in various ways, such as appointing a qualified independent third party or separating the valuation and/or pricing function from the investment function so that those responsible for making investment decisions will not also determine valuations, although the latter may provide input where appropriate.

5.2 Audited financial statements

The FMCC will be amended to codify existing industry practice that Fund Managers are required to appoint an independent auditor to perform an audit of the financial statements of each of the funds they manage and prepare an annual report in accordance with generally accepted accounting principles for each fund under its management.

5.3 Risk Management

The SFC is proposing to provide more comprehensive and extensive guidance to Fund Managers regarding risk management policies, governance structures and procedures. The FMCC will be revised to improve and update the existing requirements on risk management of the Fund Manager and of the funds it manages. A new Appendix 2 to the FMCC will set out some suggested risk management control techniques and procedures which Fund Managers should take into account, where applicable, in monitoring the risks of the funds it manages. These largely elaborate on the existing suggested risk management control techniques and procedures as set out in the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (**ICG**), but are tailored to specifically apply in the context of funds.

The SFC has also added certain specific suggestions in respect of business continuity and transition plan in line with the latest international regulations in this area. The revised FMCC does not supersede the ICG and Fund Managers will be expected to comply with both the ICG and FMCC.

5.4 Side pockets

A new section on side pockets will be added to the FMCC which largely reflects the relevant requirements of the SFC's October 2008 "Circular to All Licensed Corporations Engaged in Hedge Funds Management Business". Side pockets are used by funds to segregate illiquid or hard-to-value investments of a fund from other fund assets.

5.5 Reporting

The revised FMCC will include more detailed ongoing reporting requirements to assist and improve SFC monitoring and detection of risks arising from asset management activities such as securities lending and repos and use of leverage. The SFC plans to engage the industry on the items for data collection in due course.

5.6 House accounts

Paragraph 3.10(a) of the revised FMCC will clarify that aggregation of house orders with client orders should only be done if it is in the best interests of clients. This is due to the SFC's recognition that the FMCC's current provision (that where a client order has been aggregated with another order, the client's order must take priority in any subsequent allocation for partially filled orders) is not always in a client's best interest. This is because it can lead to an order exceeding the range of normal market order size and result in increased market impact costs. The SFC also proposes to delete the duplicated wording in paragraph 3.10(c) in the revised FMCC where it covers the aggregation of both buy and sell orders. The revised FMCC will therefore set out in paragraph 3.10(a) the requirements on order aggregation and client priority, while paragraph 3.10(c) will set out the provisions against front running.

The Code of Conduct – Intermediaries' Conduct

6 Inducements and commissions

Regulatory developments internationally

In the aftermath of the global financial crisis, a number of jurisdictions imposed restrictions on inducements and commissions received by financial advisers and distributors. In the United Kingdom, new rules implemented in 2013 prohibit financial advisers earning commissions from fund companies for selling or recommending their investment products. Instead, investors have to agree fees with advisers upfront under a "pay-for-advice" model. Financial advisers are required to offer either "independent" or "restricted" advice and must explain the difference between the two by clarifying whether their recommendations are limited to specific products or product providers. Australia has also banned commissions on securities products, adopting a "pay-for-advice" model. A drawback of this model however is that investors with limited financial resources or who are unwilling to pay for advice could be left with no or very limited access to investment products.

In the European Union, under the Markets in Financial Instruments Directive II (**MiFID II**), investment firms are prohibited from receiving and retaining any monetary (including fees or commission) or non-monetary benefits from a third party if the investment advice is provided on an independent basis. Singapore has adopted a similar position, allowing the term "independent" to be used only by financial advisers who do not receive commission.

International regulators have taken steps to increase the amount of information disclosed to investors on costs and charges. From January 2018, MiFID II will require improved disclosure of information in connection with investment services, the cost of financial instruments and the potential payment method by the client or a third-party.[8]

The Hong Kong Position

Since 2011, Hong Kong has required disclosure of monetary and non-monetary benefits received or receivable by intermediaries in relation to distributions of investment products. However, for monetary benefits that are not quantifiable prior to or at the point of entering into a transaction, such as ongoing commission payable by product issuers to intermediaries for distribution (in the context of funds, trailer fees), the Code of Conduct only imposes a general requirement for licensed or registered persons to disclose the existence and nature of such monetary benefits. The SFC notes that compliance with this requirement varies from disclosure of a maximum percentage amount receivable to disclosure of a description of the costs and fees with no indicative monetary amount or percentage. The SFC believes that without a standardised disclosure practice, this does not assist investors in comparing costs and fees between different intermediaries.

6.1 Key proposals in the Code of Conduct

The key proposed changes to the Code of Conduct are aimed at dealing with potential conflicts of interest on the sale of investment products and improving point-of-sale disclosure by:

a) restricting an intermediary from representing itself as "independent" (or using terms with a similar inference) if the intermediary receives commission or other monetary or non-monetary benefits, or it has links or other legal or economic relationships with product issuers which are likely to impair its independence; and

b) requiring an intermediary to disclose the range and maximum dollar amount of any monetary benefits received or receivable that are not quantifiable prior to or at the point of entering into a transaction.

8 Third-party payment must be identified separately. For instance, it should be clear to the client which part(s) of the costs paid is rebated to the investment firm providing the investment service.

i) Restriction on the use of the term “independence”

The SFC is proposing to prohibit intermediaries from representing themselves as being “independent” or using other terms with a similar inference (e.g. “independent financial adviser”, “IFA”, “impartial, “neutral”, “objective” or “unbiased”) if they receive monetary or non-monetary benefits from other parties, including product issuers. The SFC would also require clear disclosure to investors prior to or at the point of entering into a transaction on whether or not it is independent and the bases for such determination. A one-off disclosure is sufficient, but intermediaries must inform clients of any changes.

As to what is meant by “independent” in terms of a licensed or registered intermediary distributing an investment product, a person will not generally be considered “independent” if:

a) it receives fees, commissions, or any monetary or non-monetary benefits either directly or indirectly from any party in relation to distributing the investment product to clients; or

b) it has links or any other legal or economic relationship with the product issuer which is likely to impair its independence in terms of favouring a particular investment product, a class of investment products or a product issuer.

An intermediary which represents itself to be “independent” (or uses terms with a similar inference) cannot therefore receive fees, commissions, or any monetary or non-monetary benefits from any party in the distribution of investment products to its clients.

ii) Enhancing disclosure

The SFC proposes to enhance the disclosure requirement relating to monetary benefits received or receivable that are not quantifiable prior to or at the point of entering into a transaction (for example trailer fees). This is intended to increase transparency and enable investors to identify the fees receivable by different intermediaries, thus allowing easier detection of potential conflicts of interest.

Intermediaries will be required to disclose:

a) the existence and nature of monetary benefits received or receivable that cannot be quantified prior to or at the point of entering into a transaction;

b) the range of the monetary benefits receivable on an annualised basis; and

c) the maximum dollar amount of the monetary benefits receivable per year.

The SFC gives the following sample disclosure to illustrate the proposals at (b) and (c) above using trailer fees as an example:

Name of Fund	**Ongoing commission/monetary benefits from product issuer**
Fund A	We will receive from the fund manager as ongoing commission 40% - 60% of Fund A’s annual management fees. This means that if you invest HK$10,000 in Fund A, we will receive up to HK$x* out of the annual management fees every year throughout the term of your investment. * HK$x is based on the assumption that you remain invested in Fund A for a 12-month period, and that there is no change in the net asset value (NAV) per unit of Fund A such that the value of your HK$10,000 investment remains unchanged throughout the period.

The proposed disclosure will help investors in two aspects. First, in the example, the “40-60%” is the percentage range of the monetary benefit, namely commission, which will be received by intermediary. In giving the range of monetary benefits, intermediaries should ensure this reflects the terms of any agreement the intermediary has with the party providing the monetary benefits (e.g. the range of trailer fees should be based on the range agreed with the product issuer in the relevant distribution agreement). Second, “HK$10,000” reflects the maximum dollar amount in terms of the fees payable to the intermediary annually. In the case of trailer fees in respect of funds, the maximum dollar amount would be calculated based on the assumption that the investor will remain invested in the fund for twelve months and that there will be no change to the NAV per unit. This should standardise the calculation across the industry.

Disclosure will be made on a transaction basis and the timing for disclosure will be prior to or at the point of entering into the transaction.

iii) Other amendments

The SFC proposes amending the Code of Conduct to clarify that it and its general principles apply to all Fund Managers.

6.3 Matters not considered in the Consultation Paper

The Consultation Paper refers to overseas developments in asset management regulation which are not covered in the Consultation Paper's proposals. These relate to:

a) remuneration in the context of aligning the incentives of fund managers and investors. In Europe, remuneration rules are being put in place to ensure that remuneration does not result in excessive risk taking and does not put clients' interests at risk. In Hong Kong there are already general principles under the existing FMCC and Code of Conduct governing best execution of conflicts of interest and provisions in the ICG which seek to ensure that funds do not take on excessive risks and that there is proper management of risks which should address any mis-alignment of incentives; and

b) unbundling research from broker commissions charged to fund managers, which is a matter currently under consideration in Europe. Soft dollars are currently permissible under the FMCC and the Code of Conduct provided that requirements designed to address potential conflicts of interest are met. These include the requirement that the types of goods and services received are of demonstrable benefit to the clients, transaction execution is consistent with best execution standards, client's consent has been obtained and requisite disclosure has been made. There are also existing general principles under the FMCC and the Code of Conduct governing best execution and conflicts of interest.

As Hong Kong's existing requirements in these areas already meet relevant IOSCO standards and there is not yet any international consensus on these areas, the SFC proposes to continue to keep international regulatory developments under review, but will not make any changes to Hong Kong regulations in relation to these areas yet.

Submission of Comments

The cut-off date for submitting comments on the Consultation Paper's proposals and the draft of the proposed amendments to the FMCC (at Appendix A of the Consultation Paper) and the Code of Conduct (at Appendix B of the Consultation Paper) is **22 February 2017**.

Comments can be submitted:

By mail to: Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

Re: Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency

By fax to: +852 2877 0318

By online submission to: http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/

By email to: amrconsultation@sfc.hk

The Consultation Questions

Question 1	Do you have any comments on the proposed clarification that the FMCC applies to the business activities carried out by fund managers which would include the management of discretionary accounts?
Question 2	Under the current proposal, some of the proposed enhancements are not applicable to all Fund Managers but only to those responsible for the overall operation of a fund or having de facto control of the oversight or operation of the fund. Do you agree with such an approach? If so, do you have any views on which of the proposed enhancements should only be applicable to those Fund Managers who are responsible for the overall operation of a fund or have de facto control of the oversight or operation of the fund? Please explain your views.
Question 3	Do you have any comments on the above proposals which will be applicable to a Fund Manager which engages in securities lending, repo and similar OTC transactions on behalf of the funds it manages?
Question 4	Do you have any views or comments on the proposal that Fund Managers should design their haircut methodologies which should reflect the standards set by the FSB in its recommendations?
Question 5	Is the requirement to disclose details of non-cash collateral re-hypothecation sufficient to enable investors to understand the relevant risks and exposures to the fund? Please explain your views.
Question 6	Do you have any comments on the proposed requirements on reporting to fund investors? In particular, do you have any comments on the minimum disclosure requirements proposed?
Question 7	Do you have any comments on the above proposals regarding custodian and safe custody of fund assets?
Question 8	Do you have any comments on the above proposals regarding liquidity risk management?
Question 9	Do you have any suggestions on any particular liquidity management measures which a Fund Manager should put in place for effective liquidity management, for example, in terms of setting liquidity targets or stress testing?
Question 10	Do you consider it appropriate for Fund Managers to disclose the maximum leverage of the fund it manages to fund investors?
Question 11	Do you have any comments on how leverage should be calculated?
Question 12	Do you have any comments on the other amendments proposed to the FMCC?
Question 13	Under the existing requirement, where a client's order has been aggregated with a house order, the client's order must take priority in any subsequent allocation of partially filled orders. Are there any circumstances where it is in the best interests of clients to aggregate their orders with house orders? What are those circumstances which justify that they are in the best interests of clients? Are there any circumstances in which an institutional professional investor should be able to request pro rata allocation of aggregated but partially filled orders, on the terms specified by such an investor? What are those circumstances? Does the investor who request pro rata allocation have concerns that the flexibility can be abused by the licensed manager?
Question 14	Do you have any comments on the suggested risk-management control techniques and procedures as set out in Appendix 2?
Question 15	Do you have any comments on the requirements set out in Appendix 1?
Question 16	Do you think a 6-month transition period following gazettal of the final form of the amendments to the FMCC is appropriate? If not, what do you think would be an appropriate transition period and please set out your reasons.
Question 17	What is your view on a pay-for-advice model for Hong Kong? Do you have any comments on our suggested approach to addressing the inherent conflicts of interest arising from receipt of commissions by intermediaries from other parties including product issuers?

Question 18	Do you have any comments on the proposed disclosure requirement in relation to independence set out above?
Question 19	Do you have any comments on the enhanced disclosure proposed with regard to monetary benefits received or receivable by intermediaries that are not quantifiable prior to or at the point of entering into a transaction (and in particular, in relation to specific types of investment products)?
Question 20	Do you have any comments on the suggested manner of disclosure of trailer fees (in the context of funds) set out in the sample disclosure above? Do you have any other suggestions to ensure the disclosure of non-quantifiable monetary benefits relating to other types of investment products will be clear, fair, meaningful and easily understood by investors?
Question 21	Do you think a 6-month transition period following gazettal of the final form of the amendments to the Code of Conduct is appropriate? If not, what do you think would be an appropriate transition period and please set out your reasons.

CHARLTONS

Best Boutique Firm 2016
Asian Legal Business Awards

This newsletter is for information purposes only.

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at unsubscribe@charltonslaw.com

Hong Kong Office
Dominion Centre
12th Floor
43-59 Queen's Road East
Hong Kong
Tel: + (852) 2905 7888
Fax: + (852) 2854 9596

www.charltonslaw.com