

Date: 28 August 2017

To: The Securities and Futures Commission
25/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

By email: ofc-consultation@sfc.hk

From: The Hong Kong Trustees' Association

Subject: **Consultation Paper on the Securities and Futures (Open-ended Fund Companies) Rules and Code on Open-ended Fund Companies ("this Consultation")**

The Hong Kong Trustees' Association ("HKTA") welcomes the SFC's consultation on the subject matter in an effort to enhance market infrastructure to further develop Hong Kong as a full-service international asset management centre and a preferred fund domicile.

As an organization that represents the trustees in Hong Kong, we wish to respond with our comments as set out in the table below. Please note that we do not have any comments on the questions which are not included in our responses below.

Please also refer to the HKTA's submission dated 25 April 2017 on Soft Consultation on OFC – Proposed OFC Rules and OFC Codes. A copy of our submission is attached for your ready reference.

Item	Key Scope of Coverage/ Questions of this Consultation	HKTA responses on behalf of the fund trustee industry
1	<u>Overall</u>	We are of the view that the respective provisions with regard to custodian and safe-keeping of fund assets under the proposed draft Code on Open-Ended Fund Companies (the proposed "OFC Code"), the Code on Unit Trusts and Mutual Funds (the "UT Code") and the enhanced Fund Manager Code of Conduct (FMCC) should be set in alignment to avoid duplication of roles and ambiguous delineation of liabilities among the Fund Manager, the Trustee, the OFC Board of Directors and the Custodian.
2	<p data-bbox="432 576 994 639"><u>Section II - B. Instrument of Incorporation and legal capacity of an OFC (paragraphs 36 to 43)</u></p> <p data-bbox="432 687 994 783">Q3. Do you have any views on the proposals regarding the instrument of incorporation and the legal capacity of an OFC?</p> <p data-bbox="432 871 994 935"><u>Appendix B – Proposed draft of the OFC Code</u> <u>Chapter 7: Custodian and custody of assets</u></p>	<p data-bbox="1012 687 1935 855">It is set out in paragraph 39 of this Consultation that an OFC may amend its instrument of incorporation where the shareholders' approval has been obtained or where the custodian has certified the immateriality of the change or the necessity to comply with applicable statutory or regulatory requirements.</p> <p data-bbox="1012 903 1935 1007">We consider that the proposal to allow for changes to be made to the instrument of incorporation with merely a custodian's certification would not be appropriate because:</p> <ul data-bbox="1057 1054 1935 1334" style="list-style-type: none"> <li data-bbox="1057 1054 1935 1334">□ this contradicts with paragraphs 66 to 68 of this Consultation as well as Chapter 7.3 of the proposed OFC Code that the duties of a custodian would only be (i) to hold in its custody all assets entrusted to it or maintain a record of all other assets of which the OFC which by their nature cannot be held in custody; (ii) to ensure proper segregation and safekeeping of the OFC's assets; and (iii) to exercise due care in the selection, appointment and mentoring of its delegates, including sub-custodians; and

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	<p><u>C. General principles for the OFC and its key operators (clause 44-46)</u></p> <p>Q4. What are your views on the proposed General Principles in the draft OFC Code as outlined above? Are there any other areas which you think the General Principles should cover?</p> <p><u>Appendix B – Proposed draft of the OFC Code Chapter 3: General Principles</u></p>	<p><input type="checkbox"/> it is confusing the role and responsibilities of a custodian with that of a trustee for a unit trust. Whilst Chapter 6.7 of the Code on Unit Trust and Mutual Funds in the SFC Products Handbook allows the trustee to sign off on such changes to the trust deed, it is the actually the fiduciary duty of the trustee which permits the trustee to provide such certification. In the context of an OFC, such fiduciary duty would rest with the directors of the OFC as specified in paragraph 53 of this Consultation.</p> <p>For the above reasons, we consider that the directors of the OFC, rather than the custodian, would have the duty and be in the best position to provide such certification when the instrument of incorporation would need to be amended.</p> <p>Under the proposed General Principles (GP 6 Regulatory compliance), the OFC and its key operators (i.e. directors, investment manager and custodian) have the obligation to inform the SFC promptly of any material breach of the OFC Code. To avoid a situation where the same breach is reported to the SFC by various parties and, given directors of an OFC have a fiduciary duty, it is suggested that the breach reporting requirement applies to the OFC and its directors and not to other key operators.</p>
3	<p><u>Section II - D. Key Operators (paragraphs 47 to 70)</u></p> <p>Q5. Do you have any comments on the</p>	<p>Refer to (a) Chapter 1.7 of the proposed OFC Code, “Public OFCs and their key operators are also required to comply with all applicable requirements in the SFC Products Handbook”, where the key operators include the OFC</p>

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	<p>propose requirements as to the eligibility, appointment and removal, and duties of the key operators of an OFC?</p> <p><u>Appendix B – Proposed draft of the OFC Code</u> <u>Chapter 1: Introduction and administrative matters</u> <u>Chapter 6: Investment manager</u> <u>Chapter 7: Custodian and custody of assets</u></p>	<p>custodian, and (b) Chapter 4.5 of the UT code of the SFC Products Handbook (i.e. the general obligations of trustee/custodian).</p> <p>In light of this, we would like to clarify whether the OFC custodian is required to comply with the general obligations as stipulated in Chapter 4.5(b) –(g) of the UT Code, on top of the responsibility of the safe-keeping of the asset under Chapter 7.3 of the proposed OFC Code.</p> <p>According to paragraphs 25(c) and 53 of this Consultation, directors owe the OFC to which they are appointed a fiduciary and the duty to exercise reasonable care, skill and diligence. As a result, we believe that the general obligations imposed on trustee / custodian under the SFC Code on Unit Trusts and Mutual Funds (which are largely fiduciary duties to the unit trusts and mutual funds), should be the responsibility by the directors of an OFC. There might also be practical difficulties to impose similar fiduciary duties on a custodian given its duty is largely related to the segregation and safekeeping of the OFC’s assets according to paragraphs 66 to 68 of this consultation and Chapter 7.3 of the proposed OFC Code.</p> <p>It is also suggested that more clarity be provided on which part of the SFC Products Handbook is applicable to an OFC and the corresponding responsible party.</p> <p><u>Directors</u></p> <p>Pursuant to our responses to Question 3 and 4 above, we suggest that paragraph 53 on the duties of directors of an OFC as well as Chapter 5 of the proposed OFC Code should be expanded to include the following:</p> <ul style="list-style-type: none"> <input type="checkbox"/> elaborate on the fiduciary duty of the directors; and

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		<p data-bbox="1066 261 1944 400">□ include as the directors' duty to certify the immateriality of the change or the necessity to comply with applicable statutory or regulatory requirements in respect of the instrument of incorporation of the OFC.</p> <p data-bbox="1021 445 1146 472"><u>Custodian</u></p> <p data-bbox="1021 517 1133 544"><u>Eligibility</u></p> <p data-bbox="1021 555 1944 655">Referring to paragraph 63 of this Consultation, it is stated that eligibility requirements for the custodian be essentially the same as those applicable to custodians of SFC-authorized funds in the SFC Products Handbook.</p> <p data-bbox="1021 702 1944 841">Accordingly, we would expect that a trust company registered under Part VIII of the Trustee Ordinance as per UT Code 4.2 (c) which meets relevant capital and internal control requirements will also be eligible to act as Custodian of an OFC. We would be grateful if the SFC could clarify and confirm.</p> <p data-bbox="1021 885 1102 912"><u>Duties</u></p> <p data-bbox="1021 924 1944 1168">We are generally in agreement with paragraphs 66 to 68 as well as Chapter 7.3 of the proposed OFC Code that the duties of a custodian would be (i) to hold in its custody all assets entrusted to it or maintain a record of all other assets of the OFC which by their nature cannot be held in custody; (ii) to ensure proper segregation and safekeeping of the OFC's assets; and (iii) to exercise due care in the selection, appointment and mentoring of its delegates, including sub-custodians.</p> <p data-bbox="1021 1214 1944 1315">However, in relation to Chapter 7.3(a) of the proposed OFC Code, we suggest that the following enhancements could be introduced such that it is in line with international practices:</p>

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		<ul style="list-style-type: none"> <li data-bbox="1059 264 1946 660"> <input type="checkbox"/> in relation to assets which are capable to be held in the custody as set out in Chapter 7.3(a)(i) of the proposed OFC Code, the types of assets should be limited to: <ol style="list-style-type: none"> <li data-bbox="1149 376 1946 440">1. Materialised financial instruments which are physically delivered to the custodian, and <li data-bbox="1149 448 1946 660">2. Dematerialised financial instruments that are capable of being registered or held in a securities account directly or indirectly in the name of a custodian, a sub-custodian or the fund, such as securities and money market instruments dealt in regulated markets and recorded on the books of Central Securities Depositories operating as a Securities Settlement System. <li data-bbox="1059 708 1946 1318"> <input type="checkbox"/> in relation to all other assets of the OFC which by their nature cannot be held in custody in the account of the OFC in the custodian's books as set out in Chapter 7.3(a)(ii) of the proposed OFC Code, the custodian should only be responsible for maintaining a record of such non-custodied assets of the OFC to the extent that the Investment Manager has provided the relevant instruction and information in a timely manner. This is because the Investment Manager in such cases will be positioned to have the necessary information as the counterparty to a bilateral transaction in furtherance of their investment management strategy on behalf of the OFC, and because these OFC assets are likely to be in the nature of contract rights (e.g., derivatives, loans and similar rights) rather than property rights which are capable of being held in custody. Therefore, the Investment Manager should have the primary responsibility for ensuring the OFC's ownership rights over such assets together with the onward provision of information to the custodian necessary to record them in a timely and accurate manner.

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		<p data-bbox="1016 293 1279 320"><u>Investment Manager</u></p> <p data-bbox="1016 363 1951 507">Pursuant to our suggestions on the duties of the custodian, we would recommend that the duties of the investment manager as set out in Chapter 6 of the proposed OFC Code should also include, but not be limited to, the following:</p> <ul data-bbox="1061 550 1951 1134" style="list-style-type: none"> <li data-bbox="1061 550 1951 655">□ reviewing and agreeing to the fees, services, terms and conditions of the contract/agreement with the agent/counterparties taking into consideration the interest of the OFC/investors; <li data-bbox="1061 699 1951 767">□ the selection, appointment and on-going monitoring of the suitability of these agents/counterparties; <li data-bbox="1061 810 1951 954">□ arranging/putting in place appropriate measures to ensure that proper and up-to-date records of all non-custodided assets of the OFC are maintained which should include verification of ownership and frequent reconciliations; and <li data-bbox="1061 997 1951 1134">□ putting in place appropriate measures to ensure all instructions and relevant information related to the OFC’s non-custodised assets are sent to the custodian on a timely manner so as to ensure the effectiveness of Chapter 7.3(a)(ii) of the proposed OFC Code.
4.	<u>Section II – H. Auditors and financial reports (Paragraphs 81 to 87)</u>	We are generally in agreement with the proposed requirements regarding the financial reports of an OFC. However, in respect of the proposed section

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	<p>Q10. Do you agree with the proposed requirements regarding the financial reports of an OFC?</p> <p><u>Appendix A – Proposed draft of the OFC Rules</u> <u>Part 7 Financial Statements and Financial Reports</u> <u>Division 1 – Financial Year (Paragraph 149)</u></p>	<p>149(2) of the proposed OFC Rules in which it has been suggested that the directors should only shorten or extend the accounting reference period of an OFC after consulting the auditors and the custodian, we consider that consultation should only be conducted by the auditor only and not by the custodian as this would be inconsistent with the duties of a custodian as set out in paragraphs 66 to 68 as well as Chapter 7.3 of the proposed OFC Code.</p>
5	<p><u>Section II – K. Termination and winding-up (Paragraphs 94 to 103)</u></p> <p>Q13. What are your views on the proposed requirements and steps for termination by application to the SFC?</p> <p><u>Appendix A – Proposed draft of the OFC Rules</u> <u>Part 11 Winding Up of Open-ended Fund Companies</u> <u>Division 2 – Modifications (Paragraph 176)</u></p>	<p>Refer to paragraph 176 of the proposed OFC Rule, “A petition for winding up of an open-ended fund company may be presented by the custodian of the company as well as any of the parties...”, we would like to clarify the obligation of the OFC custodian in case the OFC custodian is confirmed to be responsible for safe-keeping of the asset only. Any parties, such as creditors or independent directors of the OFC, can also present a petition for winding up of the OFC. As such, what additional duty is expected of the OFC custodian in this regard?</p>

If the SFC has further queries or wishes to discuss the submission with the HKTA, please contact
and
Thank you.