



**SECURITIES AND FUTURES COMMISSION**  
證券及期貨事務監察委員會

**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**

November 2017



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## Foreword

On 23 November 2016, the Securities and Futures Commission (**SFC**) issued a Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency (**Consultation Paper**). This paper summarises the comments received on the Consultation Paper, provides the SFC's responses to the feedback and also further consults the public on proposed disclosure requirements applicable to discretionary accounts.

Market participants and interested parties are invited to submit written comments on the further consultation or to comment on related matters that might have a significant impact upon the proposals by no later than 15 January 2018. Any person wishing to comment on the proposals on behalf of an organisation should provide details of the organisation whose views they represent.

**Please note that the names of the commentators and the contents of their submissions may be published on the SFC's website and in other documents to be published by the SFC. In this connection, please read the Personal Information Collection Statement attached to this paper.**

**You may not wish your name and/or submission to be published by the SFC. If this is the case, please state that you wish your name and/or submission to be withheld from publication when you make your submission.**

Written comments may be sent as follows:

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

Re: Further Consultation on Proposed Disclosure  
Requirements Applicable to Discretionary Accounts

By fax to: (852) 2284-4660

By online submission at: [www.sfc.hk/edistributionWeb/gateway/EN/consultation/](http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/)

By e-mail to: [Discretionaryaccounts\\_Disclosure@sfc.hk](mailto:Discretionaryaccounts_Disclosure@sfc.hk)

All submissions received during the consultation period will be taken into account before the proposals are finalised and a consultation conclusions paper will be published in due course.

Securities and Futures Commission  
Hong Kong

16 November 2017



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  - (c) for research and statistical purposes; or
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<sup>2</sup> The term "relevant provisions" is defined in section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571) and refers to the provisions of that Ordinance together with certain provisions in the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Companies Ordinance (Cap. 622) and the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Cap. 615).



## Enquiries

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The Data Privacy Officer  
Securities and Futures Commission  
35/F Cheung Kong Center  
2 Queen's Road Central  
Hong Kong

7. A copy of the Privacy Policy Statement adopted by the SFC is available upon request.



## Executive summary

1. On 23 November 2016, the Securities and Futures Commission (**SFC**) issued a Consultation Paper (**Consultation Paper**) on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency inviting public comments on proposed amendments to (a) the Fund Manager Code of Conduct (**FMCC**) and (b) the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (**Code of Conduct**) (collectively, the **Proposals**). These Proposals were made with a view to enhancing asset management regulation in light of international regulatory developments and point-of-sale transparency to better address potential conflicts of interest in the sale of investment products.
2. The consultation ended on 22 February 2017. The SFC received 38 written submissions, including from asset management firms, various industry associations, asset management service providers, law firms and individuals. A list of respondents (other than those who requested anonymity) is set out in **Appendix D**.
3. A majority of the respondents supported the Proposals, agreeing that they would strengthen Hong Kong's position as a leading asset management centre and are broadly in line with regulations in comparable international markets. The key comments received focused on inducements / commissions and on the scope of application of the FMCC. Other comments mainly sought clarification of various technical issues.
4. The SFC further met with relevant industry stakeholders in June 2017 to discuss issues raised in their submissions and to better understand their comments.
5. For the reasons set out below, and having regard to the majority support for the Proposals, the SFC has adopted the Proposals and the proposed amendments to the FMCC and Code of Conduct, with certain modifications or clarification of the regulatory intent as set out in this paper. We will also provide further guidance to the industry by way of a set of Frequently Asked Questions (FAQs), which will be updated from time to time.
6. The SFC is conducting a further consultation on the disclosure requirements applicable to discretionary accounts under the Code of Conduct, which is set out in Part III of this paper. The indicative draft of the corresponding proposed amendments to the Code of Conduct is set out in **Appendix C**.

### Key comments on proposals to enhance asset management regulation in the FMCC

7. While respondents generally agreed that some of the proposed enhancements to the FMCC should only be applicable to those fund managers responsible for the overall operation of a fund, many sought clarification of when a fund manager would be regarded as being "responsible for the overall operation" of the fund. In particular, some had concerns about the concept of "de facto control" proposed to be introduced into the FMCC.
8. In view of the comments received, we have provided further clarification on the concept of "*fund manager who is responsible for the overall operation of a fund*" and have removed the references to the concept of "de facto control" in the revised FMCC.



9. Some modifications have also been made to the revised FMCC including in the areas of custodian / safe custody of fund assets and disclosure requirements for securities lending and repurchase agreements (repos).
10. Details of the major comments received and our responses are set out in Part I of this paper.

#### Key comments on proposals to enhance point-of-sale transparency in the Code of Conduct

11. Respondents generally agreed that Hong Kong is not yet ready to adopt a pay-for-advice model (i.e. banning of commissions) at this juncture and supported the proposed two-pronged approach to address the conflicts of interest arising from intermediaries receiving benefits from other parties in the sale of investment products. Accordingly, the SFC will adopt this approach.
12. However, the consultation feedback did point out that these enhancements may not serve to achieve other stated objectives, such as facilitating competition and driving down fees. In particular, the enhanced disclosure of trailer fees would not serve to drive down retail fees significantly, unless non-bank sales channels such as online platforms and independent financial advisers can operate at scale.
13. The SFC has been monitoring measures taken in some overseas jurisdictions, over and above disclosure of commissions, to address conflicts of interest and incentives in order to further reduce the risk of mis-selling investment products. We will therefore keep under active consideration the merits of pay-for-advice models taking into account local and international market and regulatory developments. In this connection, we will closely monitor the impact of the new measures governing independence and disclosure of trailer fees and commissions, as well as the growth of online distribution and advisory platforms. These may have a material effect on distribution channels, access to advice and fee structures. We will also continue thematic inspections of the selling practices of licensed corporations.
14. A majority of the respondents agreed with the proposal to restrict intermediaries from representing themselves as being “independent” if they receive monetary benefits from other parties and to require disclosure of their independence or non-independence. In light of the comments received, we have fine-tuned the definition of “independence” and have also provided more guidance to clarify this concept.
15. A majority of the respondents supported the proposal to enhance point-of-sale disclosure to increase transparency. However, some respondents were of the view that enhanced disclosure may not be sufficiently meaningful to investors to justify the increased burden on the industry. There were also diverse views on the suggested manner of disclosure. Respondents either supported the proposed disclosure of a range or a maximum percentage but many industry representatives did not support the proposed disclosure of a maximum dollar amount given the practical difficulties and costs involved in implementation.
16. On balance, taking into account the potential burden on the industry and the potential benefits to investors, we consider that disclosure of the maximum percentage receivable should achieve the objective of highlighting distributors’ potential conflicts of interest. We have modified the amendments to the Code of Conduct accordingly.



17. Details of the major comments received and our responses are set out in Part II of this paper.

#### Implementation

18. The marked-up texts of the amendments to the FMCC and Code of Conduct are set out in **Appendix A** and **Appendix B** respectively.
19. To allow the industry reasonable time to implement the necessary operational and system changes to comply with the enhanced requirements, the amendments to the FMCC will become effective 12 months from the gazettal of the revised FMCC. In view of the simplified disclosure requirements, the amendments to the Code of Conduct will become effective nine months from the gazettal of the amendments to the Code of Conduct.
20. We would like to thank all respondents for their time and effort in reviewing the Proposals and for their detailed and thoughtful comments.
21. The Consultation Paper, the responses (other than those from respondents who requested they be withheld from publication) and this paper are available on the SFC website at [www.sfc.hk](http://www.sfc.hk).





## Part I - Fund manager conduct

### Section 1 – Key proposals in the FMCC

22. This section discusses the major comments received on the key proposals to enhance asset management regulation in the FMCC, namely (1) the scope of application of the FMCC; (2) securities lending and repos; (3) custodian / safe custody of fund assets; (4) liquidity risk management; and (5) disclosure of leverage, along with the SFC's response.

#### I. Persons to whom the FMCC applies

##### (a) Discretionary accounts

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?

##### *Public comments*

23. There was broad support for the proposed clarification given the similarity between the business activities of fund management and discretionary account management. Some respondents, notwithstanding their agreement with the proposed clarification, commented that some of the requirements may not be applicable to discretionary account managers. A few respondents disagreed with the proposed clarification in view of the operational differences between the management of funds and discretionary accounts, especially for those discretionary accounts operating within private banks. Their concerns were mainly about (i) the selection and appointment of a custodian where the discretionary account client has selected and appointed its own custodian; and (ii) liquidity management where the discretionary account manager has agreed an investment mandate with its client or the client has selected a pre-defined model investment portfolio.

##### *The SFC's response*

24. The SFC appreciates the operational differences between the management of funds and discretionary accounts. However, the SFC also recognises that the investment management functions performed by discretionary account managers and fund managers, ie, the aspects covered by the FMCC, are largely similar.
25. In view of the above, the SFC has already made clear in the introductory paragraph of Appendix 1 to the FMCC that discretionary account managers should observe the principles and requirements applicable to fund managers more generally to the extent relevant to the functions and powers of the discretionary account manager.
26. To address concerns about the selection and appointment of a custodian, the SFC reiterates that where a discretionary account client has selected and appointed its own custodian and the discretionary account manager is not involved in this process, the discretionary account manager will not be required to observe the relevant principles and requirements.



27. Regarding liquidity management, the SFC acknowledges that discretionary account managers typically either establish a bespoke investment mandate with their clients or manage the accounts based on a pre-defined model investment portfolio selected by their clients. However, this should not affect the need for discretionary account managers to integrate liquidity management in investment decisions or to regularly assess the liquidity of the assets held in discretionary client accounts. Moreover, it is important that other liquidity management principles should apply subject to the capital withdrawal policy agreed with the client.

**(b) Fund managers responsible for the overall operation of a fund**

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.

*Public comments*

28. A majority of the respondents agreed with the approach that some of the proposed enhancements to the FMCC should only be applicable to those fund managers responsible for the overall operation of a fund or that have de facto control of the oversight or operation of the fund. In this connection, respondents sought clarification of when a fund manager would be regarded as being “responsible for the overall operation” or having “de facto control of the oversight or operation” of a fund.
29. Some respondents, while agreeing with the proposed approach, were of the view that the concept of “having de facto control of the oversight or operation of a fund” failed to recognise the significant role played by the governing body of the fund (for example the board of directors of a corporate fund, the trustee of a unit trust or the general partner of a limited partnership).
30. In the context of a corporate fund, the board of directors has the primary responsibility for overseeing the management of the fund from a corporate law perspective and also owes fiduciary duties to fund investors. Although the board may delegate certain matters to the fund manager, it is still legally required to exercise oversight of matters relating to the fund. Respondents also stressed that fund managers do not have the power to override decisions made by the governing body.
31. To determine whether a fund manager is responsible for the overall operation of a fund or has de facto control of the oversight or operation of a fund, a respondent suggested that the SFC should adopt a facts-based review of a fund’s governance structure and the actual relationship between a fund and its fund manager and/or third parties.
32. A few respondents disagreed with the example provided in the Consultation Paper that a fund manager may be considered to have de facto control of the oversight or operation of a fund where its representatives and/or representatives of its affiliate(s) constitute a majority of the fund’s board of directors. For example, in the case of an offshore fund, while the board of the fund would normally consist of representatives of



the parent offshore management company (ie, an *affiliate* of the Hong Kong fund manager), the Hong Kong fund manager is a delegated manager and would not have the power to control or influence its parent company.

*The SFC's response*

33. The SFC has engaged with relevant industry associations to better understand their concerns and the roles played by all relevant parties in the operation of a fund.

*Governance structures and parties involved in a fund's operation*

34. It was pointed out that where a fund is initiated and set up by a fund manager, the fund manager would typically be heavily involved in the fund's establishment, for example, in approaching and choosing directors for the board, selecting the trustee for a fund or recommending the custodian to be appointed.
35. For funds in corporate form, representatives of the fund manager may not constitute a majority of the fund's board. The board may consist of external parties such as lawyers and other independent directors.
36. Once the fund has been set up, the fund manager's role will focus mainly on day-to-day operations and investment management. For major issues such as pricing errors and fair valuations, the fund manager would likely need to make recommendations or proposals to the board on how such issues should be dealt with. The board, as the governing body, can decide against a recommendation of the fund manager and has final decision-making power.
37. For funds adopting a unit trust structure, the fund manager would typically need to seek the agreement of the trustee on important matters.
38. Where a fund manager is only appointed as a sub-advisor or a sub-manager, the fund manager will likely only be involved in day-to-day management of the portion of the fund that has been delegated to it.

*De facto control*

39. The SFC recognizes the role that the governing body of a fund plays in the operation of a fund. However, given the important role played by a fund manager in the day-to-day investment management of fund assets and the duties it owes to the fund and fund investors, we expect that fund managers should use due skill, care and diligence to comply with the requirements in the FMCC to the extent this is within the fund manager's control.
40. By introducing the concept of "de facto control", we do not disregard the function of a fund's governing body. However, although a fund manager may not be formally responsible for making decisions, it may still in substance be responsible for the overall operation of a fund, and therefore should be subject to the relevant requirements in the FMCC. A fact-based review should identify who, in substance, is responsible for the overall operation of the fund.
41. We also received feedback that the concept of "de facto control" may have legal connotations in the context of a regulatory code which does not itself have the force of law.



42. We have no intention to give any legal effect to the “de facto control” concept. Therefore, references to “having de facto control of the oversight or operation of a fund” will be removed from the final revisions to the FMCC. Accordingly, the relevant proposed enhancements to the FMCC would be applicable only to fund managers that are “responsible for the overall operation of a fund”, which is in line with relevant IOSCO principles.
43. We nevertheless stress that the intended scope of a “fund manager that is responsible for the overall operation of the fund” remains unchanged. A fund manager would not be able to cite the existence of a governing body to conclude that it is not “responsible for the overall operation of the fund” just because it does not formally make final decisions or enter into legal agreements.

#### Further guidance

44. The SFC will issue further FAQs from time to time to illustrate when a fund manager may be considered to be “responsible for the overall operation of a fund”.
45. In the Consultation Paper we suggested that a fund manager would have “de facto control” where representatives of its affiliates constitute a majority of the board of a fund. The SFC agrees that a fund manager may not always have control over its affiliates, especially where the affiliate is its parent company or a sister company. We have revised the example such that where the representatives of the fund manager or its subsidiaries constitute a majority of the fund board, then the fund manager may be considered to be responsible for the overall operation of the fund.

### **(c) Implications for offshore and private funds**

#### *Public comments*

46. Clarification was sought as to whether FMCC requirements would have extra-territorial application to overseas fund managers. It was asked whether the delegation of certain functions to Hong Kong fund managers by overseas fund managers would result in the overseas fund managers having to comply with the FMCC. There were concerns that the proposed requirements may deter delegation because overseas fund managers could become subject to additional or conflicting regulations after taking into account those applicable in their home jurisdictions.
47. Some respondents were of the view that some of the proposed requirements may have fund-level implications, and hence would blur the differences between public and private funds. Further, there were views that the proposed enhancements may conflict with fund-level requirements in offshore jurisdictions.
48. In this connection, a few respondents requested the SFC to provide “carve-outs” for Hong Kong fund managers that are investment managers of offshore funds. Such “carve-outs” were requested for US 1940 Act funds, Undertakings for the Collective Investment of Transferable Securities (**UCITS**) funds and other overseas-regulated funds. There were also comments that the proposed disclosure and reporting requirements should not apply to private funds as private funds come in a wide variety of forms, invest in a wide variety of asset classes, adopt a wide variety of investment strategies and target a different investor base from public funds.



49. Finally, respondents also suggested that the requirements should be relaxed for offshore or private funds as they are sold to professional investors who do not need the level of protection expected in the case of retail investors.

*The SFC's response*

50. As set out in the Introduction to the FMCC, the FMCC sets out conduct requirements for, and applies to, only persons licensed by or registered with the SFC.
51. The primary focus of the proposed enhancements is on asset management activities and the conduct of fund managers. The proposals aim to reflect the latest international benchmarks concerning the conduct of fund managers issued by the International Organization of Securities Commissions (**IOSCO**), the Financial Stability Board (**FSB**) and other international expectations to ensure Hong Kong has a robust regulatory regime that is in line with international regulatory developments.
52. As noted in the Consultation Paper, the international benchmarks on which our proposals are based do not distinguish between public and private funds. Similarly, the regulated activity of “asset management” under the Securities and Futures Ordinance (**SFO**) does not make a distinction between whether a licensed or registered fund manager is managing a public fund or a private fund.
53. The SFC has engaged in further discussions with industry associations to understand how any of the proposed requirements may conflict with fund-level requirements in offshore jurisdictions or those imposed by other regulatory regimes.
54. The main concern seems to centre on where a Hong Kong fund manager acts only as a sub-manager or sub-advisor of an offshore fund. The question is whether the Hong Kong fund manager would be deemed to have de facto control of the offshore fund on the basis that representatives of its affiliates (eg, its parent offshore management company) constitute a majority of the fund’s board of directors. The Hong Kong fund manager would need to ensure that the parent offshore management company would also comply with the FMCC in managing and operating the offshore fund, notwithstanding that any conduct and fund-level requirements of the offshore jurisdiction would apply to the offshore management company and the offshore fund.
55. The SFC believes that the clarification in paragraph 45 adequately addresses this concern.

**(d) Other comments**

*Public comments*

56. Respondents queried whether there may be conflicts between the requirements imposed on mandatory provident fund (**MPF**) schemes in Hong Kong and the proposed enhancements to the FMCC. A respondent suggested a “carve-out” be provided for fund managers when managing MPF schemes. However, no specific conflicting requirements were identified.
57. Comments that there may be conflicts between the requirements of the FMCC and other SFC codes and guidelines were also received. Clarification was sought on whether the requirements of an activity-specific code (such as the FMCC) would prevail over the requirements of a code of general application (such as the Code of Conduct).



Respondents were also of the view that the requirements under the SFC's Code on Unit Trusts and Mutual Funds (**UT Code**) should prevail over the requirements under the FMCC.

*The SFC's response*

58. The proposed enhancements to the FMCC are principles-based and generally in line with IOSCO and FSB recommendations. It therefore seems unlikely that the requirements would conflict with other applicable laws, regulations and codes, especially those relating to different subjects. As set out in the Introduction to the FMCC, in the unlikely event of any inconsistency between any legislation, other applicable codes and guidelines, the more stringent provision will apply.
59. We also sought further information from the industry on how any of the proposed enhancements may conflict with requirements imposed by other applicable laws, regulations and codes. No specific conflicts were revealed.

## **II. Securities lending and repos**

### **(a) Scope of the application of the enhanced requirements**

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?

*Public comments*

60. Many respondents supported the proposals. A respondent commented that the proposals are in line with regulations in the United Kingdom and European Union (**EU**). One respondent disagreed that the proposals should apply to fund managers of funds which are beneficial owners in lending activities.
61. Respondents also sought various clarifications. For example, it was asked whether the proposals would apply to a fund manager that lends securities through third-party lending agents (eg, the fund manager does not operate the lending program but receives part of the lending fees) and further, whether the fund manager is required to ensure that the third-party lending agent complies with the FMCC requirements. During discussions with the industry, the question was asked whether the proposed securities lending and repo requirements would apply to hedge fund managers that borrow securities from prime brokers rather than engage in lending activities.
62. A discretionary account manager's role may be limited to providing assistance to the client and its custodian in order to facilitate the client's securities lending arrangements with third parties. The SFC's clarification was sought as to whether the discretionary account manager would be considered to be "engaging in" securities lending.

*The SFC's response*

63. As set out in the introductory paragraph of the "Securities Lending" section of the FMCC in Appendix A to the Consultation Paper, the requirements for securities lending and



repos are applicable to fund managers that engage in securities lending, repo and similar OTC transactions on behalf of the funds managed by them. Where a fund manager decides that securities lending should be a fund activity, or is materially involved in determining a securities lending mandate or in actual lending activities, then the fund manager would be considered to be engaging in such transactions.

64. The proposed securities lending and repo requirements were designed to apply to a fund manager that engages in activities on behalf of a fund managed by it, and is not limited in application to a fund manager that is responsible for the overall operation of a fund. This is in line with FSB recommendations. We also note that in practice, any fund manager (ie, not only the fund manager that is responsible for the overall operation of a fund) may engage in such activities.
65. If a third party (eg, a prime broker or custodian) is engaged, the fund manager is expected to act with due skill, care and diligence in the selection, appointment and ongoing monitoring of the third party. This would include being satisfied that the third party's policies and procedures are consistent with the FMCC.
66. In this connection, we take this opportunity to clarify the general application of the FMCC to the outsourcing of a fund manager's functions. Many comments were received on this topic. Fund managers are expected to exercise due skill, care and diligence in the selection and appointment of third-party delegates, and where functions are delegated to third parties, there should be ongoing monitoring of the competence of delegates to ensure that the principles of the FMCC are followed.
67. For hedge fund managers that mainly borrow securities from prime brokers rather than engage in lending activities, whether the proposed securities lending and repo requirements apply would depend on the nature of the transactions. This is because the requirements not only cover stock lending but also repo and reverse repo transactions and the key focus of these requirements is to govern how fund managers manage the collateral received as a result of these transactions.
68. Discretionary account managers that do not have any authority under an investment mandate to use securities lending and repos on behalf of a client, or are not materially involved in determining the securities lending mandate for a client generally would not fall within the scope of the requirements.

## **(b) Other comments on the application of the enhanced requirements**

### *Public comments*

69. A few respondents commented that where a fund manager engages in securities lending but is not responsible for the overall operation of the fund and is not the fund's securities lending agent, the fund manager may not be able to ensure the board of directors or trustee would receive information on the fund's securities lending activities from third party-securities lending agents.
70. Another respondent suggested that the SFC should introduce a "substituted compliance" mechanism for SFC-authorized UCITS funds in relation to securities lending and repo requirements, provided that the fund manager is in compliance with the relevant UCITS requirements.



71. Some respondents sought clarification of the term “similar over-the-counter (**OTC**) transactions” and asked the SFC to provide examples of similar OTC transactions.

*The SFC’s response*

72. The SFC is of the view that a fund manager that engages in securities lending but is not responsible for the overall operation of the fund would still be in a position to receive information from third-party agents. This view was supported by some respondents. We would expect the fund manager to ensure that adequate arrangements are in place to enable it to access the relevant information.
73. Regarding the proposed requirement to disclose a summary of the securities lending, repo and reverse repo transactions policy and the risk management policy, we will now specify that disclosure is to be made to fund investors but will not need to be made in the fund’s offering documents.
74. Regarding the suggestion for carve-outs for UCITS funds, it is relevant that we have not specified any particular limits or numerical haircuts that should apply. We understand that while these types of specific requirements may be prescribed under the UCITS framework, it should be in line with relevant FSB recommendations on which the proposed requirements are also based. We are not aware of any examples where compliance with the FMCC requirements would result in inconsistencies or non-compliance with UCITS requirements. We are of the view that carve-outs for UCITS funds are unnecessary.
75. In respect of the term “similar OTC transactions”, the intention was to cover other types of securities financing transactions which achieve a similar economic effect as securities lending and repo transactions. However, as the relevant FSB recommendations do not make any reference to “similar OTC transactions” other than reverse repos, we will replace references to “similar OTC transactions” with references to reverse repo transactions.

**(c) Haircut policy and haircut methodologies**

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?

*Public comments*

76. Most respondents did not provide any particular view on whether haircut methodologies should reflect FSB recommendations but a few respondents suggested that the SFC should consider providing flexibility so that fund managers are free to design their own haircut methodologies.

*The SFC’s response*

77. The SFC expects that the fund manager has in place a haircut policy to properly manage counterparty risk arising from engaging in securities lending, repo and reverse repo transactions on behalf of the fund it manages. The fund manager should have a properly designed methodology to calculate haircuts on collateral received. We will not prescribe numerical haircut floors. Fund managers therefore have the flexibility to





design their own haircut methodologies, as long as they are consistent with FSB recommendations. We have set out certain FSB recommendations in relation to the design of a haircut methodology in Appendix C to the Consultation Paper.

78. Similarly, where third-party agents are engaged, the fund manager should be satisfied that the third party's haircut policy and methodologies are consistent with the requirements of the FMCC.

#### **(d) Non-cash collateral re-hypothecation**

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.

##### *Public comments*

79. A majority of the respondents agreed that disclosing details of re-hypothecation of collateral, for example, non-cash collateral re-use arrangements, and related risks would be sufficient. Respondents also sought guidance on the method, format and frequency of disclosure, and whether disclosure can be made on a "request" basis. One respondent disagreed that these disclosures should be made to investors as sophisticated investors would ask for the details if needed, and unsophisticated investors would be unlikely to understand or be confused.

##### *The SFC's response*

80. We will require fund managers to disclose re-use and re-hypothecation data to investors as items for disclosure under the overall requirement to report information relating to securities lending, repo and reverse repo transactions to fund investors discussed in more detail in paragraphs 81 to 86.

#### **(e) Reporting to fund investors**

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?

##### *Public comments*

81. While some respondents supported reporting to fund investors, several respondents were of the view that the proposed minimum disclosure requirements set out in Appendix C to the Consultation Paper are too prescriptive and onerous, and suggested adopting a principles-based approach to allow fund managers the flexibility to decide the information to be disclosed. Two respondents were further of the view that such information is confidential and commercially sensitive and disclosure would be detrimental to fund managers.
82. Two respondents suggested that the SFC's proposed disclosure requirements should be aligned with EU's regulation on Transparency of Securities Financing Transactions and Reuse (**SFTR**) for consistency and operational efficiency as many global fund managers have taken steps to ensure compliance with the SFTR. Although supporting



the requirement to report to fund investors, a few respondents requested that the disclosure be made on a “request” basis.

83. A few respondents reiterated the view that private funds should not be subject to disclosure standards applicable to public funds.

#### *The SFC’s response*

84. As stated in the Consultation Paper, we propose to adopt relevant FSB recommendations to address shadow banking risks in securities lending and repos in the funds sector. The FSB recommends that information on securities lending and repo activities be frequently disclosed in order to allow investors to select their investments with due consideration of the risks taken by fund managers. The FSB further recommends the specific information that should be reported by fund managers to investors. This is set out in Appendix C to the Consultation Paper.
85. We have also taken into account the EU regulations on SFTR. A few items for disclosure which are recommended by the FSB are not included in the EU regulations. Hence, we have aligned the disclosure requirements with the relevant FSB recommendations which have now been set out in the FMCC. We will require that disclosure be made at least annually by fund managers that are responsible for the overall operation of a fund. Fund managers should refer to the SFC’s website for any further guidance or updates which may reference future international regulatory expectations.
86. The disclosure requirements reflect FSB recommendations. These do not distinguish between public and private funds.

### **III. Custodian / safe custody of fund assets**

Question 7: Do you have any comments on the above proposals regarding custodian and safe custody of fund assets?

#### *Public comments*

87. A majority of the respondents agreed with our proposals in principle. However, respondents were nevertheless concerned that the proposals may blur roles and responsibilities.
88. In many cases a fund manager does not actually appoint custodians and therefore does not have a direct contractual relationship with the custodian. For a fund adopting a unit trust structure, the custodian is appointed by the trustee. For a corporate fund, the custodian is appointed by the board of directors.
89. For SFC-authorized funds structured in unit trust form, the UT Code and related FAQs impose obligations on trustees to (i) exercise reasonable care and diligence in the selection, appointment and ongoing monitoring of its nominees, agents and delegates (such as custodians); and (ii) be satisfied that the nominees, agents and delegates retained remain suitably qualified and competent to provide the relevant service. Hence, a few respondents wanted to clarify whether the proposals would impose new obligations on the fund manager with regard to appointing and monitoring of custodians.



90. While agreeing that fund managers generally perform a monitoring function over custodians, respondents commented that such an obligation should be subject to a “reasonable basis” or “reasonable efforts” standard.
91. In the context of discretionary account management within a bank, some respondents pointed out that the custodian is typically the bank itself or the bank’s affiliates. A respondent asked whether such an arrangement would satisfy the “functionally independent” criterion. One respondent further noted that in another overseas jurisdiction, a trustee would not be considered independent if the fund manager had a 20 percent or more interest in the shares of the trustee and vice versa.

*The SFC’s response*

92. Where a fund is initiated and set up by a fund manager, the fund manager would typically be heavily involved in fund establishment, including recommending a custodian or selecting a trustee. Hence, some industry participants considered it would be important to distinguish between the act of appointment (which is within the powers of the governing body) and the act of selecting or recommending a custodian for appointment.
93. The proposals focus on the role of the fund manager that is responsible for the overall operation of a fund in selecting and arranging for the appointment of the custodian. We will retain our original proposal with revisions to the FMCC to clarify that the relevant provisions are applicable to fund managers that are responsible for the overall operation of funds even though they may not be the party which formally appoints custodians.
94. It was also acknowledged that where a fund manager is responsible for the overall operation of a fund, it generally performs a monitoring function over service providers including custodians. Fund managers should therefore be able to fulfil the proposed requirements including the requirement to exercise due skill, care and diligence in the selection and on-going monitoring of the custodian.
95. In the context of funds adopting a unit trust structure, the fund manager that is responsible for the overall operation of a fund should act with due skill, care and diligence in the selection and appointment (where applicable) of the trustee and the ongoing monitoring of the trustee’s performance of its custodial functions. As part of its selection process for the trustee, the fund manager should consider whether the trustee would exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of a custodian. We have also clarified in the revised FMCC that where a fund adopts a unit trust structure, the reference to a custody agreement should be read as a reference to the trust deed.
96. In relation to “functional independence”, we are of the view that a custodian may be functionally independent notwithstanding that it is within the same group. To be considered functionally independent, there should be policies, procedures and internal controls in place to ensure that the persons fulfilling the function of safekeeping of assets are independent from the persons performing the investment management function.



## IV. Liquidity risk management

### (a) Enhanced requirements on liquidity risk management

Question 8: Do you have any comments on the above proposals regarding liquidity risk management?

#### *Public comments*

97. Those who responded to this question generally agreed with our overall proposals in relation to liquidity risk management. A few respondents commented that fund managers should be given the discretion to decide which funds require regular stress testing. The extent and frequency of stress testing should also be left for the fund manager to decide.
98. One respondent also commented that even if a fund manager is responsible for managing liquidity risk, it should not be deemed to be a fund manager that is “responsible for the overall operation of the fund” by that reason alone.

#### *The SFC’s response*

99. As stated in the Consultation Paper, although liquidity risk management is a particular concern for open-ended funds, our proposals are also relevant to closed-ended funds (for example, sources of liquidity risk may include margin calls for derivatives and other financing obligations).
100. This view was further reiterated in IOSCO’s latest consultation on the topic, the *Consultation on CIS Liquidity Risk Management Recommendations*<sup>3</sup>. The paper noted that the IOSCO *Principles of Liquidity Risk Management for Collective Investment Schemes*<sup>4</sup>, on which our proposals were based, are relevant to closed-ended funds, and fund managers responsible for the overall operation of such funds should consider which principles are relevant.
101. The SFC expects that a fund manager of any type of fund should adopt a proportionate approach to liquidity management and consider the extent of the applicability of the proposed liquidity risk management requirements to the funds it manages and ensure that its activities are commensurate with the liquidity profiles of those funds.
102. In addition, our view is that a fund manager should perform liquidity stress testing on its funds on an ongoing basis to assess the impact of plausible severe adverse changes in market conditions. In adopting a proportionate approach, the extent or frequency of the testing may vary, depending on the nature and liquidity profile of each fund, by taking into consideration, for example, whether it is an exchange-traded fund or closed-ended fund, as well as the availability of appropriate liquidity management tools.
103. While all fund managers should establish, implement and maintain liquidity risk management policies and procedures, fund managers will not be deemed to be responsible for the overall operation of a fund simply by virtue of its responsibility in managing liquidity risk.

<sup>3</sup> Consultation on CIS Liquidity Risk Management Recommendations, IOSCO, July 2017

<sup>4</sup> Principles of Liquidity Risk Management for Collective Investment Schemes, IOSCO, March 2013



104. The proposed requirement to disclose the liquidity risks involved in investing in a fund, the liquidity management policies and an explanation of any tools or exceptional measures that could affect redemption rights will now specify that disclosure can be made in the fund's offering documents or otherwise made freely available to fund investors.

#### **(b) Liquidity risk measures**

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?

##### *Public comments*

105. A few respondents commented that setting liquidity targets is too prescriptive. As funds differ based on their investment strategies or liquidity profiles, the SFC should not require fund managers to set liquidity targets for all funds. While supporting the idea that fund managers should set liquidity targets, some respondents were of the view that the SFC should not define what the liquidity targets should be.

##### *The SFC's response*

106. We wish to clarify that our proposals are principles-based such that fund managers have the flexibility to exercise professional judgement to decide whether to set liquidity targets for the funds they manage. In this connection, it should be noted that SFC-authorized funds are subject to additional requirements<sup>5</sup>.
107. As noted in paragraph 100 above, IOSCO has recently published a consultation on the liquidity risk management of funds<sup>6</sup>. The SFC will continue to keep in view international regulatory developments in this area and review our regulations where appropriate.

## **V. Disclosure of leverage**

### **(a) Disclosure of maximum leverage**

Question 10: Do you consider it appropriate for Fund Managers to disclose the maximum leverage of the fund it manages to fund investors?

##### *Public comments*

108. A majority of the respondents agreed with our proposal to disclose maximum leverage to fund investors. A few respondents disagreed and were of the view that leverage disclosure is too complicated for retail or unsophisticated investors to understand and would lead to confusion. There were also comments that generic disclosure of leverage and its potential risks is likely to be more useful.

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<sup>5</sup> Circular to management companies of SFC-authorized funds on liquidity risk management issued, SFC, 4 July 2016

<sup>6</sup> Consultation on CIS Liquidity Risk Management Recommendations, IOSCO, July 2017. The consultation ended on 18 September 2017 but conclusions to the consultation have not been issued by IOSCO as at the date of this paper.



109. A few respondents who agreed with the proposals in principle suggested that average leverage or expected leverage should be disclosed as disclosure of maximum leverage may be misleading and would impose disproportionate or burdensome obligations on fund managers to monitor leverage to comply with a “hard cap”. Comments were also made to the effect that private funds should be given discretion to disclosure.

*The SFC’s response*

110. The SFC is of the view that disclosure of leverage is key information that should be provided to investors. Disclosure of the expected maximum leverage to be employed by the fund manager can achieve this purpose. Fund managers should ensure that the disclosure is arrived at based on a reasonable and prudent calculation methodology and that the disclosure is fair and not materially misleading.
111. As set out in the Consultation Paper, the SFC notes that leverage is a key piece of information for investors in private funds. Therefore, the SFC believes that in practice there should not be any major difficulty for fund managers to comply with this disclosure requirement.

**(b) Calculation of leverage**

Question 11: Do you have any comments on how leverage should be calculated?

*Public comments*

112. There were diverging views from those respondents who commented on how leverage should be calculated. Some referred to the leverage calculation required by the Alternative Investment Fund Managers Directive (**AIFMD**) or UCITS’ commitment method. Other respondents suggested gross leverage based on a risk weighted exposure relative to the NAV of the fund and net leverage. There were also respondents who urged the SFC not to require the disclosure of leverage until IOSCO has developed consistent measures of leverage.

*The SFC’s response*

113. As set out in the Consultation Paper, the SFC recognises that there is currently no general consensus on how leverage should be calculated. Accordingly, the SFC does not propose to prescribe the method for calculating leverage at this stage. A fund manager should take into account its investor base when disclosing the relevant calculation methodology such that it is easy for its investors to understand, and clearly explain and prominently disclose the basis of calculation which should be reasonable and prudent. The SFC will continue to keep in view the international regulatory developments in this area, and review our regulations where appropriate.



## Section 2 - Other amendments

Question 12: Do you have any comments on the other amendments proposed to the FMCC?

### I. Fund portfolio valuation

#### *Public comments*

114. A few respondents commented that different valuation models or policies may be adopted for different funds managed by the same manager. For example, an open-ended fund may have a different valuation policy for certain hard-to-value assets from that of a closed-ended private equity fund, and different funds have their own objectives, risk levels and policies which are set out in fund offering documents. As such, they disagreed with the requirement that valuation methodologies be consistently applied to the valuation of assets across all the funds managed by a fund manager.
115. Some respondents requested that the SFC clarify who should be the competent and functionally independent party to review the valuation policies, procedures and process. They asked whether a professional firm, pricing committee or the auditor—as part of the annual fund audit—would suffice.
116. A comment was received suggesting that the SFC should clarify that independence in the valuation process does not relieve a fund manager from the responsibility to estimate fair value.
117. One respondent also highlighted that the reference to qualified accountants in determining fair value should be removed as valuations should be performed by valuation specialists (appraisers), which are not limited to accountants or auditors.

#### *The SFC's response*

118. We have revised the FMCC to require fund managers to ensure that valuation methodologies are consistently applied to the valuation of similar types of fund assets.
119. In relation to the identity of the functionally independent party for the review of the valuation policies, procedures and process, an internal auditor that is functionally independent from the valuation team or an external auditor would be considered to be appropriate.
120. Regarding the comment that a fund manager should not be relieved of the responsibility to estimate fair value notwithstanding that it has delegated the valuation function, we would like to emphasize that the FMCC requires a fund manager to exercise due skill, care and diligence in the selection and appointment of third-party delegates. There should be ongoing monitoring of the competence of delegates to ensure that the principles of the FMCC are followed.
121. In relation to the reference to qualified accountants in the FMCC, we have now revised the FMCC to refer to a “suitably qualified person” to align with the terminology used elsewhere in the relevant paragraph.



## II. Miscellaneous amendments

### (a) House orders

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?

#### *Public comments*

122. An industry association commented that brokers may combine trades executed by clients with house orders because this may work in the client's favour where favourable terms are offered for larger trade orders. Another respondent supported the proposed additional requirement that "aggregation of house orders with client orders should only be made if it is in the best interests of clients".
123. One respondent did not agree that an institutional professional investor should be able to request pro rata allocation of aggregated but partially filled orders on such investor's terms as the institutional investor itself has a fiduciary obligation to treat all customers fairly.

#### *The SFC's response*

124. Since the existing FMCC requirement about client priority in the allocation of aggregated and partially filled orders has not given rise to major operational difficulties, this approach should continue to be adopted as a general practice. The SFC acknowledges that an institutional professional investor may request a different allocation priority, in which case the fund manager should be able to make pro rata allocation for aggregated but partially filled orders as requested.

### (b) Risk-management control techniques

Question 14: Do you have any comments on the suggested risk-management control techniques and procedures as set out in Appendix 2?

#### *Public comments*

125. A majority of the respondents agreed with the proposals. It was suggested that the use of ex-ante tracking error as a measure of market risk be added. Another respondent commented that it was highly unlikely that transition plans would ever be implemented because, historically, fund managers do not fail.





#### *The SFC's response*

126. The SFC understands that risk controls depend on the type and nature of the fund. Fund managers should exercise professional judgement about which control techniques are appropriate for the funds they manage.

#### **(c) Other comments**

##### *Public comments*

127. Respondents pointed out that a strict functional separation between the investment decision-making process and the dealing process might not be possible in all cases.
128. Regarding the identification, reporting and rectification of non-compliance matters in paragraph 3.15 of the FMCC, respondents sought clarification as to whether those matters to be reported are limited to non-compliance with SFC codes and regulations, and whether passive breaches need to be reported.
129. Clarification was sought as to whether the requirements governing the setting up and managing of side pockets only applied to a fund manager that is responsible for the overall operation of a fund.

#### *The SFC's response*

130. The investment decision-making process and the dealing process need not be strictly separated if it is not reasonably practicable in light of the small size of the fund manager or the nature of the investments. For example, in private equity investments, the legal and economic terms of the investment are often an integral part of the investment decision-making process.
131. In relation to non-compliance matters, the requirement is to identify, report and remedy *material* non-compliance (emphasis added). These are not limited to non-compliance with SFC codes and regulations.
132. The requirements governing disclosure of side pocket arrangements apply to a fund manager that is responsible for the overall operation of a fund while the requirements governing the setting up and managing of side pockets apply to any fund manager that is responsible for that activity.

### **III. Appendix 1 to the FMCC – Requirements for licensed or registered persons conducting discretionary accounts management**

Question 15: Do you have any comments on the requirements set out in Appendix 1?

##### *Public comments*

133. Some of the respondents considered that the requirements set out in Appendix 1 are reasonable and in line with general industry practice and standards.
134. Regarding the minimum content of discretionary client agreements, a few respondents suggested grandfathering agreements signed before the effective date of the revised



FMCC to avoid lengthy negotiation with existing clients. A few other respondents considered it unnecessary to mandate the terms of discretionary client agreements. One pointed out that some clients may wish to adopt their own standard investment management agreement for increased contractual protection.

135. One respondent suggested not to mandate “consent from the client” in discretionary client agreements for managers to receive soft commissions or retain cash rebates as the manager may only decide to receive or retain these after signing the agreement.
136. Some respondents pointed out that not all discretionary client agreements would set out an agreed performance benchmark. Some other respondents wished to clarify how a discretionary account manager should review the performance of an account which is not subject to an agreed performance benchmark.

#### *The SFC’s response*

137. The SFC is of the view that grandfathering existing discretionary client agreements should not be necessary given that (i) the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (Internal Control Guidelines) require discretionary account managers to execute a discretionary account agreement which sets out the investment objectives and strategies of the client; and (ii) the 12-month transition period set out in paragraph 143 should allow sufficient time for discretionary account managers to negotiate any necessary changes with their clients.
138. The SFC appreciates that certain clients may negotiate their own investment management agreements. However, as these should provide protection over and above the minimum content of discretionary account agreements, this should be the basis on which clients may add further terms and conditions.
139. Client consent for receipt of soft commissions or retention of cash rebates is an existing requirement under paragraphs 13.1 and 13.2 of the Code of Conduct. Consent may be provided in an addendum to the client agreement.
140. Given that not all discretionary client agreements refer to an agreed performance benchmark, we agree to amend the minimum content of discretionary client agreements to only require the setting out of a performance benchmark if the client’s mandate provides for this. A discretionary account manager should assess the performance of a discretionary account against any previously agreed benchmark. In cases where there is no previously agreed benchmark, the discretionary account manager should determine an appropriate performance indicator based on the client’s investment objectives.

#### **IV. Transition period**

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.



*Public comments*

141. A majority of the respondents commented that a 12-month transition period would be more appropriate as it would take time for a fund manager to amend its offering documentation to ensure compliance. One respondent stated that fund managers may need to renegotiate custodial arrangements.
142. Respondents also noted that discretionary account client agreements or investment mandates may need to be renegotiated with existing clients.

*The SFC's response*

143. We will allow a 12-month transition period before the amendments to the FMCC take effect following the gazettal of the final form of the revised FMCC.



## Part II - Intermediaries Conduct

### I. Inducements / commissions

#### (a) Adoption of a pay-for-advice model

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?

#### *Public comments*

144. Among those who responded, a majority agreed that Hong Kong is not yet ready for a pay-for-advice model (ie, banning commissions) at this juncture. A few respondents were concerned that a pay-for-advice model could result in the emergence of an advice gap. One respondent strongly felt that a pay-for-advice model would have severe unintended consequences. Other respondents were of the view that more investor education would be needed before a pay-for-advice model could be adopted. The respondents who were not supportive of a pay-for-advice model were generally supportive of adopting the proposals in the Consultation Paper.
145. A respondent who was supportive of the proposals nevertheless suggested that the SFC consider how the total cost of advice or commissions paid by the client or a third party as well as product costs can be disclosed in a single comparable figure. The respondent also suggested that the SFC should also focus on enhancing the transparency of the overall value for money clients receive.
146. Respondents who supported the pay-for-advice model were of the view that it has less inherent biases and conflicts of interest and that it better aligns the interests of investors and intermediaries. A few respondents suggested that the SFC consider adopting a phased approach by first enhancing transparency and education for investors followed by introducing a pay-for-advice model.
147. A respondent was of the view that a pay-for-advice model would increase product access and competition, increase cost transparency and would allow investors to identify clearly the cost of services they pay for. They would be in a better position to compare products. To tackle any advice gap that might emerge, the respondent asked the SFC to explore the establishment of affordable product advisory and distribution channels such as an exchange-based channel for the distribution of funds. Another respondent suggested that the SFC should consider measures which will lead to a major shift in the market towards competition in the quality of advisory services.
148. A few respondents commented that investors should be given a choice as to whether to pay for advice.

#### *The SFC's response*

149. For the reasons set out in the Consultation Paper, we believe that the proposed approach to disclosure and independence would be more appropriate under Hong Kong's current market conditions. In particular, as pay-for-advice is still uncommon among investors in Hong Kong, an advice gap could develop if we changed the model.



The SFC will therefore adopt the two-pronged approach put forward in the Consultation Paper. The recent enhancements to intermediaries' selling practices, such as the new client agreement clause to require intermediaries to ensure the suitability of any solicited or recommended investment product as well as our clarification of and guidance on the suitability requirement<sup>7</sup>, also complement our proposals.

150. However, the consultation feedback did point out that the enhancements to point-of-sale transparency may not serve to achieve other stated objectives, such as facilitating competition and driving down fees.
151. The SFC has been monitoring the measures taken in some overseas jurisdictions over and above disclosure of commissions, to address conflicts of interest and incentives in order to further reduce the risk of mis-selling investment products. We will therefore keep under active consideration the merits of pay-for-advice models taking into account local and international market and regulatory developments. In this connection, we will closely monitor the impact of the new measures governing independence and disclosure of trailer fees and commissions, as well as the growth of online distribution and advisory platforms. These may have a material effect on distribution channels, access to advice and fee structures. We will also continue our thematic inspections of the selling practices of licensed corporations. Please also refer to paragraphs 201-206 below.

**(b) Restriction on the use of the term “independent”**

Question 18: Do you have any comments on the proposed disclosure requirement in relation to independence set out above?

***“Links or other legal or economic relationships”***

*Public comments*

152. A majority of the respondents agreed with the proposed disclosure requirement concerning independence. Several respondents sought clarification of the meaning of “links or other legal or economic relationships” with product issuers.
153. Some respondents commented that intra-group entities may act independently despite the group relationship and the proposed language should reflect this.

*The SFC's response*

154. The SFC wishes to emphasize that “links or other legal or economic relationships” with product issuers would not themselves render an intermediary “non-independent”. The key is whether such links or other legal or economic relationships are likely to impair the independence of the intermediary to favour a particular investment product, a class of investment products or a product issuer (emphasis added). The assessment of independence is principles-based and is dependent on the facts and circumstances of the links or other legal or economic relationship.

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<sup>7</sup> For example, we issued two circulars in December 2016, providing updated guidance in relation to discharging the suitability requirement, clarifying the scope of its application and providing guidance and illustrations of whether the suitability requirement would be triggered under certain scenarios. We also issued a Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms in May 2017.



155. We have now emphasized in the revised Code of Conduct that the “links” should be “close links”, and have provided further guidance by referring to the “controlling entity relationship” concept in the SFO. This covers group affiliates.
156. We will provide more guidance on what may amount to “other legal or economic relationships” by means of FAQs.

### ***Receipt of monetary benefits***

#### *Public comments*

157. A respondent disagreed that the receipt of monetary benefits from third parties would undermine an intermediary’s ability to act independently of the third party. The respondent was of the view that intermediaries are required to act in the best interests of clients which would require that they are not unduly influenced by third party remuneration. In light of the various conduct requirements already imposed on intermediaries, the respondent considered that conflicts of interest arising from third-party remuneration should not affect the objectivity of any advice provided by an intermediary.

#### *The SFC’s response*

158. If fees, commission or any other monetary benefits are received by a distributor from a third party for distributing an investment product, it is the SFC’s view that such monetary benefits give rise to inherent conflicts of interest that are likely to undermine the independence of the distributor, notwithstanding any other applicable conduct requirements.
159. Where a distributor is remunerated for selling a particular issuer’s products or for meeting a specified sales target set by the product issuer, such arrangements are also considered as likely to undermine independence. As such, the distributor cannot represent itself as being independent.

### ***Receipt of non-monetary benefits***

#### *Public comments*

160. Another respondent asked whether non-monetary benefits, such as professional service support and product training provided by product issuers, would render the intermediary “non-independent”.

#### *The SFC’s response*

161. Non-monetary benefits may impair an intermediary’s independence, depending on the facts and circumstances of each case. We have revised the Code of Conduct to clarify that whether non-monetary benefits would render an intermediary “non-independent” would depend on whether they are likely to impair the independence of the intermediary to favour a particular investment product, a class of investment products or a product issuer.



## ***Disclosure of non-independence and one-off disclosure***

### *Public comments*

162. Some respondents asked the SFC to require non-independent intermediaries to identify themselves as non-independent while others were of the view that only intermediaries claiming to be independent should be required to make the relevant disclosures. A few respondents also sought clarification of whether the relevant disclosures could be made on a one-off basis. It was also suggested that disclosure should be made at the earliest opportunity and not just “prior to or at the point of entering into the transaction”.
163. One respondent suggested it should be mandatory for intermediaries to provide a description of the links or other legal or economic relationships with product issuers which render them non-independent.

### *The SFC’s response*

164. Under our proposal, an intermediary is required to provide clear disclosure of whether or not it is independent and the bases for such determination (emphasis added). This means that non-independent intermediaries must disclose to clients the fact that they are non-independent and why (eg, because they receive fees, commissions, or other monetary benefits from other parties distributing investment products).
165. The objectives of the proposed disclosure were to ensure that only truly independent intermediaries could represent themselves as being independent, and to increase transparency to investors. The disclosure would also enable investors to understand why an intermediary is not independent when deciding whether to engage the services of the intermediary. Intermediaries can decide whether to provide a description of the links or other legal or economic relationships with product issuers which render them non-independent.
166. The proposal is to make, at a minimum, a one-off disclosure prior to or at the point of entering into a transaction, but intermediaries must inform clients of any changes. The disclosure of the changes could take the form of an update, or a specific disclosure for each transaction where there is a change from the one-off disclosure.

## **(c) Enhancing disclosure**

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?



## ***Rationale for enhancing disclosure***

### *Public comments*

167. A majority of the respondents supported enhancing point-of-sale disclosure to increase transparency. A few respondents opposed the proposals and commented that the amount of trailer fees paid to a distributor will not have any direct impact on investors as the total amount of management fees paid by investors would be unaffected. Many were of the view that enhanced disclosure may not result in driving down trailer fees, and even if trailer fees were driven down, it may be unlikely that management fees would be reduced. It was also pointed out that fees are primarily determined by the volume of business which can be generated, and that pricing dynamics are complex. One respondent believed, however, that the disclosure of the contractual arrangements between product issuers and intermediaries would result in fierce competition in the industry.
168. Some respondents felt that the proposed disclosure is overly complicated, onerous and unjustified from a cost/benefit standpoint. There were also concerns about the confidentiality of commercial terms in distribution agreements.
169. A few respondents commented that disclosure of the maximum dollar amount may be misleading as it may never be reached in practice. There would also be practical difficulties and cost implications in calculating the maximum dollar amount for intermediaries which distribute a large number of funds. One respondent commented that the maximum dollar amount may mislead investors as it is based on overly simple assumptions.

### *The SFC's response*

170. The objective of enhancing disclosure requirements is to enable investors to make better informed decisions. Increased transparency makes it easier to detect potential conflicts of interest. It also facilitates comparison of the fees received by different intermediaries. We hope that increased transparency encourages investors to seek quality advice and services, facilitates competition and even drives down some fees.

## ***Manner of disclosure***

### *Public comments*

171. A respondent was of the view that the disclosure should be made at the earliest opportunity and not just "prior to or at the point of entering into the transaction". Similarly, another respondent commented that the Code of Conduct should establish fee bands (eg, high, medium or low) and intermediaries be required to disclose which fee band they would fall into before there is a client relationship. Respondents commented that in addition to the current proposed disclosure, distributors should disclose in the client account statements the actual amount of monetary benefits received or receivable by the distributor once these benefits become quantifiable, and another respondent further suggested that intermediaries should also disclose in the client account statements the cumulative monetary benefits received.
172. A few respondents suggested that disclosure of a percentage range alone would be sufficient as it would address the conflicts of interest whilst being easy to implement.





However, one commented that disclosure of a percentage range could increase the complexity of the decision-making-process for investors.

173. As trailer fees are generally received by intermediaries from fund houses on an aggregate basis and not on a per-fund basis, it was also suggested that disclosure on an aggregate basis be allowed. Two respondents suggested that disclosure of the maximum percentage alone would be sufficient as it already provides an indication of the maximum extent of any conflict of interest.
174. We also received comments that disclosure of the maximum dollar amount on an annualised basis may not be suitable for structured products as the tenor may be shorter than twelve months.

#### *The SFC's response*

175. On balance, taking into account the potential burden for the industry and the potential meaningfulness of enhanced disclosure for investors, we consider that disclosure of the maximum percentage receivable should achieve the main objective to highlight to investors any distributor's potential conflict of interest. The disclosure would need to be made prior to or at the point of entering into the transaction.
176. We have revised the Code of Conduct accordingly. In the case of trailer fees, the maximum percentage of the management fees receivable as per the distribution agreement with the product issuer should be disclosed. Intermediaries may comply with this requirement by disclosing the range of trailer fees receivable on an annualized basis as long as the maximum percentage receivable is disclosed in each case.
177. We also received feedback that intermediaries should be allowed to choose to disclose trailer fees receivable in dollar amounts. Intermediaries may provide such additional information. However, if they choose to do so, the maximum dollar amount receivable per year based on the assumptions as set out in the Consultation Paper should be disclosed. This is to ensure disclosure is fair and comparable for investors. We will also provide guidance in FAQs.
178. In response to the comment about short tenor-products, the SFC believes that standardised disclosure of an annualised amount would facilitate easy comparison of fees received by different intermediaries. In any event, intermediaries are required to make adequate disclosure to clients of relevant material information and hence will have clearly informed the client of the tenor of the specific product.
179. Set out below is a sample disclosure to illustrate the final proposal using trailer fees:

<b>Name of Fund</b>	<b>Ongoing commission / monetary benefits from product issuer</b>
Fund A	We will receive from [ <i>the product issuer's name</i> ] up to 60% of Fund A's annual management fees as ongoing commission every year throughout the term of your investment.



## ***Application of the enhanced disclosure requirements***

### *Public comments*

180. Clarification was sought as to whether disclosure should be made on an individual fund basis and whether disclosure on an individual share class basis was required.
181. A question was also raised about a global fund where an overseas fund manager appoints a regional distributor, which then shares the regional distribution fees with a local distributor. The local distributor, may be an associate of the regional distributor. In such circumstances, the question was whether the local distributor could disclose the range and maximum dollar amount on a pro-rata basis, or rather would the disclosure need to also include the percentage and amount receivable by its associate (the regional distributor).
182. A respondent asked how the disclosure requirements would apply where there were no trailer fee arrangements, for example, where the intermediary and the fund house are affiliates.
183. A few respondents noted that non-quantifiable monetary benefits could also be received for the distribution of other investment products in addition to funds, for example, structured products and bonds (where distributors may receive a rebate from issuers that may be calculated based on the total amount distributed) and asked how the enhanced disclosure requirements would apply to such products. Another respondent stated that in addition to trailer fees, distributors may receive minimum service fees for distribution, and asked how the proposed disclosure requirements would apply.
184. Finally, some respondents sought clarification on the expected disclosure requirements for clients with discretionary accounts.

### *The SFC's response*

185. Enhanced disclosure is imposed on distributors which directly deal with clients. Disclosure should be made on an individual fund basis, but is not required to be made on an individual share class basis.
186. A local distributor should disclose the distribution fees receivable by the regional distributor who is an associate of the local distributor irrespective of whether the regional distributor shares fees with the local distributor. The local distributor can disclose further information (such as the actual amount of monetary benefits it has received in the past 12 months, or the fact that the maximum percentage disclosed is the percentage receivable by the regional distributor), provided that the further disclosure is accurate and not misleading.
187. Where there are no trailer fee arrangements, for example, where the intermediary and the fund house are affiliates, we have clarified that the non-quantifiable monetary benefits to be disclosed are those receivable from a product issuer (directly or indirectly) for distributing an investment product in line with paragraph 8.3(a)(i) of the Code of Conduct.
188. We expect that any monetary benefits receivable directly or indirectly for distributing an investment product should be disclosed. For example, financial advisers receiving



trailer fee rebates from distribution platforms in the sale of funds would be required to disclose such rebates as they are indirectly funded by the product issuer.

189. We are of the view that the revised wording of the Code of Conduct should be sufficiently broad to cover the different fee arrangements for the distribution of products other than funds. For example, where a distributor receives a fee from the product issuer based on an agreed percentage of the total amount of bonds or structured products sold, then the maximum percentage receivable should be disclosed.
190. The disclosure requirement would also apply to other non-quantifiable monetary benefits that are receivable for the distribution of funds in addition to trailer fees. For instance, some distributors may receive volume-based service fees for distribution. In such cases, the maximum percentage and the basis of such fees should be disclosed.
191. Finally, in relation to the disclosure of monetary benefits for clients of discretionary accounts, please refer to Part III (Further consultation on disclosure requirements applicable to discretionary accounts) in this paper.

#### **(d) General**

##### *Public comments*

192. A number of respondents agreed that the SFC should implement an education programme to enhance investors' understanding of the new disclosures, in particular, the significance of an intermediary being "non-independent" and how the various fees and costs may have an impact on their investments.
193. A few respondents were concerned about the possibility of regulatory arbitrage between the sale of securities products, banking products, insurance products and pension products and suggested that the SFC ensures a consistent approach across all regulators in Hong Kong.
194. One respondent sought clarification of how the requirement to disclose independence would apply to intermediaries working in both the securities and insurance sectors and whether an "independent" insurance broker could continue to represent itself as independent or as providing independent insurance advice.
195. Respondents also asked whether the proposed requirements under the Code of Conduct would apply to MPF intermediaries and whether intermediaries serving professional investors would need to make disclosures pursuant to paragraph 8.3A of the Code of Conduct.

##### *The SFC's response*

196. The SFC will work with the Investor Education Centre (**IEC**) on educational materials to enhance investors' understanding of the new disclosures and related matters such as the concept of trailer fees and fee structures for different products, as well as to educate investors to be alert to issues such as the churning of managed investments.
197. Regulations applicable to different types of products may not necessarily be aligned due to their different natures, market functions and regulatory regimes. The SFC has maintained close dialogue with fellow regulators when formulating these proposals and will continue to do so following implementation.



198. All SFC licensees are required to comply with the SFC's requirements when carrying on regulated activities under the SFO. They should therefore ensure that they accurately represent their independence or non-independence in their dealings with clients (eg, clients of their securities businesses) regardless of any other business being carried on.
199. As regards the application of the Code of Conduct to MPF intermediaries, it should be noted that it only applies to persons licensed by or registered with the SFC. The conduct of MPF intermediaries when conducting MPF business is thus not subject to the Code of Conduct.
200. Finally, an exemption from compliance with the proposed disclosure requirements is available for professional investors pursuant to paragraph 15 of the Code of Conduct.

#### **(e) Outlook**

201. As mentioned above, consultation feedback pointed out that our proposals may not serve to achieve some of the objectives of enhancing point-of-sale transparency, such as facilitating competition and driving down fees. In particular, enhanced disclosure of trailer fees may not drive down retail fees significantly, unless non-bank sales channels such as online platforms and independent financial advisers are able to operate at sufficient scale.
202. One respondent suggested that the SFC should also focus on enhancing the transparency of the overall value for money clients receive. This has also become an area of focus for the Financial Conduct Authority and was discussed in its Asset Management Market Study Final Report<sup>8</sup>. Another respondent suggested the SFC should consider measures that will lead to a major shift in the market towards competition on the quality of advisory services.
203. Fund sales in Hong Kong are currently highly concentrated through a few major banks. Trailing commissions and distribution costs tend to be high compared to other leading markets. A concentrated distribution channel may also limit the choice of funds for investors and represent a high entry barrier for new fund managers and their products. Together with relatively low investor awareness of costs and fees, this may not encourage significant industry competition.
204. To strengthen Hong Kong as a leading asset management centre and in line with international regulatory developments, the SFC will continue its efforts to achieve better investor outcomes. This will include keeping under active consideration the merits of pay-for-advice models. We will continue to closely monitor local and international market and regulatory developments, including the evolution of pay-for-advice models overseas.
205. In addition, to facilitate the development of online platforms to broaden distribution channels, the SFC will shortly provide specific guidance on their design and operation<sup>9</sup>. It is hoped that these platforms will afford investors greater choice, facilitate competition in the quality of services and reduce fees.

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<sup>8</sup> Asset Management Market Study Final Report, UK Financial Conduct Authority, June 2017

<sup>9</sup> Please see the SFC's Consultation Paper on the Proposed Guidelines on Online Distribution and Advisory Platforms published in May 2017. The consultation period ended on 4 August 2017.



206. Drawing on overseas experience, we will also examine the feasibility of introducing “clean share classes” (ie, free of commission). The SFC will engage the industry when formulating any further policy initiatives. In addition, we will continue to conduct thematic inspections on the selling practices of licensed corporations.

## II. Transition period

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.

### *Public comments*

207. While a few respondents agreed with our proposed six-month transition period, a majority of respondents suggested a transition period of 12 months, and two respondents suggested 18 to 24 months. Most respondents stated that a longer period is needed as intermediaries need to enhance their systems and arrange operational support. Extra time to amend counterparty contracts, client agreements and marketing materials may be necessary.

### *The SFC’s response*

208. We have simplified the proposed disclosure requirements. However, the industry will require a reasonable period to enhance their systems and conduct training to comply with the new disclosure requirements. The SFC therefore will allow a nine-month transition period following the gazettal of the final form of the amendments to the Code of Conduct.

## Conclusion and way forward

209. The SFC will proceed to implement the Proposals with the modifications and clarifications set out in this paper. Marked-up versions of the amendments to the FMCC and the Code of Conduct together with minor amendments for greater clarity and consistency are set out at **Appendices A and B** to this paper.
210. The amendments to the Code of Conduct will be adopted and become effective nine months from the gazettal of the amendments. The amendments to the FMCC will become effective 12 months following the gazettal of the final form of the revised FMCC.
211. The SFC would like to take this opportunity to thank all respondents for their submissions.



## Part III - Further consultation on disclosure requirements applicable to discretionary accounts

### Background

212. Some respondents enquired whether the proposed amendments to the disclosure requirement under paragraph 8.3(b)(ii) of the Code of Conduct would apply to discretionary accounts. They commented that it would be impossible to provide specific details as to the nature and amount of the monetary benefits they would receive and retain for products purchased for their clients under discretionary portfolios prior to each transaction.
213. Some intermediaries may have incentives to purchase for their clients under discretionary portfolios products which bring higher rewards or benefits to themselves. This gives rise to potential conflicts of interest.
214. In addition, if an intermediary is to receive and retain such benefits, the Commission considers that it would be helpful for clients to be made aware of this in advance in order to facilitate their choice of discretionary account manager.

### Proposal

215. We propose the following disclosure options for discretionary accounts:

(A) Monetary benefits (under explicit remuneration arrangement)

(a) *Option 1 – Specific disclosure by type of investment product*

- (1) Under this option, an intermediary will disclose the maximum percentage of monetary benefits receivable by it and/or any of its associates by type of investment product.

(2) Example:

Type of investment product (non-exhaustive)	Monetary benefits receivable by the intermediary and/or its associates
Bonds	Up to 3% of the notional amount of the transaction
Funds	Initial commission rebate: Up to 2% of the subscription amount Trailer fee: Up to 60% of a fund's annual management fee

- (3) Monetary benefits include those benefits receivable by intermediaries and their associates under an explicit remuneration arrangement, including initial commission rebates and trailer fees.

(b) *Option 2 – Specific disclosure of the aggregate amount in percentage terms*

- (1) Under this option, an intermediary will disclose an estimated maximum percentage of monetary benefits receivable by it and/or any of its



associates. This is proposed to be calculated by aggregating the maximum monetary benefits receivable from each product type according to the proportion such product type represents in a client's investment portfolio.

(2) Example:

An intermediary manages for its client a discretionary portfolio which estimates to invest 40% of the portfolio in funds and 60% in bonds.

For funds, the intermediary will receive up to 2% of the subscription amount of the funds as one-off initial commission rebates as well as trailer fees of up to 60% of the funds' annual management fee (of which the maximum is 3%). The maximum percentage of monetary benefits from the funds will be 1.52% ( $=0.4 \times 2\% + 0.4 \times 60\% \times 3\%$ ).

For bonds, the intermediary will also receive up to 4% of the notional amount of the bond as its monetary benefits. The maximum percentage of monetary benefits from the bonds will be 2.4% ( $=0.6 \times 4\%$ ).

In this case, the aggregate of monetary benefits receivable under the discretionary account will be 3.92% (=Funds: 1.52% + Bonds: 2.4%).

Based on the above assumptions, an intermediary will disclose the following to its client:

Type of Service	Monetary benefits receivable by the intermediary and/or its associates
Discretionary Account	Up to 3.92% of the assets under management per year

(B) Monetary benefits (under non-explicit remuneration arrangement) and non-monetary benefits

- (1) An intermediary may purchase an in-house product for its clients. However, there may not be an explicit remuneration arrangement between the intermediary and the related product issuer. In such cases, the intermediary will be required to make a generic disclosure that it will benefit from purchasing in-house products for a client under a discretionary portfolio.
- (2) Further, where an intermediary will receive non-monetary benefits from a product issuer when purchasing an investment product for a client, it will also be required to make a similar generic disclosure.

216. All the proposed disclosures are to be made to investors at the account opening stage or prior to entering into a discretionary client agreement. The disclosure must be made in writing, electronically or otherwise.

217. In line with the existing position under the Code of Conduct, intermediaries will not be exempt from this proposed disclosure requirement with respect to clients who are



Individual Professional Investors, but may be exempt with respect to Institutional and Corporate Professional Investors.

218. The draft amendments to paragraphs 7 and 15 of the Code of Conduct to give effect to these proposals are set out in Appendix C to this paper.

**Questions:**

1. Do you have any comments on the proposed disclosure requirement in relation to monetary and non-monetary benefits for discretionary accounts set out above?
2. Do you have any comments on the suggested manner of disclosure set out above? Do you have any other suggestions to ensure the disclosure will be clear, fair, meaningful and easy to understand for investors?
3. Do you think a six-month transition period following the 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.

219. The SFC welcomes any comments from the public on the proposed disclosure requirements applicable to discretionary accounts and the indicative draft of the proposed amendments to the Code of Conduct in Appendix C to this paper. Please submit comments to the SFC in writing no later than 15 January 2018.



Final form of the amendments to the FMCC

*The highlighted parts indicate revisions to the FMCC which differ from the proposed amendments set out in the Consultation Paper*

## FUND MANAGER CODE OF CONDUCT

Second ~~Third~~ Edition  
pursuant to the Securities and Futures Ordinance (Cap. 571)

January 2014 [~~2017~~ November 2018]

Securities and Futures Commission  
Hong Kong

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# FUND MANAGER CODE OF CONDUCT

## HONG KONG

### INTRODUCTION

#### *Persons to whom this Code applies*

This Code sets out conduct requirements for persons licensed by or registered with the Securities and Futures Commission (SFC) whose business involves the ~~discretionary~~ management of collective investment schemes (whether ~~authorised~~ authorized or ~~unauthorised~~ unauthorized) and/or discretionary accounts (in the form of an investment mandate or pre-defined model portfolio) (Fund Managers). The particular Code requirements that are not applicable to and additional requirements that are applicable to licensed or registered persons conducting discretionary accounts management are set out in Appendix 1.

~~These guidelines apply~~ This Code applies to all licensed or registered persons acting as Fund Managers, including, as appropriate, their representatives. ~~To the extent that a Fund Manager is not responsible for the overall operation of a fund, or has no de facto control of the oversight or operation of the fund,~~ certain requirements (as specifically set out in this Code), however, are not only applicable to a Fund Manager that is responsible for the overall operation of a fund.

For the avoidance of doubt, all licensed or registered persons should also comply with the requirements set out in other applicable codes and guidelines in force from time to time, including the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (Internal Control Guidelines). In particular, a Fund Manager managing SFC-authorized collective investment schemes is required to comply with the relevant requirements under the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products in force from time to time.

#### *Interpretation*

For the purposes of this Code, a registered person means a “registered institution” and, except where the context otherwise requires, includes a “relevant individual” as defined in section 20(10) of the Banking Ordinance (Cap. 155), and “registered” shall be construed accordingly. A reference in this Code to “representatives” has the same meaning as section 167 of the Securities and Futures Ordinance (Cap. 571) (SFO).

Unless specified otherwise, a reference to a “fund” or “client” in this Code<sup>1</sup> is a reference to a collective investment scheme (whether authorized or unauthorized) managed by a Fund Manager and “fund investors” refers to investors as a whole of a collective investment scheme (whether authorized or unauthorized) managed by the Fund Manager.

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<sup>1</sup> Where the licensed or registered persons are conducting discretionary accounts management, the meaning of these terms are defined separately in Appendix 1.

Where a Fund Manager is a delegate of another fund manager for the management of a fund or a portfolio within a fund, a reference to its “client” in this Code is a reference to the delegating fund manager, and a reference to “fund” in this Code is a reference to the portfolio managed by the delegated Fund Manager.

#### *Purpose of this Code*

This Code aims, firstly, to supplement codes and guidelines applicable to all categories of licensed or registered person, including, for the avoidance of doubt, the Code of Conduct (including the General Principles set out therein), with guidance in respect of the minimum standards of conduct specifically applicable to Fund Managers. It does not replace any legislative provisions, codes or guidelines issued by the SFC. Secondly, it highlights certain existing requirements applicable to Fund Managers. Further reference should however be made to the legislation, other applicable codes and guidelines, and, in the case of any inconsistency, the more stringent applicable provision will be applied. This Code does not have the force of law and should not be interpreted in a way that would override the provisions of any law.

#### *Effect of breach of this Code*

Breach of any of the requirements of this Code will, in the absence of extenuating circumstances, reflect adversely on the fitness and properness of a Fund Manager and may result in disciplinary action. **When considering a person’s failure to comply with this Code, SFC staff will adopt a pragmatic approach taking into account all relevant circumstances, including the size of the ~~corporation~~ Fund Manager, and any compensatory measures implemented by its senior management.**

## I. ORGANISATION AND STRUCTURE

### 1. Organisation and Management Structure

#### *Incorporation and Registration*

- 1.1 A Fund Manager should ensure that its business is properly incorporated and that any person it employs or appoints to conduct business is properly licensed or registered in accordance with all applicable statutory requirements.

#### *Organisation and Resources*

- 1.2 A Fund Manager should maintain:

- (a) financial resources in accordance with all applicable statutory requirements;
- (b) sufficient human and technical resources and experience for the proper performance of its duties. This would be expected to vary depending on the amount of assets under management by the ~~corporation~~ Fund Manager, and the type and nature of the assets and markets in which the ~~corporation invests funds managed by the Fund Manager invest~~. The functions of within the corporation Fund Manager, including fund management, operations, compliance, risk management, valuation and audit, should only be performed by qualified and experienced persons, who should receive appropriate training on an ongoing basis;
- (c) satisfactory internal controls and written compliance procedures which address all applicable legal and regulatory requirements;
- (d) satisfactory risk management governance structure and procedures commensurate with the nature, size, complexity and risk profile of the firm and the investment strategy adopted by each of the funds under its business management; and
- (e) adequate professional indemnity insurance cover commensurate with its business.

#### *Functional Separation*

- 1.3 Where a Fund Manager ~~is itself undertaking or~~ is part of a group of companies which undertake other financial activities such as advising on corporate finance, banking or broking, it should ensure there is an effective system of functional barriers (Chinese Walls) in place to prevent the flow of information that may be confidential and/or price sensitive between the different areas of operations. There should be physical separation between the activities and the different persons it employs or appoints to conduct business unless this is ~~impossible~~ not reasonably practicable given the size of the ~~corporation~~ Fund Manager, together with written procedures to document the controls. If physical separation is ~~not reasonably practicable~~ impossible, the ~~corporation~~ Fund Manager should prohibit dealing in price sensitive or confidential information.

### *Segregation of Duties*

- 1.4 A Fund Manager should ensure that key duties and functions are appropriately segregated, unless this is not reasonably practicable impossible given the size of, or the nature of investment made by, the ~~corporation~~ Fund Manager. In particular:
- (a) front office functions (which include making investment decisions, marketing and dealing in ~~collective investment schemes~~ funds, and placing orders to deal with brokers) should be physically segregated from back office functions (which include receiving broker confirmations, settling trades, accounting and reconciliation, ~~valuing client portfolios~~ valuation and reporting to clients funds and their investors) and should be carried out by different staff with separate reporting lines;
  - (b) compliance and audit functions should, if possible, be separated from each other, and have separate reporting lines from other functions; and
  - (c) the investment decision making process should be clearly delineated from the dealing process.

*Note: A central dealing function is encouraged but is not mandatory.*

### Conflicts of interest

- 1.5 A Fund Manager should maintain and operate effective organisational and administrative arrangements with a view to taking all reasonable steps designed to identify, prevent, manage and monitor any actual or potential conflicts of interest, including conducting all transactions in good faith at arm's length and in the best interests of the fund on normal commercial terms. Where an actual or potential conflict arises, in particular, where such a conflict cannot be avoided, and provided that funds' interests can be sufficiently protected, the conflicts should be managed and minimised by appropriate safeguards and measures to ensure fair treatment of fund investors, and any material interest or conflict should properly be disclosed to fund investors.

### *Responsibilities of Management*

*“Senior management” means the Managing Director of a ~~corporation~~ Fund Manager or its Board of Directors, Chief Executive Officer or other senior operating management personnel in a position of authority over the ~~corporation's~~ Fund Manager's business decisions.*

- 1.56 The senior management of a Fund Manager should:
- (a) be principally responsible for compliance by the Fund Manager with all relevant legal and regulatory requirements ~~under this Code~~, as well as the nurturing of a good compliance culture within the ~~corporation~~ Fund Manager;
  - (b) maintain clear reporting lines with supervisory and reporting responsibilities assigned to qualified and experienced persons;

- (c) ensure that all persons performing functions on behalf of the ~~corporation~~ Fund Manager are provided adequate and up-to-date information about the ~~corporation's~~ Fund Manager's policies and procedures applicable to them; and
- (d) ensure that the performance of the ~~Fund Managers~~ in managing ~~client accounts funds (whether authorized or unauthorized)~~ is reviewed, ~~on at least an annual basis~~ annually.

### Risk Management

1.7.1 The Fund Manager should establish and maintain effective policies and procedures as well as a designated risk management function to identify and quantify the risks, whether financial or otherwise, to which the Fund Manager and, if applicable, the funds are exposed. The Fund Manager should take appropriate and timely action to contain and otherwise adequately manage such risks.

1.7.2 The Fund Manager should refer to and comply with the relevant provisions under the Internal Control Guidelines.

1.7.3 A Fund Manager should review the risk management policies and procedures with appropriate frequency and enhance such policies and procedures whenever necessary.

### Compliance

1.68.1 A Fund Manager should:

- (a) maintain an effective compliance function, including a ~~Designated Compliance Officer~~ compliance officer, within the ~~corporation~~ Fund Manager to ensure that the ~~corporation~~ Fund Manager complies with its own internal policies and procedures, and with all applicable legal and regulatory requirements, including this Code; and
- (b) ensure that the compliance function possesses the technical competence and experience necessary for the performance of its functions.

1.68.2 The compliance function and ~~Designated Compliance Officer~~ the compliance officer should be independent of other functions and report directly to the ~~corporation's~~ Fund Manager's senior management, unless this is ~~impossible~~ not reasonably practicable given the size of the ~~corporation~~ Fund Manager. Where there is no separation of functions, the ~~corporation's~~ Fund Manager's senior management should assume the role of ~~Designated Compliance Officer~~ compliance officer. Compliance activities may be delegated to an appropriately qualified professional, although the responsibility and obligations may not be delegated.

1.68.3 ~~The Designated Compliance Officer~~ There should ~~maintain~~ be sufficiently detailed compliance procedures to ~~give~~ enable senior management ~~reasonable assurance that the corporation complies~~ to comply with all applicable requirements at all times.

### *Audit*

- 1.79 Where practicable, a Fund Manager should maintain an independent and objective audit function to report on the adequacy, effectiveness and efficiency of the ~~corporation's~~ Fund Manager's management, operations and internal controls. The audit function should:
- (a) where practicable, be free from operating responsibilities, with a direct line of communication to senior management or the audit committee, as applicable;
  - (b) follow clearly defined terms of reference (including monitoring the timeliness and accuracy of other functions) which set out the scope, objectives, approach and reporting requirements;
  - (c) adequately plan, control and record all audit work performed, and record the findings, conclusions and recommendations; and
  - (d) report to senior management on all matters highlighted in the audit report, which should be resolved satisfactorily and in a timely manner.

Where the size of the ~~corporation~~ Fund Manager does not justify a separate internal audit function, the relevant roles and responsibilities should be performed or reviewed by ~~the~~ external auditors.

### *Delegation*

- 1.810 A Fund Manager should exercise due skill, care and diligence in the selection and appointment of third-party delegates. Where functions are delegated to third parties, there should be ongoing monitoring of the competence of delegates, to ensure that the principles of this Code are followed. Although the investment management role of the ~~corporation~~ Fund Manager may be sub-contracted, the responsibilities and obligations of the ~~corporation~~ Fund Manager to its clients the funds it manages may not be delegated.

### *Withdrawal from Business*

- 1.911 A Fund Manager who withdraws from business should ensure that any affected clients are promptly notified and that proper arrangements remain in place for the safekeeping of client assets. Where a ~~corporation~~ Fund Manager is being wound up, it should comply with all the applicable statutory requirements.

## **2. Staff Ethics**

### *Personal Account Dealing*

*Note: The following guidelines are intended to address the basic principles that persons engaged in fund management business, when transacting for themselves, must give ~~their clients~~ the funds managed by the Fund Manager priority and avoid conflicts of interest. In the context of these guidelines, "relevant persons" means any employees or*



directors of a Fund Manager or persons accredited to a Fund Manager for conducting regulated activities:

- who in their regular functions or duties make or participate in investment decisions, or obtain information, prior to buying or selling investments on behalf of a client fund; and/or
- whose functions relate to the making of any recommendations with respect to such buying or selling;

or any persons over whom they exercise control and influence.

As a minimum, these guidelines cover trading in ~~shares~~ securities and derivatives. Beyond this, however, the scope of investments that should be covered is not defined, as this may vary depending on the business of the ~~corporation~~ Fund Manager and the underlying investments of the funds managed by the Fund Manager. A Fund Manager is expected to define the types of investment intended to be covered, and to respect the principles outlined here.

2.1.1 A Fund Manager should ensure that it has internal rules or provisions in its contracts of employment ~~for~~ or other agreements with the relevant persons as follows:

- (a) that relevant persons are required to disclose existing holdings upon joining a Fund Manager and at least semi-annually thereafter;
- (b) that relevant persons are required to obtain prior written permission for personal account dealing from the ~~Designated Compliance Officer~~ compliance officer or other person designated by senior management. The permission should be valid for no more than ~~5~~ five trading days, and be subject to the following constraints:
  - (i) that relevant persons may not buy or sell an investment on a day in which the Fund Manager has a pending “buy” or “sell” order in the same investment until that order is executed or withdrawn;
  - (ii) that relevant persons may not buy or sell an investment for their personal account within ~~4~~ one trading day before (if the relevant person is aware of a forthcoming client fund transaction) or after trading in that investment on behalf of a client fund;
  - (iii) that relevant persons may not buy or sell an investment for their personal account within ~~4~~ one trading day before (if the relevant person is aware of a forthcoming recommendation) or after a recommendation on that investment is made or proposed by the Fund Manager;

*Note: Subject to rules being set down by the ~~Designated Compliance Officer~~ senior management, the restrictions in (ii) and (iii) above need not be applied where client fund orders have been fully executed and any conflicts of interest have been removed.*

- (iv) that cross trades between relevant persons and ~~clients~~ funds be prohibited;
  - (v) that short-selling of any securities recommended by the Fund Manager for purchase be prohibited; and
  - (vi) that relevant persons should be prohibited from participating in initial public ~~offers~~ offerings available to ~~clients of~~ funds managed by the Fund Manager or its connected persons, and should not use their positions to gain access to ~~IPO's~~ initial public offerings for themselves or any other person;
- (c) that relevant persons are required to hold all personal investments for at least 30 days, unless prior written approval of the ~~Designated Compliance Officer~~ compliance officer or other persons designated by senior management is given for an earlier disposal; and
- (d) that relevant persons are required, either:
- (i) to hold their personal accounts with the Fund Manager or a connected person and place all deals through that corporation; or
  - (ii) obtain approval from the ~~Designated Compliance Officer~~ compliance officer or other persons designated by senior management for outside broking accounts, and ensure that copies of records and statements of personal transactions entered into by them are submitted to the ~~Designated Compliance Officer~~ compliance officer or other persons designated by senior management within a defined timeframe.

2.1.2 A Fund Manager should maintain appropriate procedures to distinguish personal transactions for relevant persons from other transactions, and to ensure that such transactions are properly approved and there is an adequate audit trail of such approval and the transaction [see 5.1(a)].

2.1.3 A Fund Manager should not permit relevant persons to delay settlement of personal transactions beyond the normal settlement time for the relevant market.

2.1.4 A Fund Manager ~~who is a relevant person~~ should ~~comply~~ maintain appropriate procedures to ensure compliance with the provisions set out in 2.1.1 (a) to (d) above by all its relevant persons.

#### *Receipt or Provision of Benefits*

2.2 A Fund Manager:

- (a) should not offer or accept any inducement ~~in connection with the affairs or business of a client~~ which is likely to significantly materially conflict with the duties owed to clients;

- (b) in the case of a corporation, should maintain:
  - (i) written guidelines, including monetary limits, ~~about for the offer and acceptance by,~~ staff members and persons accredited to it for conducting regulated activities, of gifts, rebates or other benefits ~~received from clients or business contacts,~~ to give effect to (a); and
  - (ii) a register of benefits received above the specified limit.

## II. FUND MANAGEMENT

### 3. Fund Management

#### *Investment within Client Mandate*

- 3.1 A Fund Manager should ensure that transactions carried out on behalf of ~~a client~~ each fund are in accordance with the ~~portfolio's~~ fund's stated investment strategy, objectives, investment restrictions and guidelines, whether in terms of asset class, geographical spread or risk profile, as set out in the respective constitutive and/or relevant documents of the funds managed by the Fund Manager. In this connection, a Fund Manager should have in place effective and properly-implemented procedures and controls.

#### *Best Execution*

- 3.2 A Fund Manager should ~~execute client~~ ensure that fund orders are executed on the best available terms, taking into account the relevant market at the time for transactions of the kind and size concerned.

#### *Prohibition on Insider Dealing*

- 3.3 A Fund Manager should establish and maintain policies and procedures to prohibit and prevent market misconduct, including, but not limited to, insider dealing and market manipulation. In particular, it should not effect or cause to be effected any transaction based on confidential price sensitive information or when otherwise prohibited from dealing by statutory restrictions on insider dealing, and should have procedures in place to ensure that staff are aware of such restrictions.

#### *Order Allocation*

- 3.4 A Fund Manager should:
- (a) ensure that all client orders are allocated fairly;
  - (b) make a record of the intended basis of allocation before a transaction is effected; and
  - (c) ensure that an executed transaction is allocated promptly in accordance with the stated intention, except where the revised allocation does not disadvantage a client and the reasons for the re-allocation are clearly documented.

### Fund Portfolio Turnover

- 3.5 A Fund Manager should ~~not trade excessively on behalf of the client portfolio, taking~~ take into account the ~~portfolio's~~ fund's stated objectives and not trade excessively on behalf of a fund.

### Underwriting

- 3.6 Unless specifically permitted in the ~~Client Agreement or client~~ fund mandate, a Fund Manager should not participate in underwriting activities on behalf of a ~~client~~ fund. Where underwriting is undertaken on behalf of a ~~client~~ fund, all commissions and fees received under such contract should be credited to the ~~client~~ fund account.

### Participation in Initial Public Offers Offerings

- 3.7 Where a Fund Manager participates in an initial public offering on behalf of ~~clients~~ funds managed by it, it should ensure that:
- (a) the allocation of stock received in the offering provides for a fair and equitable allocation amongst clients;
  - (b) preferential allocations are prohibited; and
  - (c) ~~the reasons for all allocations are documented~~ records of (i) the intended basis of allocation before a transaction is effected and (ii) the actual allocation after the transaction is effected, are made.

### Transactions with Connected Persons

- 3.8.1 A Fund Manager should not carry out any transaction on behalf of a ~~client~~ fund with a ~~corporation~~ party which is a connected person unless such transaction is carried out on arm's length terms, consistent with best execution standards, and at a commission rate no higher than customary institutional rates. ~~In the case of an authorised collective investment scheme, total transactions with connected persons should not exceed 50% of the scheme's transactions in value in any one financial year of the scheme, except with the approval of the SFC.~~
- 3.98.2 A Fund Manager should not, on behalf of a fund, deposit funds with or borrow funds ~~on behalf of a client with~~ from a connected person unless:
- (a) in the case of a deposit, interest is received at a rate not lower than the prevailing commercial rate for a deposit of that size and term; and
  - (b) in the case of a loan, interest charged and fees levied in connection with the loan are no higher than the prevailing commercial rate for a similar loan.

## Cross Trades

For the avoidance of doubt, a reference to “client” in this sub-section also includes a reference to the investors of discretionary accounts managed by the same Fund Manager.

3.409.1 A Fund Manager should only undertake sale and purchase transactions between client accounts (cross trades) where:

- (a) the sale and purchase decisions are in the best interests of both clients and fall within the investment objective, restrictions and policies of both clients;
- (b) the trades are executed on arm’s length terms at current market value;
- (c) the reasons for such trades is are documented prior to execution; and
- (d) such ~~activity is~~ activities are disclosed to ~~the both~~ both clients.

3.409.2 Cross trades between house accounts and client accounts should only be permitted with the prior written consent of the client, to whom any actual or potential conflicts of interest should be disclosed. Cross trades between staff personal accounts and client accounts should be prohibited.

## House Accounts

*“House account” means an account owned by a Fund Manager or any of its connected persons over which it can exercise control and influence.*

For the avoidance of doubt, a reference to “client” in this sub-section also includes a reference to the investors of discretionary accounts managed by the same Fund Manager.

3.410 When dealing for a house account, a Fund Manager should:

- (a) give priority to satisfying a client order. Where a client order has been aggregated with another order, the client’s order must take priority in any subsequent allocation if all orders cannot be filled, provided that if a client which is an institutional professional investor requests otherwise, allocation can be effected on the terms specified by the client. Aggregation of house orders with client orders should only be made if it is in the best interests of clients;
- (b) not deal in accordance with a recommendation, research or analysis to be published to clients until the clients have had a reasonable opportunity to act on the information; and
- (c) except with the prior written consent of the ~~Designated Compliance Officer~~ compliance officer or other persons designated by senior management, not deal ahead of any transaction to be carried out on behalf of a client, ~~or, where the house account and a client have invested in the same investment, only dispose~~

of its holdings following, or together with, the disposal of holdings on behalf of a client fund. The Designated Compliance Officer compliance officer or other persons designated by senior management should properly document the reasons for any consents given.

Note: For the avoidance of doubt, a reference to “dealing” in this sub-section includes any acquisition or disposal of securities or other fund assets.

### Risk Management

3.11.1 For risk management at the fund level, a Fund Manager should implement adequate risk management procedures (including risk measurements and reporting methodologies) in order to identify, measure, manage and monitor appropriately all risks:

- (a) relevant to each investment strategy; and
- (b) to which each fund is or may be exposed, such as market, liquidity and counterparty risks, and other risks, including operational risks, which may be material for each fund it manages taking into account the nature, scale and complexity of its business and of the investment strategy of each of the funds it manages.

Note:

Where appropriate, measures to manage risks of a fund may include:

- (a) identifying and managing potential risks of a fund throughout the fund life cycle;
- (b) ensuring that the risk profile of the fund is consistent with the nature, size, portfolio structure and investment strategies, restrictions and objectives of the fund as provided and represented to fund investors in the constitutive and/or relevant documents; and
- (c) ensuring ongoing and proper identification, measurement, management and monitoring of risks associated with each investment of the fund and their overall effects on the fund's portfolio (including via the use of suitable stress testing procedures).

3.11.2 A Fund Manager should take into account, where applicable, the suggested risk-management control techniques and procedures for funds set out in Appendix 2 to this Code in monitoring such risks.

### Leverage

3.12 Where the Fund Manager is responsible for the overall operation of a fund ~~(or has de facto control of the oversight or operation of the fund)~~, it should disclose to fund investors (i) the expected maximum level of leverage which it may employ on behalf of ~~each the fund it manages~~ and (ii) the basis of calculation of leverage which should be

reasonable and prudent, having due regard to international best practices. At a minimum, such information should be disclosed in the fund's offering document.

### Securities Lending

Paragraphs 3.13.1 to 3.13.8 (inclusive) of this sub-section are only applicable to Fund Managers that engage in securities lending, repurchase agreements (repos) and reverse repo similar over the counter transactions on behalf of the funds managed by them.

3.13.1 The Fund Manager should put in place a collateral valuation and management policy and a cash collateral reinvestment policy governing securities lending, repo and reverse repo or similar over the counter transactions and any cash collateral reinvestments in respect of collateral received by the funds managed by the Fund Manager.

3.13.2 The collateral valuation and management policy should require that:

- (a) collateral and lent securities are marked to market daily wherever and whenever practicable; and
- (b) variation margin is collected at least daily where amounts exceed a minimum acceptable threshold appropriate to the counterparty risk posed as determined by the Fund Manager.

Note: As part of its collateral valuation and management policy, a Fund Manager is generally expected to accept collateral types that it is able, following a counterparty failure, to:

- (a) hold for a period without breaching applicable laws or regulations or the relevant mandate;
- (b) value; and
- (c) risk manage appropriately.

The collateral valuation and management policy should include contingency plans to cover how collateral should be managed following default situations (in particular, the default of the largest market counterparty to securities lending, repo and reverse repo similar over the counter transactions of a fund) and the capabilities to liquidate collateral in an orderly way.

3.13.3 A Fund Manager should have in place an eligible collateral and haircut policy in determining the types of acceptable collateral and their corresponding haircut in connection with non-centrally cleared over the counter and securities financing transactions (such as securities lending, repo and reverse repo similar over the counter transactions).

3.13.4 A Fund Manager should also have ensure there is in place a properly designed methodology to calculate haircuts on the collateral received in connection with securities lending, repo and reverse repo similar over the counter transactions of its funds, whether on a transaction level basis or at the collateral portfolio level. The Fund

Manager should establish This would include there being appropriate policies, procedures, and internal controls to ensure that haircuts are set in accordance with the methodology and are consistently applied ~~when conducting such transactions on behalf of a fund.~~

3.13.5 The cash collateral reinvestment policy should ensure that assets held in the cash collateral reinvestment portfolio are sufficiently liquid with transparent pricing and low risk to meet reasonably foreseeable recalls of cash collateral, and measures are in place to manage the associated liquidity risk. A Fund Manager ~~who~~ that reinvests cash collateral received by the funds should formally document and regularly review the cash collateral reinvestment policy and communicate such policy to fund investors.

*Note: In designing its cash collateral reinvestment policy, a Fund Manager should consider setting specific requirements for the cash collateral reinvestment portfolio and/or liquidity pool maintained to meet cash collateral recalls, including:*

*(a) requiring 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*

*(b) setting specific limits for the weighted average maturity and/or weighted average life.*

3.13.6 A Fund Manager of a fund ~~which~~ that is the securities lender should stress test the ability of a cash collateral reinvestment portfolio to meet foreseeable and unexpected calls for the return of cash collateral on an ongoing basis. Stress tests should include an assessment of the ability to liquidate part of the entire reinvestment portfolio under a range of stressed market scenarios.

3.13.7 A Fund Manager that is responsible for the overall operation of a fund should provide information on a fund's securities lending, repo and reverse repo ~~similar over the counter~~ 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) at least on an annual basis ~~and upon request.~~

*Note: At a minimum, it is expected that the following information should be provided to fund investors from time to time:*

*(a) Global data:*

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

*(ii) the absolute amount of assets engaged in securities lending, absolute amounts of the repo book and the reverse repo book.*

*(b) Concentration data:*

*(i) top 10 collateral securities received by issuer;*

*(ii) top 10 counterparties of securities lending and repo transactions; and*

*(iii) top 10 counterparties of reverse repo transactions.*

*(c) Aggregate securities lending, repo and reverse repo transaction data:*

*(i) by type of collateral received;*

*(ii) by currency;*



- (iii) by maturity tenor;
- (iv) by geography (counterparty);
- (v) cash versus non-cash collateral;
- (vi) maturity of collateral; and
- (vii) settlement and clearing (tri-party, central counterparty, bilateral).

(d) Re-use and re-hypothecation data:

- (i) share of collateral received that is re-used or re-hypothecated, compared to the maximum authorised amount if any; and
- (ii) information on any restrictions on type of collateral received.

(e) Return data, including the split between the return from securities lending, repos and reverse repos and the return from cash collateral reinvestment.

(f) Number of custodians and the amount of collateral assets received / held by each of the custodians.

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

3.13.8 Where the Fund Manager is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund), it should disclose a summary of the securities lending, repo and reverse repo similar over the counter transactions policy and the risk management policy to fund investors in the fund's offering document.

Liquidity Management

Paragraphs 3.14.1 to 3.14.3 (inclusive) of this sub-section, except for 3.14.1(b) and 3.14.1(c), are only applicable to a Fund Manager that is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund).

3.14.1 A Fund Manager should:

- (a) establish, maintain and implement and maintain appropriate and effective liquidity management policies and procedures to monitor the liquidity risk of the fund, taking into account the investment strategy, liquidity profile, underlying assets and obligations, and redemption policy of the fund;
- (b) integrate liquidity management in investment decisions;
- (c) regularly assess the liquidity of the assets of a fund;
- (d) regularly assess the liquidity profile of the fund's liabilities;
- (e) regularly conduct assessments of liquidity in different scenarios, including stressed situations, to assess and monitor the liquidity risk of the funds accordingly; and
- (f) disclose in the fund's offering document the liquidity risks involved in investing in the fund, the liquidity management policies, and an explanation of any tools or

exceptional measure that could affect redemption rights in the fund's offering document or otherwise make such information freely available to fund investors.

*Note: The extent of application of these liquidity management principles will depend on the nature, liquidity profile and asset-liability management of the fund. A Fund Manager should consider which principles are relevant to the fund it manages. The obligation to assess and make disclosure regarding the liability side of a fund applies only to the Fund Manager in charge of overall operation of the fund (or has de facto control of the oversight or operation of the fund).*

3.14.2 Where the constitutive documents of a fund allow the use of specific tools or exceptional measures which could affect redemption rights, a Fund Manager should consider the appropriateness of using such liquidity management tools and exceptional measures, taking into account the nature of assets held by the fund and its investor base.

*Note:*

*Protecting the interests of fund investors should be the primary consideration in the use of liquidity risk management tools. A Fund Manager should also ensure that the investment strategy and portfolio profile of a fund are consistently maintained as much as possible when using these tools.*

*Where a Fund Manager has granted preferential treatment (eg. side letters) to certain investors have been entered into, a Fund Manager it should disclose such fact and the material terms in relation to redemption in the side letters to all relevant potential and existing fund investors.*

3.14.3 A Fund Manager should conduct periodic reviews of the effectiveness of its liquidity management policies and procedures and such policies and procedures should be updated as appropriate.

*Compliance*

3.15 A Fund Manager should ensure that all material non-compliance matters are identified, rectified and reported to the SFC and any other relevant regulators on a timely basis, where appropriate and remedied promptly.

*Termination*

*Paragraphs 3.16.1 to 3.16.2 (inclusive) of this sub-section are only applicable to a Fund Manager that is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund).*

3.16.1 A Fund Manager's decision to terminate a fund should take due account of the best interests of investors in the fund. A Fund Manager should ensure that the termination process of a fund is carried out, and fund investors are treated, fairly.

3.16.2 A Fund Manager should make adequate disclosure of all relevant material information in relation to the termination of the fund to all fund investors in an appropriate and timely manner.

Note: Such information should include without limitation termination decisions, implementation plans and material change of circumstances arising during the termination process.

#### 4. Custody

Paragraphs 4.1.2 to 4.4.1 (inclusive) of this sub-section are only applicable to a Fund Manager that is responsible for the overall operation of a fund.

In the case of funds adopting a unit trust structure, for paragraphs 4.1.1 to 4.1.2 (inclusive) and 4.2.2 to 4.3.3 (inclusive) of this sub-section, references to a “custodian” should be read as references to a “trustee” and references to “arrange for the appointment of/arranging for the appointment of” should be read as “appoint (where applicable)/appointing (where applicable)”.

##### Safety of Client Fund Assets

- 4.1.1 A Fund Manager should ensure that ~~the any~~ fund assets entrusted to it are properly safeguarded. If the Fund Manager is responsible for making custody arrangements this means: In this connection, a Fund Manager should ensure that fund assets are segregated from the assets of the Fund Manager, and, unless held in an omnibus client account, assets of its affiliates and other clients. Fund assets not capable of being held in custody shall be identified as owned beneficially by the fund and not by the Fund Manager or the custodian through proper record-keeping.

Note: Where fund assets are held in an omnibus client account, the Fund Manager should ensure that adequate safeguards are put in place such that fund assets belonging to each client are appropriately recorded with frequent and appropriate reconciliations being performed.

- 4.1.2 ~~Where the~~ A Fund Manager is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund), it should select and arrange for the appointment of, and entrust the fund assets to, a custodian that is functionally independent from it. Where self-custody is adopted, the Fund Manager should ensure that it has policies, procedures, and internal controls in place to ensure that the persons fulfilling the custodial function are functionally independent from the persons fulfilling the fund’s management or administration functions.

Note: In the case of self-custody, the Fund Manager should comply with, where applicable, all relevant requirements under the SFO, including the Securities and Futures (Client Money) Rules and the Securities and Futures (Client Securities) Rules.

##### Selection and Appointment of Custodian

- (a) ~~if permitted by the terms of its license, it may retain the responsibility for safekeeping in a segregated trust account; or~~
- (b) ~~it should arrange for the appointment of a custodian (see below), taking~~

4.2.1 Where the Fund Manager is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund), a Fund Manager should exercise due skill, care and diligence in the selection, arranging for the appointment of and ongoing monitoring of the custodian and take all reasonable steps to ensure that the custodian is properly qualified for the performance of its functions. On an ongoing basis, a Fund Manager should satisfy itself as to the continued suitability and financial standing of any appointed custodian.

Note: In the case of funds adopting a unit trust structure, a Fund Manager should exercise due skill, care and diligence in the selection and appointment (where applicable) of the trustee and ongoing monitoring of the trustee's performance of its custodial functions and references to custodian in this paragraph 4.2.1 should be read as references to the trustee (in the performance of its custodial functions). In addition, references to "sub-custodian" should be read as references to "custodian".

In considering whether a custodian is properly qualified for the performance of its functions, the Fund Manager should consider the following as part of the selection process for custodians:

- (a) whether the custodian has appropriate segregation arrangements in place such that the fund assets are segregated from
  - (i) the assets of the custodian / sub-custodian throughout the custody chain; and
  - (ii) the assets of other funds and other clients of the custodian throughout the custody chain (unless the fund assets are held in an omnibus client account, in which case the principles set out in the note to paragraph 4.1.1 should apply);
- (b) the custodian's legal and regulatory status (i.e. authorization to undertake custody business);
- (c) the custodian's financial resources (i.e. the custodian's financial capacity to safekeep the fund assets and the custodian's credit worthiness);
- (d) the custodian's management of potential conflicts of interest;
- (e) the custodian's organisational capabilities; and
- (f) where appointment of sub-custodians is allowed, the custodian would use due skill, care and diligence in the selection and monitoring of its sub-custodians.

#### Appointment of Custodian

4.2.2 In selecting and arranging for the appointment of a custodian, appointed by a Fund Manager should ensure that the custodian should be either any of the following:

- (a) a registered trust company;

- (b) an ~~authorised~~ authorized financial institution (including a licensed bank, deposit-taking company or restricted-license bank) or the subsidiary of a licensed bank;
- (c) a banking institution or trust company outside Hong Kong that is subject to prudential supervision; or
- (d) any other appropriately qualified institution ~~appointed with the prior written consent of the client.~~

### Custody Agreement

~~Paragraphs 4.3.1 to 4.3.3 (inclusive) of this sub-section are applicable to a Fund Manager that is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund).~~

4.3.1 The Fund Manager should ensure that a formal custody agreement is entered into with the custodian that is appointed for custody of to be entrusted with a fund's assets.

Note: In the case of funds adopting a unit trust structure, a Fund Manager should ensure that a formal trust deed is entered into with the trustee that is to be entrusted with a fund's assets.

4.3.2 The Fund Manager should formulate custody arrangements with due skill, care and diligence and clarify the duties and responsibilities of the various parties to the custodial arrangements. In particular, the Fund Manager should ensure that the custody agreement contains provisions to specify the scope of the responsibility and liability of the custodian.

Note: In the case of funds adopting a unit trust structure, a Fund Manager should ensure that the trust deed contains provisions to specify the scope of the responsibility and liability of the trustee in relation to the custody of fund assets.

4.3.3 The Fund Manager should monitor custody arrangements ~~and on an ongoing basis to ensure~~ the custodian's compliance with the terms of the custody agreement on an ongoing basis.

Note: In the case of funds adopting a unit trust structure, a Fund Manager should monitor custody arrangements and the trustee's compliance with the terms relevant to the custody arrangements in the trust deed on an ongoing basis.

### Disclosure of Custody Arrangements

4.4.1 ~~Where a~~ Fund Manager ~~is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund),~~ it should ensure that the custody arrangements in respect of assets of the fund and any material risks associated with the arrangements are properly disclosed to the fund investors and that fund investors are updated about any significant changes.

4.4.2 Where the Fund Manager retains custody of fund assets, the Fund Manager should also specifically disclose the existence of such an arrangement and the additional safeguards that have been put in place to mitigate any potential conflicts of interest.

## **5. Operations**

### *Records Required to be Kept Record Keeping*

5.1 A Fund Manager should keep its accounts and records properly and in line with all applicable statutory requirements. Proper record keeping includes:

- (a) maintaining an audit trail of all transactions effected by the Fund Manager, all information relating to client accounts produced by third parties and all relevant internal reports, by keeping all transaction records such as contract notes from third-party brokers, client registers, accounting/securities ledgers, registers of securities, and records of investment processes adopted;
- (b) maintaining appropriate procedures for the safekeeping, retrieval and storage of documents and records; and
- (c) complying with provisions of the Securities and Futures (Keeping of Records) Rules.

### *Auditors and Audited Accounts*

5.2.1 A Fund Manager should appoint a firm of auditors an independent auditor to perform an audit of the financial statements of the corporation on at least an annual basis Fund Manager. The audited accounts of the Fund Manager should be filed in accordance with the applicable statutory requirements and be made available to clients the fund upon request upon request.

5.2.2 Where a Fund Manager is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund), the Fund Manager should ensure that an independent auditor is appointed to perform an audit of the financial statements of each of the funds it manages (whether by appointing the independent auditor or procuring the relevant fund to appoint the independent auditor) in order to make available, at a minimum, an annual report for each of the funds it manages. The annual report for each of the funds should also be made available to fund investors of the relevant funds upon request.

5.2.3 The accounting information given in the annual report for each of the funds should be prepared in accordance with generally accepted accounting principles and with the accounting rules set out in the constitutive documents of the fund.

### *Fund Portfolio Valuation*

Paragraphs 5.3.1 to 5.3.7 (inclusive) of this sub-section are only applicable to a Fund Manager that is responsible for the overall operation of a fund or has been delegated responsibility for fund valuation.

5.3.1 ~~Where a~~ Fund Manager is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund) or has been delegated responsibility for fund valuation, it should ensure that, in respect of each the fund it manages, appropriate policies and procedures are established so that a proper and independent valuation of the fund assets can be performed and valuation methodologies are consistently applied to the valuation of similar types of fund~~the~~ assets ~~across all funds managed by the Fund Manager.~~

5.3.2 The valuation policies and procedures should also describe the process for handling situations where the value of an asset determined in accordance with methodologies of the Fund Manager's valuation policies and procedures may not be appropriate.

*Note: The valuation policies and procedures should include, and describe clearly, the process for handling exceptions, including:*

*(a) requiring the Fund Manager to document the reason for any price override or deviation;*

*(b) ensuring an appropriate review of the price override or deviation by a functionally independent party; and*

*(c) describing the method for determining the appropriate price.*

5.3.3 A Fund Manager should review the valuation policies and procedures on a periodic basis to ensure their continued appropriateness and effective implementation.

5.3.4 ~~Where a~~ Fund Manager is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund) and arranges the appointments of a third party to perform valuation services, the Fund Manager should exercise due skill, care and diligence in the selection and appointment of the third party and should ensure that the third party's activities are periodically reviewed.

*Note: For the avoidance of doubt, the Fund Manager remains responsible for the valuation of a fund's assets notwithstanding the appointment of a third party to perform valuation services.*

5.3.5 All fund assets held managed by a Fund Manager on behalf of clients should be valued on a regular basis and the. The frequency of such valuations should be appropriate to the fund assets and the dealing frequency of the fund. Where a Fund Manager is responsible for the overall operation of a fund ~~(or has de facto control of the oversight or operation of the fund)~~, it should also disclose the frequency of valuation and dealing and basis of valuation ~~disclosed to clients~~ fund investors.

5.3.6 Unless otherwise agreed with a client or specified in a collective investment scheme's fund's constitutive documents, a Fund Manager should have regard to applicable generally accepted accounting principles as well as best industry standards and practices in valuing fund assets and valuation should be made in accordance with the following general principles:

- (a) ~~listed securities which are listed or actively traded on a market~~ should be consistently valued at a price representative of either the ~~daily opening, mid, closing price or average last known market~~ price for that security at the stock exchange or market on which that security is listed or traded as indicated by an automatic price feed or other independent pricing source;
- (b) ~~the value of~~ unlisted or unquoted securities ~~that are not actively traded~~ should be ~~valued at cost price subject to adjustment based on their fair value~~ by reference to:
  - (i) comparable ~~recent~~ third-party transactions in ~~the same similar~~ investments, ~~taking into consideration exercising professional judgement and prudence in selecting appropriate comparable transactions and in assessing the cost reasonableness of the investments resulting valuation;~~
  - (ii) any appraisals of the relevant investments or issuer of the investments undertaken by ~~suitably qualified persons such as qualified accountants, or appraisers or credit rating agencies.~~ Where necessary, the Fund Manager should seek independent confirmation of the valuation from ~~a~~ ~~another~~ suitably qualified person; and/or
  - (iii) any information generally about the relevant investments or issuer of the investments that is or becomes known to the Fund Manager from independent sources;
- (c) units or shares in collective investment schemes should be consistently valued by reference to the latest quoted price;
- (d) any listed securities which are not actively traded or have been suspended from trading (~~including securities which are listed or traded on a market where the market price is unrepresentative or not available~~) should be identified and the price at which that security is valued should be monitored. In this case, a Fund Manager should maintain procedures to:
  - (i) demonstrate that it will actively seek independent confirmation of the appropriate price for the security from suitable brokers or market makers;
  - (ii) identify when such a security will be written down or written off in the valuation of a ~~client~~ fund account; or ~~and or~~
  - (iii) ascertain whether it will in appropriate situations transfer the security to its own account and, if so, at what price the ~~client~~ fund account will be compensated for the transfer; and
- (e) ~~the value of other relevant fund assets managed by the Fund Manager should be based on their fair value by reference to the factors set out under (b) above.~~

5.3.7 The valuation policies, and procedures and the valuation process should be periodically reviewed (at least annually) by a competent and functionally-independent party such as a qualified independent third party or a person performing an independent audit function.



The review by such party should also include testing the valuation procedures by which fund assets are valued. In selecting a competent and functionally-independent party, the Fund Manager should exercise due skill, care and diligence.

### Side Pockets

5.4.1 Before any side pocket is introduced in a fund (i.e. where certain illiquid or hard-to-value investments of a fund as determined by the Fund Manager are segregated from other fund assets), a Fund Manager ~~wh~~ that is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund) should disclose to the fund investors:

- (a) the limit to total assets to be put in the side pocket;
- (b) the overall fee structure and charging mechanism (in respect of, among others, any management and performance fees);
- (c) that the redemption lock-up period for a side pocket would be different from that of the ordinary units/shares of the fund;
- (d) how the Fund Manager defines and categorises investment products which are to be put into the side pocket and the policies and rationale for transferring investments in and out of side pockets; and
- (e) where the assets in side pockets are allowed to be transferred to another investment vehicle, the circumstances under which transfers are allowed and the pricing mechanism for such transfers.

Such Fund Manager should also disclose to the fund investors the actual amount of fees charged in relation to side-pocketed assets from time to time.

5.4.2. In setting up and managing side pockets in respect of fund assets managed by the Fund Manager, a Fund Manager should ensure that:

- (a) it has the risk management competency in managing side pockets;
- (b) it has a valuation policy covering side-pocketed assets which complies with the requirements in paragraphs 5.3.1 to 5.3.7 above; and
- (c) it has operational checks and controls for transferring investments in and out of side pockets;

5.4.3 Where a Fund Manager decides to side pocket any fund asset, it should arrange clear disclosure to fund investors of:

- (a) the creation of the side pocket;
- (b) the asset which has been side-pocketed; and

- (c) how the asset has been valued at the time of side pocketing and the ongoing valuation of the asset.

#### *Net Asset Value Calculation and Pricing*

Paragraphs 5.5.1 to 5.5.2 (inclusive) of this sub-section are only applicable to a Fund Manager that is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund) or has been delegated responsibility for fund valuation.

- 5.45.1 In connection with a collective investment scheme, a Fund Manager should ensure that a valuation A Fund Manager should ensure that the net asset value calculation of different unit/share classes is carried out, in accordance with the terms set out in the constitutive documents of the scheme, to calculate accurately the net asset value of the scheme fund and the valuation policies and procedures established by the Fund Manager.
- 5.5.2 A Fund Manager should ensure the valuation policies and procedures in respect of each fund it manages should seek to detect, prevent and correct pricing errors and to compensate fund investors in respect of any material error. Action should also be taken to avoid further error.

#### *Reconciliations*

- 5.56 A Fund Manager should arrange to carry out reconciliations of the corporation's Fund Manager's internal records against those issued by third parties, e.g. clearing houses, banks, custodians, counterparties and executing brokers, to identify and rectify any errors, omissions or misplacement of assets, as follows: Reconciliations should be performed regularly (and, in any event, at least monthly) having regard to the nature of the fund assets.
- (a) reconciliations should be performed at least monthly;
- (b) reconciliations should be prepared from an asset register that is maintained and used to update client asset ledger accounts.

#### *Disclosure of Interests*

- 5.67 A Fund Manager should disclose all interests in securities as required by all applicable statutory requirements and have procedures in place to ensure that staff are aware of such requirements.

### **III. DEALING WITH CLIENTS THE FUND AND FUND INVESTORS**

#### **6. Dealing with Clients the Fund and Fund Investors**

##### *Providing Provision of Information About the Corporation*

- 6.1 A Fund Manager should:

- (a) provide clients the fund (and, where the Fund Manager is responsible for the overall operation of a fund, fund investors) and fund investors with adequate information about the corporation Fund Manager, including its business address, relevant conditions or restrictions under which its business is conducted, and the identity and status of persons acting on its behalf with whom the client fund (or, where the Fund Manager is responsible for the overall operation of a fund, fund investors) or fund investors may have contact; and
- (b) disclose the financial condition of its business to a client fund upon request.

6.2 Where a Fund Manager is responsible for the overall operation of a fund (or has de facto control of the oversight or operation of the fund), it should make adequate disclosure of information (as well as any material changes to the information) on the fund which is necessary for fund investors to be able to make an informed judgment about their investment into the fund.

#### *Confidentiality*

6.2.3 A Fund Manager should maintain proper procedures to ensure confidentiality of client information kept by it in respect of the fund or fund investors.

#### *Account Opening Procedures/Information About Clients*

6.3 A Fund Manager should:

- (a) take all reasonable steps to establish:
  - (i) the client's full and true identity, including the identity of the actual beneficiaries, where appropriate, and verify that identification where required;
  - (ii) where appropriate, the client's financial situation, investment experience, and investment objectives; and
- (b) maintain written procedures to comply with all relevant legal and regulatory requirements against money laundering, including the SFC's Guidelines on Money Laundering.

#### Client Agreements (Discretionary Services)

6.4.1 A Fund Manager should ensure that a written agreement (Client Agreement) is entered into with a client before any services are provided to or transactions made on behalf of that client. A Client Agreement should contain at least such information set out in **Appendix 1** and be provided in a language understood by the client.

6.4.2 Notwithstanding the above, in the case of a collective investment scheme:

- ~~(a) — where a Fund Manager is providing services to a collective investment scheme, a written management agreement in accordance with the rules of the collective investment scheme may be regarded as a Client Agreement;~~
- ~~(b) — where a Fund Manager is acting as distributor of a collective investment scheme on a non-discretionary basis, an authorised offering document and application form in accordance with the Code on Unit Trusts and Mutual Funds may be regarded as a Client Agreement.~~

#### ~~Reporting: Periodic Statements~~

~~6.5 — A Fund Manager should adhere to all relevant legal and regulatory requirements in respect of reporting, including the Securities and Futures (Contract Notes, Statements of Account and Receipts) Rules.~~

#### ~~Valuations and Performance Reviews~~

~~6.6 — Except as agreed otherwise in writing by the client or where the portfolio is a collective investment scheme, a Fund Manager should:~~

- ~~(a) — review the performance of each client's account against any previously agreed benchmark, either in writing to the client or by way of meeting, at least twice a year;~~
- ~~(b) — provide written portfolio valuations to the client at least as regularly as provided in the Client Agreement. The report should, as a minimum, include the following:
  - ~~(i) — the date at which the report is made;~~
  - ~~(ii) — the contents and value of the client portfolio at that date including income received;~~
  - ~~(iii) — movements in the value of the client portfolio;~~
  - ~~(iv) — any open positions in relation to derivative transactions.~~~~

#### *Complaints*

6.74 A Fund Manager should maintain:

- (a) procedures to ensure that:
  - (i) complaints from clients a fund or fund investors relating to its business the management of any fund managed by it are handled in a timely and appropriate manner;
  - (ii) steps are taken to investigate and respond promptly to a complaint by a person designated by senior management other than an individual

directly concerned with the subject of the complaint; or by the ~~Designated Compliance Officer~~ compliance officer; and

(iii) if a complaint is not remedied promptly, the ~~client~~ fund or fund investor is advised of any further steps which may be available to the ~~client~~ fund or fund investor under the regulatory system; and

(b) a register of complaints to give effect to (a) above. This should be reviewed by senior management on a regular basis.

## 7. Marketing Activities

### *Representations by the Fund Manager or its Representatives*

7.1 A Fund Manager should ensure that any representations made ~~and~~ or information supplied ~~by it to a client~~ are ~~fund or any fund investor is~~ accurate and or not misleading.

### *Issue of Marketing Materials*

7.2 A Fund Manager should ensure that all advertisements and marketing materials are ~~authorised~~ authorized as required by the SFC before issue. ~~Where such materials are not required to be authorised, a Fund Manager should nonetheless~~ and, in any event, ensure that the marketing materials:

(a) are ~~accurate and~~ false, biased, misleading or deceptive;

(b) are clear, fair and present a balanced picture of the fund with adequate risk disclosures;

(c) contain information that is timely and consistent with the fund's offering document; and

(d) ~~and that any~~ only contain performance claims that can be verified.

### *Offers of Investments*

7.3 A Fund Manager should comply with all applicable statutory requirements regarding the offer of investments.

## 8. Fees and Expenses

### *Disclosure of Charges*

8.1 A Fund Manager should disclose to ~~the client~~ a fund (and where the Fund Manager is responsible for the overall operation of a fund, fund investors) the basis and amount of its fees and charges.

### *Fair and Reasonable Charges*

8.2 All charges, fees and mark-ups affecting a client fund and fund investors should be fair and reasonable in the circumstances, and be ~~characterized~~ characterised by good faith. In connection with mark-ups levied on transactions on behalf of a client fund, where the Fund Manager is:

- (a) acting as agent, such mark-ups are prohibited; and
- (b) acting as principal, the circumstances should be disclosed ~~in~~ to the Client Agreement ~~fund~~ (and where the Fund Manager is responsible for the overall operation of a fund, fund investors) and transactions be reported in periodic statements or transaction advice.

#### *Rebates and Soft Commission*

8.3 In connection with an ~~authorised~~ authorized collective investment scheme, a Fund Manager should comply with ~~40.12~~ the relevant requirements of the Code on Unit Trusts and Mutual Funds in force from time to time, and, in connection with other ~~clients funds~~, comply with 13.1 to 13.4 the relevant requirements of the Code of Conduct for Persons Licensed by or Registered with the SFC in force from time to time.

## **IV. ELECTRONIC TRADING REPORTING**

### **9. Electronic Trading Reporting Obligations to the SFC**

~~9.1 This paragraph applies a Fund Manager who conducts electronic trading of securities and futures contracts that are listed or traded on an exchange on behalf of collective investment schemes managed by it. The definition of "electronic trading" provided in paragraph 18.2 of the Code of Conduct for Persons Licensed by or Registered with the SFC (**Code of Conduct**) should be interpreted accordingly.~~

~~9.2 A Fund Manager should comply with the following principles and requirements when conducting electronic trading on behalf of collective investment schemes managed by it:~~

- ~~(a) Paragraphs 18.3 to 18.6 and 18.9 to 18.11 of the Code of Conduct; and~~
- ~~(b) Paragraphs 1.1 to 1.3 and 3.1 to 3.4 of Schedule 7 to the Code of Conduct.~~

9.1.1 Fund Managers should provide appropriate information to the SFC on an ongoing basis upon request.

*Note: For example, such information may include:*

- (a) leverage;*
- (b) assets and, where available, liability information (including illiquid assets); and*
- (c) information on each fund's securities lending, repo and reverse repo similar over-the-counter transactions.*

Where necessary, for the effective monitoring of systemic risk, a Fund Manager may be required to provide other information on a periodic as well as on an ad hoc basis as the SFC may require from time to time.

9.1.2 A Fund Manager should respond to requests and enquiries from the SFC promptly in an open and co-operative manner.

9.1.3 A Fund Manager should ensure that all information it provides and provided on its behalf to the SFC is in all material respects accurate, complete and not misleading. If it becomes aware that the information provided does not meet this requirement, the Fund Manager should inform the SFC promptly.

## APPENDIX 1

### Requirements for licensed or registered persons conducting discretionary accounts management

#### Introduction

Where applicable, those licensed or registered persons that are involved in the management of discretionary accounts which are operated in the following manner should observe the requirements of this Code as well as any additional requirements set out in this Appendix:

- (a) where a licensed or registered person provides discretionary management services to a client, in the form of an investment mandate or a pre-defined model investment portfolio; and

*Note: The investment mandate may set out, among others, the types, risks and allocation of investments after taking into account the client's investment objectives and strategies. In the case of a pre-defined model portfolio, it may specify the proportion of the asset classes and markets and the risk profile of the selected portfolio.*

- (b) the licensed or registered person receives management fee and/or performance fee as remuneration for managing the discretionary accounts for its clients.

For the avoidance of doubt, this Appendix applies to all licensed or registered persons acting as managers of discretionary accounts, including, as appropriate, their representatives. Where a person is involved in the management of both collective investment schemes and discretionary accounts, this Appendix only applies to the extent that that person is involved in the management of discretionary accounts.

*Note: In relation to certain principles and requirements (as specifically set out in this Code) that are only applicable to a Fund Manager ~~whethat~~ is responsible for the overall operation of a fund, and has de facto control of the oversight or operation of the fund, discretionary account managers should also observe these principles and requirements, ~~where applicable~~, and to the extent relevant to the functions and powers of the discretionary account manager.*

#### Interpretation

Where requirements of this Code are applicable to discretionary accounts, terminologies that are specific to collective investments schemes/funds in the Code should be read as modified below:

- any reference to “fund” or “client” in this Code refers to “Discretionary Account”;
- any reference to “fund investors” in this Code refers to “Discretionary Account Clients”;
- any reference to “Fund Manager” in this Code refers to “Discretionary Account Manager”;
- any reference to “constitutive documents”, “offering documents” in this Code refers to “Investment Management Agreement” or “Discretionary Client Agreement”; and
- any reference to “redemption” in this Code refers to “capital withdrawal”.



## **Particular requirements in the Code which are not applicable to Discretionary Account Managers**

The following requirements do not apply to a Discretionary Account Manager:

### (a) Liquidity management

The requirements in relation to the use of specific tools or exceptional measures which could affect redemption rights and corresponding explanation in the offering documents are not applicable to a Discretionary Account Manager. (Paragraphs 3.14.1(f) and 3.14.2 of this Code)

*Note: The extent of application of other liquidity management principles will depend on the capital withdrawal policy set out in the Discretionary Client Agreement.*

### (b) Termination

The requirements in relation to the termination process is not applicable to a Discretionary Account Manager. (Paragraphs 3.16.1 and 3.16.2 of this Code)

*Note: A Discretionary Account Manager should observe the relevant termination provisions set out in the Discretionary Client Agreement.*

### (c) Side pockets

The requirements in relation to side pocket arrangements are not applicable to a Discretionary Account Manager. (Paragraphs 5.4.1 to 5.4.3)

### (d) Auditors and audited accounts

The requirement in relation to the audit requirement of the financial statements of each of the funds under management and the accounting information in the annual report for each of the funds are not applicable to a Discretionary Account Manager. (Paragraphs 5.2.2 and 5.2.3 of this Code)

### (e) Valuation frequency

The requirements in relation to the valuation frequency to be appropriate for the dealing frequency of the fund and related disclosure are not applicable to a Discretionary Account Manager. (Paragraph 5.3.5)

*Note: Where applicable, a Discretionary Account should observe the relevant requirements set out in paragraphs 5.3.1 to 5.3.7 (save for the appropriateness to the dealing frequency and related disclosure set out in paragraph 5.3.5) and the relevant valuation provisions set out in the Discretionary Client Agreement.*

### (f) Net Asset Value Calculation and Pricing

The requirements in relation to net asset value calculation of different unit/share classes are not applicable to a Discretionary Account Manager. (Paragraphs 5.5.1 and 5.5.2 of this Code)

Note: Where applicable, a Discretionary Account Manager should observe the requirements in relation to overall net asset value calculation of the Discretionary Account.

(g) Offer of Investments

The requirement in relation to compliance with all applicable statutory requirements regarding the offer of investments is not applicable to a Discretionary Account Manager. (Paragraph 7.3 of this Code)

**Additional requirements applicable to Discretionary Account Managers**

In addition to the requirements set out in this Appendix, the requirements set out in the following paragraphs are also generally applicable to a Discretionary Account Manager:

Client Agreements

1. A Discretionary Account Manager should ensure that a written agreement (Discretionary Client Agreement) is entered into with a client before any services are provided to or transactions made on behalf of that client. A Discretionary Client Agreement should set out the precise terms and conditions under which discretion will be exercised and contain at least such information set out in the section “Minimum Content of Discretionary Client Agreement” and be provided in a language understood by the client. These minimum requirements do not apply to Institutional Professional Investors or Corporate Professional Investors as defined in paragraph 15.2 of the Code of Conduct and in the case of Corporate Professional Investors, the Discretionary Account Manager has also complied with paragraphs 15.3A and 15.3B of the Code of Conduct.

Performance Review and Valuation Reports

2. Except as agreed otherwise in writing by the client, a Discretionary Account Manager should:
  - (a) review the performance of each Discretionary Account against any previously agreed benchmark, either in writing to the client or by way of meeting, at least twice a year; and
  - (b) provide valuation reports to the client on a monthly basis or at such shorter intervals as provided in the Discretionary Client Agreement. The report should, as a minimum, include the following:
    - (i) the date on which the report is made;
    - (ii) the cash and investment holdings and value of the Discretionary Account on that date including all income received and charges levied against that account;
    - (iii) movements in the value of the Discretionary Account; and
    - (iv) any open positions in relation to derivative transactions.

**Minimum Content of Discretionary Client Agreement**

- (a) Full name and address of client;

- ~~(b) Full name and address of Fund Manager business, including its licensing or registration status;~~
- ~~(c) Undertakings to notify the other in the event of material changes;~~
- ~~(d) Authorisation for discretionary management;~~

In addition to the minimum content of client agreement set out in paragraph 6.2 of the Code of Conduct, a Discretionary Client Agreement should contain at least provisions to the following effect:

- ~~(a) appointment of the licensed or registered person as the Discretionary Account Manager;~~
- ~~(e) (b) Statement statement of the client's investment policy and objectives, including asset classes, geographical spread, performance benchmark, risk profile of the target portfolio, and any limitations or prohibitions on asset classes and markets or instruments (e.g. use of derivatives) and performance benchmark (if any) or geographical spread, performance benchmark and/or attitude to risk;~~

In the case where the client has selected a pre-defined model portfolio, the Discretionary Client Agreement should also specify the proportion of the asset classes, markets, and corresponding risk profile of the selected pre-defined model portfolios;

- ~~(f) (c) The the amount of all fees to be paid by the client, whether to the Fund Discretionary Account Manager or to a connected person with respect to the account, and a description of fees to be paid by the client to third parties, where applicable;~~
- ~~(g) Any necessary consents in relation to cash rebates and soft commissions, if applicable;~~
- ~~(h) Risk disclosure statement as required by the Code of Conduct for Persons Licensed by or Registered with the SFC;~~
- ~~(d) any consent from the client where the Discretionary Account Manager intends to receive soft commission or retain cash rebates;~~
- ~~(i) (e) Details details of custody arrangements if the Discretionary Account Manager provides custody arrangement by itself or through its associated entity; and~~
- ~~(j) (f) Details details of periodic reporting to be made to client.~~

## **APPENDIX 2**

### **Suggested risk-management control techniques and procedures for funds**

#### **A. Risk management**

1. A Fund Manager should establish and maintain effective risk management policies and reporting methodologies.
2. The fund's risk policies and measurements and reporting methodologies should be subject to regular review, particularly when there are significant changes to the fund or relevant market conditions, legislation, rules or regulations that might impact the fund's risk exposure.
3. The risk management policy for each fund should provide, for each fund, a system of limits concerning the measures used to monitor and to control the relevant risks.

#### **B. Market risk**

1. A Fund Manager should establish and maintain effective risk management measures to quantify the impact on the fund (especially if the fund deals in derivative financial products) and, if applicable, the impact from changing market conditions. These measures should cover all risk elements associated with the fund. Matters to be covered in such risk measures may include:
  - (a) unspecified adverse market movements - using an appropriate value-at-risk or other methodology to estimate potential losses;
  - (b) individual market factors - measuring the sensitivity of the fund's risk exposure to specific market risk factors e.g. shifts in the interest rate yield curve and changes in market volatility; and
  - (c) stress testing - determining the effect of abnormal and significant changes in market conditions on the fund using various quantitative and qualitative variable assumptions.

#### **C. Liquidity risk**

1. A Fund Manager should set and enforce concentration limits with respect to the funds' investments, collateral, markets and business counterparties, taking into account the respective liquidity profile and the fund's approved liquidity risk policies.
2. A Fund Manager should establish and regularly monitor measures of ~~maturity~~ liquidity mismatches between the funds' underlying investments and their redemption obligations using quantitative metrics or qualitative factors.
3. A Fund Manager should establish appropriate arrears and default procedures to alert staff member(s) responsible for liquidity management to potential problems and to

provide them with adequate time to take appropriate action to minimise the impact of fund counterparty liquidity problems.

4. In assessing the liquidity of the assets of a fund, a Fund Manager should consider the following, where applicable:

(a) obligations to creditors, counterparties and third parties;

(b) the time to liquidate assets;

(c) the price at which liquidation could be effected;

(d) financial settlement lag time; and

(e) the dependence of these considerations on other market risks and factors.

#### D. Issuer and counterparty credit risk

1. A Fund Manager should establish and maintain an effective credit assessment rating system to evaluate the creditworthiness of the funds' counterparties and the credit risk of the fund's investments (or, if applicable, the relevant issuers).

#### E. Operational risk

1. In designing the policies, procedures, and internal controls to reduce operational risk, a Fund Manager should consider, amongst other considerations, physical and functional segregation of incompatible duties, maintenance and timely production of proper and adequate accounting and other records, the security and reliability of accounting and other information, staffing adequacy and prompt reconciliation of trading information.

2. A Fund Manager should establish, implement and maintain a business continuity and transition plan. The plan should include policies and procedures that ensure, in the case of a business disruption or an interruption to the Fund Manager's operations, the following matters are addressed:

(a) the preservation of essential data and functions, and the maintenance of services and activities, or, where that is not possible, the timely recovery of such data and functions and the timely resumption of its services and activities;

(b) continuity of effective communications with clients, employees, service providers and regulators;

(c) identification, assessment and maintenance of third-party services critical to the operation of the Fund Manager; and

(d) appropriate transitioning arrangements that account for the possible winding down of the Fund Manager's business or the transition of the Fund Manager's business to others in the event the Fund Manager is unable to continue providing its services.

Note:

Business disruptions, whether temporary or permanent, include, without limitation, natural disasters, cyber-attacks, technology failures, key personnel departures and other similar events.

3. The business continuity and transition plan, including the adequacy of the plan and the effectiveness of its implementation, should be reviewed at least annually. Records of such reviews should be maintained

## Final form of the amendments to the Code of Conduct

*The highlighted parts indicate revisions to the Code of Conduct which differ from the proposed amendments set out in the Consultation Paper*

### Paragraph 1

#### Interpretation and application

#### 1.4 ~~Persons to which the Code does not apply~~ [deleted]

~~To the extent that a licensed or registered person acts in the capacity of a management company in relation to the discretionary management of collective investment schemes (whether authorised or unauthorised), the Code does not apply to such activity. In relation to such activities, such licensed or registered persons are subject to the Fund Manager Code of Conduct issued by the Commission.~~

### Paragraph 8

#### Information for clients

#### 8.3 Disclosure of monetary and non-monetary benefits

##### Part A

##### Disclosure of monetary benefits

*Where the monetary benefits received or receivable are quantifiable prior to or at the point of entering into a transaction*

##### (a) Specific disclosure

###### *Explicit remuneration arrangement*

- (i) Where a licensed or registered person and/or any of its associates explicitly receives monetary benefits from a product issuer (directly or indirectly) for distributing an investment product, the licensed or registered person should disclose the monetary benefits that are receivable by it and/or any of its associates as a percentage ceiling of the investment amount or the dollar equivalent.

###### *Trading profit made from a back-to-back transaction*

- (ii) Where a licensed or registered person enters into a back-to-back transaction concerning an investment product, the licensed or registered person should disclose to the client the trading profit to be made. The trading profit should be disclosed as a percentage ceiling of the investment amount or the dollar equivalent.

## Notes

For the avoidance of doubt, the specific disclosure should be made on a transaction basis.

As a minimum, a licensed or registered person should disclose the monetary benefits that are receivable by it and/or any of its associates or the trading profit in the form of a percentage ceiling of the investment amount rounded up to the nearest whole percentage point or the dollar equivalent. However, having regard to its own circumstances, the licensed or registered person may disclose a specific percentage or the dollar equivalent instead.

Back-to-back transactions refer to those transactions where a licensed or registered person, after receiving –

- (a) a purchase order from an investor, purchases an investment product from a third party and then sells the same investment product to the investor; or
- (b) a sell order from an investor, purchases an investment product from the investor and then sells the same investment product to a third party,

and no market risk is taken by the licensed or registered person.

### **(b) Generic and other disclosure**

#### *Non-explicit remuneration arrangement*

- (i) Where a licensed or registered person does not explicitly receive monetary benefits for distributing an investment product which is issued by it or any of its associates, the licensed or registered person should disclose that it or any of its associates will benefit from the origination and distribution of this product.

*Where the monetary benefits received or receivable are not quantifiable prior to or at the point of entering into a transaction*

- (ii) Where the monetary benefits received or receivable by a licensed or registered person and/or any of its associates from a product issuer (directly or indirectly) for distributing an investment product are not quantifiable prior to or at the point of entering into a transaction, the licensed or registered person should disclose the existence and nature of such monetary benefits, the range of such monetary benefits receivable on an annualised basis, and the dollar equivalent of the maximum amount maximum percentage of such monetary benefits receivable per year.

## Notes

For the avoidance of doubt, the disclosure in respect of this paragraph 8.3(b)(ii) of the Code should be made on a transaction basis.

The maximum amount of monetary benefits receivable per year should be determined on the assumption that the client will remain invested in the relevant investment product for a 12-month period and the value of the client's invested amount in the investment product will remain unchanged throughout that period.



## Part B

### Disclosure of non-monetary benefits

- (a) Where a licensed or registered person and/or any of its associates receives from a product issuer non-monetary benefits for distributing an investment product, the licensed or registered person should disclose the existence and nature of such non-monetary benefits.

### 8.3A Disclosure of transaction related information

- (a) Where a licensed or registered person distributes an investment product to a client (including where it sells an investment product to or buys such product from the client), the licensed or registered person should deliver the following information to the client prior to or at the point of entering into the transaction:
- (i) The capacity (principal or agent) in which a licensed or registered person is acting;
  - (ii) Affiliation of the licensed or registered person with the product issuer;
  - (iii) Whether or not the licensed or registered person is independent (with reference to the requirements set out in paragraph 10.2 of the Code) and the bases for such determination;
  - ~~(iii)~~(iv) Disclosure of monetary and non-monetary benefits (~~Please please refer to paragraph 8.3 of the Code~~); and
  - ~~(iv)~~(v) Terms and conditions in generic terms under which client may receive a discount of fees and charges from a licensed or registered person.
- (b) The disclosure must be made in writing, electronically or otherwise. In respect of the disclosure to be made under paragraph 8.3A(a)(iii), the disclosure should be made in the form of a statement as specified in Schedule 9 to the Code. The licensed or registered person should have adequate measures in place to ensure that the above information is provided to the client prior to or at the point of entering into the transaction. In respect of the disclosure to be made under paragraph 8.3A(a)(i), (ii), (iii), and (v) above, a one-off disclosure (“One-off Disclosure”) is acceptable. Where there are changes to the One-off Disclosure, either (1) an updated One-off Disclosure, or (2) individual disclosure for each transaction where the information for which deviates from the information in the One-off Disclosure, must be provided to the client prior to or at the point of entering into a transaction.
- (c) In circumstances where provision of information in written form is not possible before a transaction is concluded, the licensed or registered person should make a verbal disclosure and provide such information in writing to the client as soon as practicable after the conclusion of the transaction.
- (d) The information disclosed in written form should be in Chinese or English according to the language preference of the client.

## Notes

The licensed or registered person should ensure that the disclosure in writing is prominent, is presented in a clear and concise manner and is easy for average clients to understand.

## Paragraph 10

### Conflicts of interest

#### 10.1 Disclosure and fair treatment

Where a licensed or registered person has a material interest in a transaction with or for a client or a relationship which gives rise to an actual or potential conflict of interest in relation to the transaction, it should neither advise, nor deal in relation to the transaction, unless it has disclosed that material interest or conflict to the client and has taken all reasonable steps to ensure fair treatment of the client.

#### 10.2 Independence

Where a licensed or registered person represents itself as being independent, or uses any other term(s) with similar inference, when distributing an investment product:

- (a) it should not receive fees, commissions, or any monetary or non-monetary benefits, paid or provided (whether directly or indirectly) by any party in relation to such distribution of investment product to clients; and
- (b) it should not have any close links or other legal or economic relationships with product issuers, or receive any non-monetary benefits from any party, which are likely to impair its independence in respect of favouring to favour a particular investment product, a class of investment products or a product issuer.

#### Notes

“Close links” which may impair independence include where a licensed or registered person has a parent company and subsidiary relationship with a product issuer, or is in a controlling entity relationship (as defined in the SFO) with the product issuer.

## **Schedule 9 Disclosure statement in respect of an intermediary's independent status**

Under paragraph 8.3A(a)(iii) of the Code, where a licensed or registered person distributes an investment product to a client (including where it sells an investment product to or buys such product from the client), the licensed or registered person should inform the client, prior to or at the point of entering into the transaction, whether or not the licensed or registered person is independent (with reference to the requirements set out in paragraph 10.2 of the Code) and the bases for such determination.

Such disclosure should be made by the licensed or registered person to the client containing the substance set out in the following disclosure statements.

### **Where the licensed or registered person is independent:**

"We are an independent intermediary because:

1. we do not receive fees, commissions, or any other monetary ~~or non-monetary~~ benefits, provided by any party in relation to our distribution of any investment product to you; and
2. we do not have any ~~close~~ links or other legal or economic relationships with product issuers, or receive any non-monetary benefits from any party, which are likely to impair our independence ~~in respect of favouring~~to favour any particular investment product, any class of investment products or any product issuer."

### **Where the licensed or registered person is NOT independent:**

"We are **NOT** an independent intermediary because:

1. we receive fees, commissions, or other monetary benefits from other parties (which may include product issuers) in relation to our distribution of investment products to you. For details, you should refer to our disclosure on monetary benefits which we are required to deliver to you prior to or at the point of entering into any transaction in investment products;

and/or

2. we receive non-monetary benefits from other parties, or have close links or other legal or economic relationships with issuers of products that we may distribute to you."

*Note: in addition to making the disclosure in the paragraph above, it is optional for a licensed or registered person to further provide a description of the close links or other legal or economic relationships with product issuers which are likely to impair the intermediary's independence ~~in respect of favouring~~to favour any particular investment product, any class of investment products or any product issuer. Licensed and registered persons should also note the disclosure requirements in relation to non-monetary benefits in paragraph 8.3 of the Code.*

and/or

2. we receive fees, commissions, or other monetary or non-monetary benefits, from other parties (which may include product issuers) in relation to our distribution of investment products to you. For details, you should refer to our disclosure on

monetary and non-monetary benefits which we are required to deliver to you prior to or at the point of entering into any transaction in investment products.”

### Proposed amendments to the Code of Conduct in respect of disclosure requirements applicable to discretionary accounts

#### Discretionary accounts

##### 7.2 Disclosure of benefits

- (a) Specific disclosure - monetary benefits under explicit remuneration arrangement

Option 1 as proposed under the further consultation on disclosure requirements

Where a licensed or registered person and/or any of its associates explicitly receives monetary benefits from a product issuer (directly or indirectly) for effecting a transaction in an investment product for a client, the licensed or registered person should disclose the maximum percentage of the monetary benefits receivable by it and/or any of its associates by the type of investment product.

Option 2 as proposed under the further consultation on disclosure requirements

Where a licensed or registered person and/or any of its associates explicitly receives monetary benefits from a product issuer (directly or indirectly) for effecting a transaction in an investment product for a client, the licensed or registered person should disclose an estimated maximum percentage of monetary benefits receivable by it and/or any of its associates. This should be calculated by aggregating the maximum monetary benefits receivable from each product type according to the proportion such product type represents in the client's investment portfolio.

- (b) Generic disclosure - monetary benefits under non-explicit remuneration arrangement and non-monetary benefits
- (i) Where a licensed or registered person effects a transaction in an investment product which is issued by it or any of its associates and it will not explicitly receive monetary benefits when effecting such transaction for a client, the licensed or registered person should disclose that it or any of its associates will benefit from effecting such transaction.
- (ii) Where a licensed or registered person and/or any of its associates receives from a product issuer non-monetary benefits for effecting a transaction for a client, the licensed or registered person should disclose the existence and nature of such non-monetary benefits.

The licensed or registered person should make the above disclosure to clients at the account opening stage or prior to entering into a discretionary client agreement with a client for discretionary management services. The disclosure must be in writing, electronically or otherwise. The information disclosed in written form should be in Chinese or English according to the language preference of the client.

The licensed or registered person should ensure that the disclosure in writing is prominent, is presented in a clear and concise manner and is easy for average clients to understand.

## **Professional investors**

15.4 Exempt provisions for Corporate Professional Investors where licensed or registered persons have complied with paragraphs 15.3A and 15.3B and Institutional Professional Investors

(d) Discretionary accounts

(i) ...

(ii) ...

(iii) the need for a licensed or registered person to disclose benefits receivable for effecting transactions for a client under a discretionary account (paragraph 7.2 of the Code).



## Appendix D

### List of respondents

(in alphabetical order)

1. Alternative Investment Management Association
2. Asia Securities Industry & Financial Markets Association
3. Association of Independent Asset Managers of Hong Kong
4. BlackRock, Inc.
5. Clifford Chance
6. CompliancePlus Consulting Limited
7. Consumer Council
8. Deacons
9. Duff & Phelps LLC
10. Enhanced Investment Products Limited
11. Eversheds
12. HedgeSPA Pte. Ltd.
13. Hong Kong Investment Funds Association
14. Hong Kong Trustees' Association
15. ICI Global
16. Investec Asset Management
17. Private Wealth Management Association
18. Simmons & Simmons
19. St. James's Place (Hong Kong) Limited
20. Timothy Loh LLP
21. The DTC Association
22. The Hong Kong Society of Financial Analysts
23. The Institute of Financial Planners of Hong Kong
24. The Law Society of Hong Kong
25. Vanguard Investments Hong Kong Limited
26. 杨锋
27. Submissions of 6 respondents are published on a "no-name" basis upon request
28. Submissions of 6 respondents are withheld from publication upon request