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COMMENTS ON THE CONSULTATION PAPER ON PROPOSALS TO ENHANCE ASSET MANAGEMENT REGULATION AND POINT-OF-SALE TRANSPARENCY

Thank you for the opportunity to comment on your proposals to enhance asset management regulation and point-of-sale transparency. Although we support your proposals in the latter regard, the proposals in the former regard:

(a) appear to run counter to the global trend toward better corporate governance;

(b) may exceed the scope of what may be permissible in attempting to provide guidance as to the standard of fitness and properness under the Securities and Futures Ordinance ("**SFO**"); and

(c) may undermine Hong Kong as a centre for the management of funds.

In light of the foregoing, we believe that these proposals should be re-considered.

2. ASSET MANAGEMENT REGULATION

As proposed in the consultation, the Fund Manager Code of Conduct ("**FMCC**") will require fund managers, in essence, to require funds to make certain disclosures and to make certain decisions as to the custody of assets and to manage the fund in prescribed ways. As proposed, these requirements would not apply where the fund manager is not responsible for the overall operation of a fund or lacks *de facto* control of a fund. However, in practice it may be difficult to establish whether a fund manager has *de facto* control given the fund directors generally have no duty to follow instructions of a fund manager.

The consultation itself recognizes that these new requirements are regulations of the fund rather than the fund manager but insists that they are necessary to comply with IOSCO principles and FSB recommendations, to "reinforce good governance" and to "enhance transparency".

2.1. Basis for Proposal Unclear

Whilst the consultation cites specific IOSCO principles and FSB recommendations to support the need for specific regulations of funds, it does not cite any specific IOSCO principle or FSB recommendation which suggests that these regulations should be implemented by regulating fund ***managers***.

As we have not had the opportunity to fully canvass IOSCO and FSB literature, in the absence of any specific citation, the extent to which these types of regulations should apply to private funds through the fund manager is unclear. We note

however, for example, that IOSCO's Final Report on Standards for the Custody of Collective Investment Schemes' Assets (FR25/2015), which the consultation cites as authority for the proposals in relation to custody, specifically provides that custody arrangements described therein apply only to registered or authorized open-ended collective investment schemes, specifically excluding hedge funds which use prime brokers and schemes which invest in private equity or venture capital.

2.2. Governance Concerns

A fund, if constituted as a company, is a legal entity separate from the fund manager. In the common law world, the fund will have its own governing board which will have legal duties to act in the best interest of shareholders. We do not see how good governance is reinforced by emasculating the governing board, making it no more than a rubber stamp for the dictates of the fund manager. It is undoubtedly the case that fund managers exercise significant influence over the governing boards of funds and, in some cases, all the members of the governing board may be officers and employees of the fund manager. This does not however, mean that these individuals can and should ignore their legal duties to cater to the needs of the fund manager.

2.3. Jurisdictional Concerns

The FMCC is no more than guidance as to the standards of fitness and properness which all persons licensed or registered with the SFC must meet.

In this regard, under Schedule 1 of the SFO, the regulated activity for which the license is required is the "service of managing a portfolio of securities or futures contracts…". It is not clear how there is any rational connection between this discrete service and, for example, the proposed requirements for the fund to make certain disclosures or as to how the fund selects a custodian. In the absence of concerns as to honesty, integrity or reputation, it is difficult to see how fitness and properness in providing this discrete service can be impugned merely by reasonable conduct outside the bounds of this service which differs from the conduct prescribed by the SFC.

Even where there is a rational connection, we do not see how the failure to over-ride a governing body of a client fund acting rationally in respect of a matter properly under the jurisdiction of the client can fall below the standard of fitness and properness.

2.4. Impact on Fund Management Industry

Changes to the FMCC which affect private funds may have a significant and adverse effect on Hong Kong as a centre for the management of private funds.

The deletion of the word "discretionary" in the introductory language of the FMCC suggests that the FMCC now applies to private equity fund managers. Many of the requirements of the new FMCC are completely inapposite to private equity.

The deletion of the language making the FMCC mutually exclusive with the Code of Conduct for Persons Licensed by or Registered with the SFC ("**Code of Conduct**") suggests that the requirements under the Code of Conduct, such as suitability, would apply to dealings between fund managers and funds. In this regard, not all fund clients will qualify as professional investors eligible for exemption from these requirements. For example, it is not uncommon for a Cayman fund to delegate investment management discretion to a Cayman fund manager which in turn delegates investment management discretion to a Hong Kong fund manager. It is unclear whether the Cayman fund manager (or, indeed the Cayman fund itself) would qualify under the SFO as an "institutional professional investor" under the Code of Conduct. Accordingly, it is possible that the Hong Kong fund manager would need to treat the Cayman manager as a corporate professional investor or, worse, retail client. The wholesale inclusion of requirements of the Code of Conduct into the management relationship of private funds will be unwelcome.

Existing private funds may need to undergo significant documentation amendments or structural changes. Some private funds will no longer be operable with management in Hong Kong where those funds cannot or choose not to meet the new FMCC requirements. Some managers of private funds will find the increased regulatory burdens of the new requirements of the FMCC undesirable and may elect to relocate management activities elsewhere.

3. POINT-OF-SALE TRANSPARENCY

We agree with the proposed two-pronged approach to enhancing point-of-sale transparency. We would suggest consideration be given to going further in 2 respects:

(a) A licensed or registered person who is not independent should be required to disclose the fact that he is a selling agent for a specific fund.

(b) The Code of Conduct should establish fees bands (*e.g.* high, medium or low) and a licensed or registered person should be required to disclose which band fees receivable by him in aggregate fall before the client is invested into the KYC process.

4. CONCLUSION

We would be happy to discuss our submission further should this be useful.

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