Room 1302, 13/F Winsome House
73 Wyndham Street, Central, Hong Kong
+852 2526 0211
info@aima.org

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

Sent via email

28 February 2017

Dear Sirs

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

We are writing in response to the Securities and Futures Commission's (the "**SFC**") consultation dated 23 November 2016 on proposed amendments to the Fund Manager Code of Conduct (the "**FMCC**") and the Code of Conduct for Persons Licensed by or Registered with the SFC (the "**Code of Conduct**"). The Alternative Investment Management Association ("**AIMA**")[1] welcomes the SFC's initiative to review and update Hong Kong's asset management regulatory framework. As the truly global representative of the alternative investment industry, AIMA Hong Kong represents the vast majority of the leading hedge fund managers in Hong Kong.

We strongly agree that robust regulation is fundamental to the development and growth of an international asset management centre. As such, in strengthening Hong Kong's position as a leading asset management centre, it is important to ensure that the regulatory regime for the industry is in line with international regulatory developments.

We welcome the fact that a number of the points we raised during the soft consultation have been addressed in the formal consultation paper. A key issue for AIMA members is the distinction between the different roles and responsibilities of different parties in the asset management industry, namely the board of directors of a corporate fund and asset managers. The SFC has sought to deal with this by proposing that some requirements only apply to those "*responsible for the overall operation of a fund*" or having "*de facto control of the oversight or operation of the fund*". It is helpful that the SFC has confirmed that a Hong Kong fund manager appointed as a sub-manager to manage only an allocated portion of a fund will not be considered as responsible for the overall operation of a fund or to have de facto control of the fund. AIMA takes the view that sub-advisers fall into the same category.

[1] AIMA is the global representative of the alternative investment industry, with more than 1,800 corporate members in over 55 countries. AIMA works closely with its members to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes, and sound practice guides. Providing an extensive global network for its members, AIMA's primary membership is drawn from the alternative investment industry whose managers pursue a wide range of sophisticated asset management strategies. AIMA's manager members collectively manage more than US$1.7 trillion in assets. AIMA is committed to developing industry skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the industry's first and only specialised educational standard for alternative investment specialists. For further information, please visit AIMA's website, http://www.aima.org/.

As a general comment, we believe that some of the proposed changes, such as those relating to disclosure and reporting, are overly onerous and may have the unintended effect of favouring non-Hong Kong based fund managers. Such fund managers may be able to avoid compliance with the additional requirements by appointing licensed third party distributors or group companies to market their funds in Hong Kong. This may have a detrimental impact on the local asset management industry. In relation to the proposed requirements around disclosure and reporting, we strongly consider that these issues should be subject to separate formal consultation, given the significant burden that the proposed requirements will impose on fund managers. We also consider that such requirements should be consistent with international standards already in place (please see our response to questions 6, 12, 16 and 21 for further detail).

We set out our detailed responses to the questions posed in the consultation below.

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?

The introductory section to the proposed FMCC confirms that the Code applies to licensed or registered persons whose business involves the management of discretionary accounts (in the form of an investment mandate or pre-defined model portfolio). During the soft consultation we commented that in circumstances where a discretionary account fund manager is obliged to act within the investment and risk parameters of a discretionary account mandate, some of the SFC's regulatory requirements would not align with the operational realities of managing discretionary accounts.

If adopted, Appendix 1 of the proposed FMCC will outline those requirements which will not apply to managers of discretionary accounts and these relate to, for example, liquidity management, termination, side pockets, auditors and audited accounts, valuation frequency, net asset value calculation and pricing and offers of investments. AIMA agrees that those matters should not apply to discretionary account managers. However, in AIMA's view, the carve-outs are quite limited and should be more extensive. In particular, the provisions relating to the appointment of custodians should not apply to discretionary accounts as discretionary account clients will frequently have a preferred custodian which they may appoint themselves (and which the discretionary account managers are obliged to use). We also believe it is unnecessary and disproportionate to mandate the terms of discretionary account client agreements. We have therefore suggested a series of amendments to Appendix 1 of the FMCC, which we have set out in the Annexure to this letter.

We also consider that it is unhelpful that the proposed FMCC applies to three different configurations: (i) direct fund managers; (ii) delegated fund managers; and (iii) segregated accounts. There could be overlap of responsibilities between direct and delegated fund managers and the proposed FMCC does not cater for this.

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.

As mentioned during the soft consultation, typically the relevant governing body in the context of alternative asset managers is the fund's board of directors. The SFC proposes to broaden the scope of the FMCC by imposing greater responsibilities on those fund managers "*who may in substance be responsible for the overall operation of the fund or have de facto control of the oversight or operation of the fund*", notwithstanding that those fund managers may not be the legal entity responsible for making formal decisions in relation to the fund.

It must be acknowledged that the relationships which exist between a fund manager and its clients and the funds it manages differ significantly from one mandate to another. In some cases, the fund manager will have been appointed solely to manage the fund for investment returns and the responsibilities in relation to, for example, disclosures or the appointment of service providers, will be retained by the fund's board of directors or delegated to another entity. For example, while a fund manager who is the main sponsor to a fund will be instrumental in

the appointment and monitoring of the key service providers to the fund, it will remain the fund's board of directors' responsibility to appoint such service providers and to mandate the fund manager with the task of carrying out due diligence around the service provider, as well as monitoring its performance on an ongoing basis. This means that the ability of a fund manager to select or monitor a service provider will differ in each mandate but, in each case, it is subject to the ultimate decision of the board of directors. The same is true for disclosures that are made in the Offering Memorandum. It is critical to recognise the authority and responsibility of the board of directors, as fund boards will generally have a number of independent and non-executive directors whose fiduciary duties and responsibilities are to ensure that the interests of investors are safeguarded. Diluting the responsibility and power of the fund's board of directors would lead to less effective boards and ultimately fewer checks and balances, which would be detrimental to investors.

As noted in our response to the soft consultation, AIMA is also concerned that a number of the SFC's proposals concern the fund more than the fund manager and that most of the alternative fund vehicles managed or advised by AIMA members are not established in Hong Kong and are therefore not, nor should be, subject to the SFC's regulations.

Subject to our comments below, it is helpful that the SFC has confirmed that a Hong Kong fund manager appointed as a sub-manager to manage only an allocated portion of a fund would <u>not</u> be considered as responsible for the overall operation of a fund or to have de facto control of the fund. AIMA takes the view that sub-advisers fall into the same category.

We make further comments as set out below:

- The SFC has indicated that where a fund manager and/or its affiliate(s) constitute a majority of the board of directors of the fund, they may be considered to have de facto control of the oversight or operation of the fund. However, even where a majority of the board of directors are representatives of the fund manager, it goes against the fiduciary duties of the directors to simply implement the instructions of the fund manager. The directors of the fund must act in the best interests of the fund.
- It is also not appropriate to impute the control by affiliates of a fund manager to the fund manager itself. A small Hong Kong office of a larger internationally active fund manager should not be required to impose Hong Kong regulatory requirements on a fund and other fund managers outside Hong Kong on the basis that those non-Hong Kong fund managers are affiliates of the Hong Kong fund manager. Accordingly, we consider that the inclusion of "*and/or its affiliate(s)*" is too wide-ranging and lacks certainty, and we therefore request that this wording be deleted.
- We also consider that it is important to clarify that each fund can only have one fund manager with de facto control. It would not be feasible for a fund to have two or more fund managers with de facto control, particularly because many of the responsibilities as set out in the proposed FMCC are not suitable to be apportioned between multiple fund managers.
- Paragraph 15 of the consultation paper also suggests that a sub-manager manages only an "*allocated portion of the fund*". In practice, a sub-manager/sub-adviser that has day-to-day discretionary investment management of a fund's entire investment portfolio is still considered to be a sub-manager/sub-adviser when appointed by a fund manager. The fact that a sub-manager/sub-adviser has day-to-day discretionary investment management responsibility of a fund's entire investment portfolio should not by itself make that entity a fund manager with de facto control for the purposes of the FMCC.
- We also consider that it should be made clear that the same entity can be: (i) a fund manager with de facto control of Fund A; and (ii) a sub-adviser to Fund B without any of the obligations imposed on the fund manager in respect of Fund A (by virtue of having de facto control) being imposed on the same entity in respect of Fund B. We therefore suggest that paragraphs which begin with the following wording should be amended as follows:
    - "*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.....on behalf of [that/the] ~~**each**~~ **fund** ~~it manages~~...*
    - Impacted paragraphs include the following: paragraphs 3.12, 3.13.7, 3.13.8, 3.14.1, 3.14.2, 3.14.3, 3.15, 4.1.2, 4.2.1, 4.3, 4.4.1, 5.2.2, 5.3.1, 5.3.4, 5.3.5, 5.4.1, 5.5 and 6.2.

- In circumstances where the proposed requirements apply to sub-managers/sub-advisers to a fund, AIMA's view is that their application should be limited to the relevant assets under management by the sub-adviser. An example is in relation to the proposed obligation to regularly assess the liquidity of the assets of a fund (please see paragraphs 3.14.1(b) and (c) of the proposed FMCC). This is on the basis that sub-advisers may not have access to the whole portfolio and, even if they do, they would be duplicating the efforts of the fund manager.
- We consider that the following paragraphs should only apply to those fund managers who are considered to be "*responsible for the overall operation*" or have "*de facto control*" of the fund: paragraphs 4.1.1 (safety of fund assets), 5.5.1 and 5.5.2 (NAV calculation and pricing) and 9.1.1 (reporting obligations to the SFC).

Finally, we also consider that it is important to include a provision in the new FMCC which provides that Fund Managers should use their 'best efforts' to comply with all requirements under the FMCC, recognising that there may be circumstances where the fund's board of directors overrules the Fund Manager's decision. Such a scenario is likely to arise in the context of the appointment of a custodian, fund audit waivers, liquidity or valuation, where the fund's board of directors is the entity legally or contractually responsible to undertake a particular step, notwithstanding the fact that the Fund Manager may still have de facto control.

Securities lending and repurchase agreements (repos)

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?

In paragraphs 26 to 34 of the consultation paper, the SFC has made certain proposals regarding funds which engage in securities lending, repo and similar over-the-counter ("**OTC**") transactions. Those proposals relate to collateral valuation and management, eligible collateral and haircuts, reinvestment of cash collateral and reporting to end-investors.

As mentioned during the soft consultation, to the extent that AIMA members engage in securities lending, they largely engage in that activity from the borrower side (i.e. borrowing securities and giving collateral) rather than from the lender side (i.e. lending securities and receiving collateral). Some of the principles proposed by the SFC will only be relevant where collateral is received by the fund manager, such as the proposals in relation to eligible collateral and haircuts. We should be grateful if the SFC would clarify that the proposals regarding securities lending and repos will only apply to the extent that they are relevant to the activity undertaken by a fund manager (and would not, for example, extend to a fund manager that engages in securities lending on the borrower side).

It is not clear whether the SFC's proposals are intended to apply to a fund manager who is lending securities indirectly through their prime broker/custodian. For example, where the fund manager does not operate the lending program but only receives part of the lending fees from lending out fully paid securities from their portfolio holdings. The prime broker already lends out securities that are margined but normally keeps the entire lending fees. For fully paid securities, the fund manager could give permission for these to be lent out as well. Does the fund manager have any responsibility to ensure that the prime broker complies with the SFC requirements?

We consider that the phrase "*similar OTC transaction*" lacks clarity. We presume that the following are not considered similar and are therefore not within scope: equity swaps, contracts for difference and other market access-type products. If these or other types of transactions are considered similar and therefore in scope, the particular characteristics which link them should be clearly identified.

We also consider that the entirety of paragraph 3.13 should <u>only</u> apply to fund managers with de facto control, as sub-advisers will not have sufficient control over or access to relevant records in order to be able to comply with the proposed obligations.

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?

Please see our response to question 3 above.

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.

Please see our response to question 3 above.

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?

As explained during the soft consultation, AIMA considers it important that any information required to be disclosed should be proportionate to the operational burdens the reporting requirements will place on fund managers compiling the information. Further, the quantum of information required to be disclosed should not overwhelm other risk disclosures such that it would create the perception that the impact of securities lending, repos and other OTC transactions on the portfolio's overall risk profile is much larger than it actually is.

During the soft consultation, the SFC broadly indicated that a fund manager should provide information on a fund's securities lending and repos and similar OTC transactions without identifying the precise information that would need to be reported. In Appendix C to the consultation paper, the SFC has now proposed a series of different data points that must be reported to clients and investors on securities lending, repos and similar OTC transactions "*at least on an annual basis and upon request*". We propose that the additional reporting requirements be subject to further formal consultation to give the industry an opportunity to comment on the feasibility and cost of complying with the requirements. For example, in many cases the information required to be reported will be held by counterparties and industry members will need to liaise with those counterparties to determine if the information can be easily obtained. AIMA also seeks further clarity from the SFC as to the purpose for which such reporting is required. Is it, for example, intended to allow the SFC to monitor systemic risk and, if so, will it fulfil that purpose such that the burden on fund managers is warranted?

Our view is also that the disclosure of such information should only be mandated where clients and investors specifically request it. AIMA urges the SFC to impose reporting requirements no more onerous than those imposed in the EU under the European Regulation on Transparency of Securities Financing Transactions and Reuse ("**SFTR**"). There are inconsistencies between the SFC's proposals and the reporting requirements under the SFTR. By way of example, Appendix C requires the disclosure of cash versus non-cash collateral (paragraph (c)(v)) whilst no equivalent obligation exists under the SFTR. Many fund operators with a global presence have taken steps to ensure compliance with the SFTR and it is desirable that the SFC's reporting requirements are consistent with the SFTR requirements.

<u>Custodian/safe custody of fund assets</u>

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

We note that the requirement that a fund manager should ensure that fund assets are segregated from the assets of the fund manager and its affiliates is consistent with AIMA's policy principles.

However, as expressed during the soft consultation, it will generally be the fund's board of directors' responsibility to select and appoint service providers, including the custodian, and contract with such custodians. The fund manager does not have a formal relationship with the custodian.

In addition:

- We suggest that paragraph 4.1.1 of the proposed FMCC is amended as follows: "*A Fund Manager should ensure that the fund assets entrusted to it if any are properly safeguarded.*"
- Paragraph 4.2.1 states that "*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), a **Fund Manager should exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of the custodian**…..*" (emphasis added). As described above, in most cases it will be the fund board's responsibility to select and appoint

the custodian and therefore, in practice, the fund manager can only recommend the appointment of a particular custodian.

- Paragraph 40 of the consultation paper states that "*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 arrange for the appointment of**, and entrust the fund assets to, a custodian that is functionally independent from it*" (emphasis added). This is at odds with the proposed paragraph 4.2.2 which states that the Fund Manager must appoint a custodian. As described above for question 2, it is important to delineate between the roles of the fund manager and the fund in relation to, for example, the appointment of a custodian. Save where explicitly delegated, the fund's board of directors have ultimate responsibility for such appointments and the contractual arrangements will be between the fund and the custodian (we acknowledge that in practice the fund manager may make recommendations regarding the appointment of custodians). It is therefore not appropriate for the FMCC to be drafted in such a way which suggests that the fund manager appoints the custodian; this only occurs where the responsibility is explicitly delegated to the fund manager.
- Many of the SFC's requirements relating to custodians and safe custody of assets impose obligations on those fund managers who are deemed to be responsible for the overall management of the fund or who have de facto control of the oversight or operation of the fund. As such, we reiterate our comments regarding the interpretation of those concepts (please see question 2 above).
- The terms of custody arrangements will vary depending on the provider, nature of the assets and the market where the assets are traded or held. We suggest that paragraph 4.3.2 of the proposed FMCC is amended as follows: "*In particular, the Fund Manager should ensure that the custody agreement contains normal commercial provisions prevailing in the relevant market ~~to specify the scope of the responsibility and liability of the custodian~~*".
- Finally, we mentioned in the soft consultation that the majority of Asia based alternative funds use custodians domiciled outside Hong Kong, including prime brokers. We wish to clarify with the SFC that its proposals would not seek to change this feature and, for example, require that the custodian be based in the same jurisdiction as the fund manager.

Liquidity risk management

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

Paragraph 3.14.1 of the proposed FMCC requires fund managers to adhere to a number of liquidity management principles, which derive from the 15 principles set out in the IOSCO report entitled "*Principles of Liquidity Risk management for Collective Investment Schemes.*" During the soft consultation, we noted that the IOSCO principles are focused primarily on retail open-ended collective investment schemes, and therefore many of the assumptions are not applicable to alternative investment funds.

We also note that paragraph 3.14.1(b) of the proposed FMCC requires fund managers to "*integrate liquidity management in investment decisions*". On one reading, this would require fund managers to consider liquidity when following their investment strategy and doing so may inhibit or conflict with certain strategies. In our view, which is consistent with IOSCO's report, it is not appropriate for detailed analysis to be undertaken before every individual transaction. Rather, the application of the liquidity risk management process should provide reasonable assurance that the investment decisions are consistent with the fund's overall liquidity profile. We therefore request that the SFC amends this paragraph to reflect the practical reality (as described above) or deletes it completely.

We also consider that the liquidity management provisions should include a carve-out for any fund where there are no redemptions at the option of the investor i.e. closed-ended funds.

AIMA agrees that fund managers should have a liquidity management policy, but we note that this should be fund-specific and it will need to be tailored to the redemption policy of the fund, which is set by the fund's board of directors. We welcome the fact that the proposed changes to the FMCC are not prescriptive as regards the contents of a liquidity management policy.

The note to paragraph 3.14.1 states that the obligation to "*assess and make disclosure regarding the liability side of a fund.....*" only applies to a fund manager with de facto control, and yet paragraph 3.14.1(c), which applies to sub-managers as well, imposes an obligation to "*regularly assess the liquidity of the assets of a fund*". This appears to us to be contradictory.

We suggest that the note to paragraph 3.14.2 be clarified as follows: "*Where side letters have been entered into, a Fund Manager should disclose such fact and the material terms in relation to redemption in the side letters to all fund investors, before they invest in the relevant fund ~~all potential and existing fund investors~~*".

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?

AIMA agrees that it is necessary for fund managers to conduct regular stress testing, and we consider that fund managers should have flexibility to devise their own methodology for stress testing.

AIMA is supportive of the need for fund managers to set appropriate liquidity targets, but we do not consider that the SFC should attempt to define what those liquidity targets should be, as it would be extremely challenging to define in a manner that would be applicable to all types of strategy. We therefore agree with the fact that the proposed principles do not specifically refer to liquidity targets.

Disclosure of leverage

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

We believe that leverage and risk are the two concepts which investors find most difficult to understand. The confusion is compounded by the lack of consensus over how leverage is to be calculated. Sophisticated investors ask their own questions about leverage. We do not believe that mandating disclosure of a maximum level of leverage and the method of calculating leverage (particularly synthetic leverage) is likely to be helpful. In the absence of a commonly accepted and easily understood method of measuring embedded leverage in complex derivatives and short strategies, we believe generic disclosures regarding leverage and its potential risks (tailored by the manager according to the nature and extent of their proposed use of leverage) are likely to be more useful to investors.
In addition, it is undisputed that there are no international standards or best practices for calculating leverage and therefore we suggest that the following is deleted from paragraph 3.12: "*having due regard to international best practices*".

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

As explained during the soft consultation, AIMA does not consider it appropriate to mandate that all fund managers disclose leverage on a gross and net (i.e. commitment) leverage basis, as there are many well documented deficiencies associated with such methods. It is therefore helpful that the proposed new paragraph 3.12 does not require a particular approach for calculating leverage.

Other amendments

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

Organisation and resources

In relation to paragraph 1.2(b) of the proposed FMCC, we do not consider that it is appropriate that human and technical resources and experience should vary depending on assets under management ("**AUM**"). We suggest that this provision is re-drafted to be less prescriptive and more principles-based. For example, human resources will depend on a combination of factors including one or more of the following: AUM, investment strategies,

geography and the type of investors in the funds (retail versus institutional/professional). AUM on its own may not be an important factor.

We also consider that paragraph 1.2(d) is incorrectly framed and should be amended to make it clear that risk management structures and procedures should relate to the nature of: (i) the fund manager's business; and (ii) the size, complexity, risk profile and investment strategy of the funds/discretionary client accounts.

Conflicts of interest

We suggest that the SFC revisits the proposed paragraph 1.5. Where a conflict can be justified and managed then it should be permissible as seems to be accepted in the first sentence of paragraph 1.5. The second sentence is somewhat contradictory in that it states “where such conflict cannot be avoided” indicating on one reading that a conflict can only be allowed to occur where it is not possible to avoid it.

We assume that the disclosure requirement at paragraph 1.5 can be dealt with by pre-contractual generic disclosure regarding the nature of the conflict(s).

Compliance

We suggest that the SFC revisits the proposed paragraph 3.15 as, on one reading, the current drafting suggests that notification of material non-compliance should only be made to the SFC once the matter has been rectified, which we do not think is the SFC's intention. We also note that fund managers have self-reporting obligations under paragraph 12.5 of the Code of Conduct.

Fund portfolio valuation

In relation to fund portfolio valuation, paragraph 5.3.4 of the proposed FMCC provides that where a Fund Manager is responsible for the overall operation of a fund and appoints 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** (emphasis added). We note that, in practice, fund managers do not generally appoint the valuation agent.

Valuation policies also need to be on a fund by fund, account by account basis, or at least must allow for variation as agreed with clients. The final sentence of paragraph 5.3.1 is too restrictive as fund managers are not necessarily going to have consistent valuation policies across the funds that they manage. We therefore suggest the following amendment:

> "*.....it should ensure that, in respect of each such 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 the assets across all funds managed by the Fund Manager.~~*"

We also consider that the following paragraphs should only apply to a fund manager with de facto control, and not SFC licensed sub-advisers, on the basis that they are not the appropriate entity to be in control of valuation: paragraphs 5.3.2, 5.3.3, 5.3.5, 5.3.6 and 5.3.7.

It would be helpful if the SFC could confirm the reasons for deleting the following wording from paragraph 5.3.6(a): "*daily opening, mid-price and average*".

In relation to paragraph 5.3.7, we also consider that this requirement can be satisfied where the auditor performs regular annual audit procedures in accordance with the International Financial Reporting Standards (IFRS) or generally accepted accounting principles (GAAP).

Side pockets

We do not consider that it is necessary to include a section on side pockets in the FMCC as the standards expected around side pockets are adequately set out in the SFC Circular entitled "*Circular to All Licensed Corporations Engaged in Hedge Funds Management Business*" (27 October 2008).

Reconciliations

We consider that the scope of paragraph 5.6 should be limited to those assets managed by the fund manager and, in the case of a sub-advisory relationship, the sub-adviser.

Disclosure of interests

In relation to the fund manager's obligation to disclose all interests in securities, it is important to distinguish between the manager's obligations in respect of securities bought for its own account, and the fund's obligations; the latter should apply to a sub-adviser only in accordance with the terms of the sub-advisory relationship, and then only to the extent of the assets managed by the sub-adviser.

Dealing with the fund and fund investors

We agree with the inclusion of paragraph 6.2 but we consider that all other requirements in the proposed FMCC around disclosure to clients and fund investors should be deleted. Please also see our comments in response to question 6 above around reporting on securities lending, repos and similar OTC transactions, as well as our comments on reporting to the SFC (see section entitled "Reporting" below).

Paragraph 6.3 requires a fund manager to maintain proper procedures to ensure confidentiality of information in respect of the fund or fund investors. We suggest that this be limited to the extent that the manager has confidential information itself, as opposed to being required to ensure the confidentiality of information held by other service providers. In the case of sub-advisers, they would be unable to obtain the necessary assurances from other sub-advisers or service providers around ensuring the confidentiality of information they possess.

Audited financial statements

The SFC's proposals require fund managers to appoint an independent auditor to perform an audit of the financial statements of each of the funds it manages and make available an annual report for each of the funds it manages, which is prepared in accordance with generally accepted accounting principles (see also paragraphs 5.2.2 to 5.2.3 of the proposed FMCC).

- Fund managers, even where they may have de facto control, do not typically appoint auditors; this is done by the fund's board of directors. We therefore consider that paragraph 5.2.1 of the proposed FMCC needs to be amended as it requires Fund Managers, as opposed to the fund, to appoint auditors.
- Is it possible to waive this requirement in certain circumstances? This would be consistent with the approach taken by the Cayman Islands Monetary Authority, which may grant waivers/exemptions to their audit requirements, for example when a fund is being voluntarily liquidated, or when all investors consent.
- We also assume that "*generally accepted accounting principles*" includes IFRS but we should be grateful if the SFC would confirm this point.

Reporting

In relation to reporting, paragraph 9.1.1 of the proposed FMCC requires fund managers to provide "*appropriate information to the SFC on an ongoing basis upon request*", and such information may include: (i) leverage; (ii) assets and, where available, liability information (including illiquid assets); and (iii) information on each fund's securities lending, repo and similar OTC transactions. The SFC's proposals also state that, 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.

AIMA agrees in principle with the concept of data reporting, provided that the requests are proportionate and the information requested will be of utility to monitoring systemic risk. SFC-licensed asset managers make up only a part of the Hong Kong securities markets and we do not consider that they are the main drivers of systemic risk. It is also not clear from paragraph 9.1.1 what constitutes "*on an ongoing basis upon request*" and we would ask that the SFC ensures that the scope, timing and frequency of such requests are commensurable with the benefit derived from receiving such data, so that such requests do not become disproportionately burdensome for fund managers to comply with.

We note that the SFC will engage with the industry on the items for data collection in due course and we would urge the SFC to formally consult the industry as regards ongoing reporting requirements to give it an opportunity to comment on the feasibility and associated costs of providing the proposed data. We consider that it will be important that such requirements are consistent with international standards already in place, such as AIFMD, as global institutions will have already spent significant time complying with these requirements.

We suggest that paragraph 9.1.3 is amended as follows to ensure that liability is not extended to information submitted to the SFC by third parties:

> "*A Fund Manager should ensure that all information it provides to the SFC is in all material respects accurate, complete and not misleading.*"

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?

We do not have any comments, save that we note that house accounts are not very common amongst AIMA members. To the extent that a house account exists, for example in the context of an internal or pension fund, AIMA's view is that it is unlikely that there are any circumstances in which it would *not* be appropriate to aggregate client orders with house orders, noting that the fund manager is under a duty to act in the best interests of its clients.

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

No comments.

<u>Appendix 1 to the FMCC - Requirements for licensed or registered persons conducting discretionary accounts management</u>

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

Please see our comments in response to question 1 above.

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.

AIMA's view is that the proposed new requirements under the FMCC will require a significant amount of work to implement, as it will be necessary to analyse the impact of the new rules on business models, update policies and procedures and initiate IT and systems amendments. AIMA members are operating in an environment where there are significant regulatory changes, both at a Hong Kong and a global level. For example, AIMA members are in the process of implementing the SFC's recent "Manager in Charge" regime which, for some of the more complex and global firms, is proving to be a time-consuming process. In light of this, as well as the fact that firms were afforded two years to implement AIFMD (one year for transposition and one year for transition), AIMA considers that at least a 12-month transition period would be more appropriate. This transition period should also only start from when the new FMCC is finalised. If further guidance is issued post the introduction of the FMCC, then we request that the transitional period is extended. In addition, we suggest that, following the transition period, there should be a period of time in which the SFC would agree not to take enforcement action for non-compliance with the FMCC provided that fund managers had undertaken to comply on a best efforts basis.

Finally, we suggest that the requirements around reporting to clients, investors and the SFC should be carved out on the basis that we consider that a separate formal consultation should be undertaken in this regard.

Inducements/commissions

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?

AIMA's view is that the proposed changes to the Code of Conduct are targeted at intermediaries providing financial advice, rather than AIMA members who are predominantly hedge fund managers. This is supported by paragraph 78 of the consultation paper which states: "*One significant change relates to inducements and commissions received by financial advisers and distributors.*"

Notwithstanding this, we support the SFC's proposed approach of restricting the use of the term "independence", and the enhanced disclosure requirements around monetary benefits which are not quantifiable at the point of sale. We consider that adopting a pay-for-advice model would have severe unintended consequences, depriving many non-institutional investors from the ability to seek financial advice. This is supported by the survey results contained in the consultation paper. We would therefore not advocate the SFC adopting such a model in the future.

We also consider that it is important to ensure consistent levels of disclosure for all investment products (asset management products, banking products and insurance products) and intermediaries. For example, it would be inappropriate to use a wrapper to circumvent the relevant regulatory rules. We therefore urge the SFC to collaborate with the Hong Kong Monetary Authority and the Office of the Commissioner of Insurance to ensure that the rules around independence and disclosure of monetary benefits are harmonised.

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

Please see our comments in relation to question 17 above.

Question 19: Do you have any comments on the enhanced disclosure proposed with regard to monetary benefits received or receivable by intermediaries that are not quantifiable prior to or at the point of entering into a transaction (and in particular, in relation to specific types of investment products)?

AIMA's view is that the enhanced disclosure requirements apply to monetary benefits applicable to distributing non-private funds, e.g. trailer fees. We consider that paragraphs 8.3 and 8.3A of the proposed Code of Conduct do not apply to any fees that may be received by a fund manager in respect of services it provides to the fund, and which are paid for by the fund. We should be grateful if the SFC would confirm the point.

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?

No comments.

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.

Please see our comments in response to question 16 above.

Other issues: Private funds and extraterritorial application

The SFC has stated that its current proposals apply equally to fund managers managing public funds and those managing private funds, whether those funds are domiciled in Hong Kong or in overseas jurisdictions. As

mentioned during the soft consultation, we are concerned about the impact of regulation applying to private funds domiciled overseas for the following reasons:

1. Such funds will already be subject to regulations in the jurisdictions in which they are established, which may conflict and/or be incompatible with any specific Hong Kong requirements; and
2. Hong Kong fund managers are seldom exclusive managers of the fund and are usually appointed as one of a number of sub-managers or sub-advisers to manage a portion of the fund's portfolio.

If the FMCC and Code of Conduct were to have extraterritorial application to private funds, this would lead to conflicts with the regulations applicable to such private funds in their home jurisdiction, as well as conflicts with sub-managers or sub-advisers that are not subject to the codes.

In acknowledging this fact, the SFC has suggested that the proposals tend to be more principles-based. At least in the case of the proposals regarding risk management, leverage, securities lending, liquidity management and custodians, we do not agree that they are only principles-based requirements. In many cases the requirements are highly prescriptive and place onerous obligations on the relevant fund managers.

Other issues: Sub-advisory relationships

AIMA's view is that the SFC's proposed requirements which apply to sub-advisers would impact how they deal with the fund, particularly where they require the fund to take specific steps or, worse, require the fund to do something contrary to regulations applicable to the fund. Such tensions could cause a Hong Kong fund manager to lose out on particular mandates. We therefore strongly urge the SFC to introduce a full carve-out for the following types of funds: (i) a US 1940 Act fund; (ii) a UCITS fund; and (iii) any other regulated retail fund with provisions which compete with the SFC's proposals. Whilst many countries are addressing the IOSCO principles, a consistent approach is not being taken and therefore the SFC's proposals need to make appropriate exceptions.

Other issues: Disclosure and reporting generally

We believe that fund-related disclosure and reporting requirements for authorised funds should be dealt with in the UT Code. The SFC's Investment Product Department in practice comments on disclosures in the offering document as part of the approval process.

However, we do not believe it is appropriate to mandate specific disclosure and reporting requirements for private funds, which take a wide variety of forms, invest in a very wide variety of asset classes, adopt an extremely wide variety of investment strategies, and target a different investor base from public funds. If the SFC has concerns about levels of disclosure in particular areas, such concerns can be addressed by way of circulars, but we would caution against the risk of excessive focus on specific current or cyclical issues.

The revised FMCC imposes an obligation on a fund manager to make adequate disclosure and we believe that the fund manager who is responsible for the investment management function and overall operation of a fund is best placed to decide what disclosure is relevant to that fund. Please also see our comments in response to questions 6, 12, 16 and 21 above.

Other issues: Fund investors and the client agreement requirements

It is helpful that the proposed FMCC distinguishes between the fund as the client of a fund manager and fund investors. However, we believe that further clarification in the Code of Conduct may be required. There appears to be a divergence of views as to whether, and to what extent, fund investors are clients of a fund manager. Where a fund manager is purely conducting asset management activity, the consensus view seems to be that fund investors are not clients. However, where the fund manager markets directly to potential fund investors, they may be clients on the basis that the fund manager is engaging in dealing activity. However, in engaging in such activity, the fund manager is not providing a service in any conventional sense to the fund investors. It is making solicitations, but it is not arranging deals in the way that a broker provides a dealing service to its clients: it is actually an agent and service provider of the fund in this respect.

Under the existing FMCC, paragraph 6.4.2 provides that where a Fund Manager is acting as distributor of a collective investment scheme, the fund's authorised offering document and application form may be regarded as a Client Agreement. However, this provision is proposed to be deleted. The SFC has not provided any commentary regarding this deletion, and therefore the rationale for this change is unclear.

To the extent that fund investors are clients of a fund manager, the FMCC needs to be revised to address the form of client agreement required if the offering document and application form or subscription agreement are not to serve as the client agreement: the Code of Conduct client agreement requirements are not appropriate as the scope of service provided by the fund manager is so limited. Our view is that fund managers who wish to do so should be able to continue to treat the offering document and application form as a client agreement where these documents clearly set out the services provided to investors. We therefore ask the SFC to clarify this point.

The terms of discretionary investment management agreements, and the terms of fund documentation (particularly in the hedge and private fund arena) are often heavily negotiated with potential clients or investors. We therefore believe it is unnecessary and disproportionate to mandate the terms of client agreements and have suggested amendments to Appendix 1 accordingly (please see the Annexure below).

We also ask the SFC to confirm that in the case of discretionary account client agreements, it will be sufficient for discretionary account managers to provide a description of the fees to be paid by the client rather than an absolute value.

Other issues: Potential conflict between the SFC's codes

The various codes applicable to fund managers' business activities and products have been expanded and enhanced substantially since the Securities and Futures Ordinance came into effect, and they include statements of general principle as well as activity or product specific requirements. We believe that, in the event of conflict between a code of general application (such as the Code of Conduct) and an activity-specific code (such as the FMCC), the FMCC should prevail. Similarly, in the event of a conflict between the UT Code and the FMCC, the UT Code should prevail. This will help to avoid confusion and duplication.

We hope that the SFC will find the points set out above helpful and that it will address them in the consultation conclusions.

Yours faithfully

Annexure 1 –

Suggested amendments to Appendix 1 to the proposed FMCC

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 3.14.2 of this Code) [**We suggest deleting this paragraph reference on the basis that, in our view, all disclosure requirements save for those set out at paragraph 6.2 should be removed from the FMCC. Please see our response to question 12.**]

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) The provisions relating to custody, other than paragraph 4.1.1

[Discretionary Account clients frequently appoint their own custodians. The Fund Manager should not be required to take any responsibility for the choice of custodian or to monitor the custodian in such circumstances.]

(c) Termination

The requirements in relation to the termination process are 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.

[**We suggest deleting this section on the basis that, in our view, the entire section on side pockets should be deleted from the FMCC. Please see our response to question 12.**]

(d) Auditors and audited accounts

The requirement in relation to the audit requirement of the financial statements of each of the funds under management is 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)

(h) The provisions of this Code relating to disclosure to clients.

[**Discretionary Account Agreements are typically negotiated, and clients are in a position to specify the limits of the mandate and reporting information they require.**]