THE

LAW SOCIETY OF HONG KONG

香港律師會

3/F WING ON HOUSE · 71 DES VOEUX ROAD
CENTRAL · HONG KONG DX-009100 Central 1
香港中環德輔道中71號
永安集團大廈3字樓

TELEPHONE (電話): (852) 2846 0500
FACSIMILE (傳真): (852) 2845 0387
E-MAIL (電子郵件): sg@hklawsoc.org.hk
WEBSITE (網頁): www.hklawsoc.org.hk

Our Ref : IPFS/3246368
Your Ref :
Direct Line :

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BY EMAIL & BY POST

21 February 2017

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

Dear Sirs,

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

I refer to the captioned Consultation and I enclose the Law Society's Submissions on the subject matter for your attention.

Encl.

5 years+ 同心展關懷 caringorganisation

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

THE LAW SOCIETY'S SUBMISSIONS

The Law Society has reviewed a consultation paper issued by the Securities and Future Commission on 23 November 2016 ("the Consultation Paper"). In respect of those questions listed out in the Consultation Paper, we have the following responses.

Question 1: *Do you have any comments on the proposed clarification that the Fund Manager Code of Conduct ("FMCC") applies to the business activities carried out by fund managers which would include the management of discretionary accounts?*

Law Society's response:

This is a sensible clarification, reflecting the need to regulate all intermediaries involved in discretionary fund or account management activity in a similar way under the regime, subject to specific differences in treatment where appropriate accounting for the differences in structure and activity; the exceptions stated in paragraph 21 for in-scope discretionary account managers also need to be set out clearly in Appendix 1 to the FMCC.

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.*

Law Society's response:

We recognize, and support, the importance of applying regulations that concern a fund at the fund level and not at a Fund Manager level.

Furthermore, as a legal matter, we note that the role of the funds governing body and its responsibilities which are distinct from those of the Fund Manager.

For this reason we support the SFC's approach that certain requirements or proposed requirements in the FMCC apply to Fund Managers who are responsible for the overall operation of the fund (or have de facto control of the oversight or operation of the fund).

This is consistent with certain International Organization of Securities Commission ("IOSCO") principles and standards, such as in relation to liquidity risk management, Collective Investment Scheme ("CIS") valuations, and suspensions, are targeted at a person or persons – including in normal circumstances a fund manager - who is/are "responsible" for the "overall operation" of a fund.

The IOSCO paper on liquidity risk management, for example, states that *the principles are addressed to the entity/entities responsible for the overall operation of the CIS*. It goes on to say that *their implementation may vary from jurisdiction to jurisdiction, depending on local conditions and circumstances*.

In this regard, we note that the SFC proposes similarly in the Consultation Paper the setting of liquidity management policy and the appointment of a qualified custodian, follows the "overall responsibility" approach and would only be applicable to a fund manager who is responsible for the overall operation of a fund.

We consider that the overall responsibility approach is appropriate – it would be useful to market participants for the SFC, in the light of the Hong Kong's individual circumstances, to describe what is meant by "overall responsibility", so as to promote certainty.

The Consultation Paper goes on to say that any person who has "de facto" control of the oversight or operation of the fund would also be within the scope of the requirements.

As regards "*de facto*" control of the "oversight or operation" of the fund, the example given in the consultation paper is where (paragraph 15):

…the representatives of the fund manager and/or its affiliate(s) constitute a majority of the board of directors of the fund.

The SFC appears to have chosen to interpret this as not being aimed at anyone who,

for example, only manages a "portion" of a fund (presumably including, for example, a specialist sub-manager responsible only for a particular market sector – see below). We recognize that this example is focused on the private fund management industry in particular – and this acknowledges this importance. However, the concept could be more precisely provided for and defined by reference to a "control" test (apparent – to capture shadow directors at the Fund Manager level – and achieve) in the FMCC to avoid arguments as to when and how "de facto" responsibility (which is not fully explored in the IOSCO materials) is met.

Paragraph 15 also states that:

"To the extent that a fund manager is not responsible for the overall operation of a fund (and has no de facto control of the [overall] [Comment: our added wording, for clarity] *oversight or operation of the fund), for example, where the Hong Kong fund manager is appointed as sub-manager to manage only an allocated portion of the fund, certain FMCC principles and requirements will not be applicable.* [Comment: It needs to be made clear that the sub-manager in that case is not responsible to the extent that the manager or other entity is so responsible, otherwise a responsibility gap would be created. There is clearly an issue in this regard where there is an offshore manager delegating to a Hong Kong sub-manager, where the offshore manager is not SFC-licensed. Again, there is potentially a regulatory gap, unless the SFC relies upon the offshore regulator (if any). Nevertheless, we recognize the practical difficulties where the sub-manager is merely delegated the discretionary management function (excluding valuation, liquidity management – except within already defined parameters. The powers lie with the manager and/or the fund board (and its advisers).] *However, the generally-applicable FMCC principles and requirements, such as organisation and management structure, staff ethics, record keeping and conflicts of interest requirements, should be complied with by all fund managers."* [Comment: This sentence is agreed]

Notwithstanding the above, we consider there to be an over-arching interpretation point in the proposed revisions to the FMCC in relation to the drafting of Appendix A which we consider needs to be addressed:

There seems to be a degree of confusion concerning the application of the FMCC in relation to overall responsibility and de facto control.

In the introduction to the FMCC, it states:

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) are not applicable.

That on its face provides for all Fund Managers to be fully caught under the FMCC unless they are responsible overall / in de facto control and explicitly carved out. Accordingly, the coverage is all-inclusive, subject to specific exceptions.

However, the coverage is different in provisions such as:

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 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) maintain and implement effective liquidity management policies and procedures to monitor the liquidity risk of the fund, taking into account the investment strategy, liquidity profile, underlying 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 conduct assessments of liquidity in different scenarios, including stressed situations, to assess and monitor the liquidity risk of the funds accordingly; and
(e) disclose in the fund's offering document the liquidity risks involved in investing in the fund, and explanation of any tools or exceptional measure that could affect redemption rights.

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).

The wording in red is couched differently: as drafted, the note positively applies the obligation in respect of assessment and disclosure to overall/de facto Fund Manager, i.e. outside the approach set out in the introduction. The provisions and notes need to be checked to ensure that they fall within a consistent scheme, to avoid confusion – in this case the (somewhat unclear term) "liability side" provisions positively apply to overall/de facto Fund Managers and no other Fund Managers. Concepts which apply only to overall/de facto Fund Managers need to be clearly identified in the revised FMCC.

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 similar over-the-counter transactions policy and the risk management policy in the fund's offering document.

On the face of it this only applies where a Fund Manager has overall responsibility/de facto control, not other Fund Managers who are not in such a position.

From the above, we would suggest that it appears to be the basis of the FMCC interpretation which causes the problem. (There is a similar issue in 3.16, 4.1.2 and 4.2.1, and 4.3.1, in this regard.)

The above are examples; the issue runs throughout the document.

SUGGESTED SOLUTION

The simplest solution would appear to be to amend the introductory wording in the FMCC to say:

This Code applies to all licensed or registered persons acting as Fund Managers, including, as appropriate, their representatives. Certain requirements (as specifically set out in this Code) are not applicable, or are only applicable, to a Fund Manager depending either on whether it is responsible for the overall operation of a fund or has de facto control of the oversight or operation of the fund.

Question 3: *Do you have any comments on the above proposals [in the relevant paragraphs of the Consultation Paper] which will be applicable to a Fund Manager which engages in securities lending, repo and similar over-the-counter ("OTC") transactions on behalf of the funds it manages?*

Law Society's response:

Where fund managers engage in securities lending, repo and similar OTC transactions, it may not be feasible for them to put in place a collateral valuation and margin policy. As recognized by the SFC, fund management activity in Hong Kong does not, in many cases, include overall responsibility for the fund or de facto control (which lies with an offshore manager and/or fund board). It is at this level that such a collateral valuation and margin policy would be designed and approved. The fund proposals should, as elsewhere, acknowledge this.

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 Financial Stability Board ("FSB") [in the relevant recommendations]?*

Law Society's response:

For the purposes of ensuring that Hong Kong remains in line with international norms, this seems to us uncontroversial. The proposed use of SFC guidance, by way of FAQs, as the vehicle by which those norms would be incorporated into the Hong Kong regime seems to be the most flexible approach. That means that the guidance needs to be presented fully rather than by way of cross-reference, and to take into account any local Hong Kong market idiosyncrasies. That is, the FSB recommendations should not simply be copied into the Hong Kong regime.

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.*

Law Society's response:

Provided the disclosure is "adequate", then investors in non-SFC authorized funds should be sufficiently protected, in the light of the typical nature of investors in private funds and their being provided with sufficient information to decide on the merits of allowing re-hypothecation as part of the overall assessment process when investing in the fund.

When it comes to discretionary account management, the institutional asset owner sets the investment and risk parameters and where this is the case, the requirements proposed would not be aligned with practice.

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?*

Law Society's response:

We support the reporting requirements in respect of collateral valuation and management policy, and the eligible collateral and haircut policy, where such policies are required and in place.

It seems sensible to limit the reporting obligations to a Fund Manager who is responsible for the overall operation of a fund or has de facto control of the fund. See above. This would avoid potential double-counting in terms of reporting and focusing the regulatory requirements on the primary actor in a fund. In practice we would expect reporting to be in relevant offering documentation.

Question 7: *Do you have any comments on the [relevant proposals in the Consultation Paper] regarding custodian and safe custody of fund assets?*

Law Society's response:

Overall, the proposals appear to be appropriate for the development of the market in the light of international trends and the crucial importance of the custody function.

Having said that:

- In paragraph 40, the obligation needs to be expressed as arranging for the appointment of a functionally independent custodian, in the case of a corporate fund such "arranging" being always subject to the final say of the Board of the fund – this recognizes the hierarchy of decision-making without disturbing the practical realities. We note that the selection of a suitable custodian is often left to institutional investors.
- Paragraph 41 recognises the position of private funds, but offers little by way of protection to the private fund investors. That gap on the buy side would in any event appear to be sufficiently closed by the disclosure requirements in paragraph 44, given the nature of typical private fund investors.
- The proposed custody agreement provisions are in keeping with allowing a reasonably flexible approach on the part of Fund Managers.

Question 8: *Do you have any comments on the [relevant proposals in the Consultation Paper] regarding liquidity risk management?*

Law Society's response:

Overall, we agree that the preparation of a liquidity management policy is a key area of risk management for funds generally.

We welcome the recognition by the SFC that there is no one-size-fits-all approach which would be appropriate in this area, and in particular the recognition that the extent or frequency of stress testing should be flexibly handled depending on the liquidity profile and nature of the relevant fund. We consider that to be an important check and balance here, given that we appreciate the perceived regulatory need for private and non-private funds to be covered in this regard as a starting point. Guidance would accordingly be needed for market participants to calibrate their internal operational processes for these purposes.

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?*

Law Society's response:

No comment.

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

Law Society's response:

Yes, in principle, but see our response to the next question.

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

Law Society's response:

Calculation of "leverage", to be meaningfully disclosed to fund investors, needs to be a consistently handled across the board. If not, the information provided to investors would not be useful (and indeed could be misleading) since there would be a potential for "apples" to be compared with "oranges" across the various investment decisions. This is an issue which needs to be considered further with the fund management industry before settling the approach.

We do agree that the various components of "leverage" for these purposes need to include financial leverage arising from borrowings and synthetic leverage from the use of derivatives: given the complexities in particular of derivative products, a lack of workable consistency across the market in relation to the calculation mechanism would potentially create significant confusion.

Question 12: *Do you have any comments on the other amendments proposed [in the Consultation Paper] to the FMCC?*

Law Society's response:

1.3 and 1.4 – On functional separation and segregation of duties, this may be a suitable time to change references to "impossible" to "not reasonably practicable", for the sake of good order.

2.1.1 (b)(vi) – typo – change "offering" to "offerings".

3.5 – It would be helpful to have the phrase "trade excessively" on behalf of a fund more clearly defined.

3.8.1 – We welcome the removal of the 50% limit; it makes sense to allow transactions which are restricted by the need for arm's length, best execution and

market commission rates.

Note: The reference to “connected persons” is not defined – it would seem reasonable for that expression to be defined or cross-referred to a relevant defined term. We note that paragraph 13.3 of the SFC Code of Conduct refers to a “person connected with”, raising the same point of clarification.

3.10 – We note that the meaning of “dealing” here is restricted to the acquisition or disposal of securities. Some additional detail as to how this is intended to be applied in practice would be helpful, since for example stock futures would fall outside this interpretation.

3.16 – We consider this should be amended to say that fair treatment should be should be given/made to the “client”, in cases where there is delegation of fund management responsibility. That issue is explored further below.

The provision regarding termination below creates confusion as a result: it is presumably only relevant to Fund Managers which have overall responsibility/de facto control.? In which case, the wording needs to be amended as below. Consistency of approach is important here.

TERMINATION

The confusion created here is in the same vein as for how overall responsible/de facto controlling Fund Managers are generally handled under the FMCC, as currently drafted (see above).

The FMCC provisions in relation to termination state:

Paragraphs 3.16.1 to 3.16.2 (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)****.*

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.

We consider that in order to remove confusion in this context, the paragraph should be amended to say:

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).*

In addition, we consider that care needs to be taken in references to *fund investors*, in the light of the interpretation provisions concerning delegate Fund Managers:

Where a Fund Manager is a delegate of another fund manager for the management of 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.

For the sake of consistency the termination provisions should refer to its "client" in the context of a delegate Fund Manager, and not to the "fund investors" / "investors in the fund".

DEALINGS WITH FUNDS AND FUND INVESTORS

6.1(a):

A Fund Manager should:
(a) provide the fund and fund []'/>investors with adequate information about the 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 fund or fund investors may have contact; and
(b) disclose the financial condition of its business to a fund upon request.

The delegate point discussed above is relevant here, since

Where a Fund Manager is a delegate of another fund manager for the management of 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.

There is no reference to "fund investors" here: "client" in the context of a delegate Fund Manager would be the correct reference.

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?

Law Society's response:

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?

Where an aggregated order either reaches a threshold above which it is eligible to invest or as a result of its "bulk" nature achieves a better price for the investor.

What are those circumstances which justify that they are in the best interests of clients?

See above.

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?

It is difficult to see why this would occur. Insofar as the investor wanted to use the manager as a place to "park" securities, clearly questions would arise in the context of, for example, potential takeover offers and securities disclosure of interests.

Does the investor who request pro rata allocation have concerns that the flexibility can be abused by the licensed manager?

Much would depend upon the terms specified by the investor.

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

Law Society's response:

We have no comments on this appendix, other than to remind the SFC that it is important that the breadth of the measures, and their applicability for Fund Managers, depends upon the nature and profile of the fund or other arrangements in

question, and needs to be supervised accordingly. Provided that sufficient or equivalent measures are put in place by a Fund Manager consistent with its status, size and services, we have no overall substantive quarrel with the proposed requirements.

Question 15: *Do you have any comments on the requirements set out in Appendix 1 [in the Consultation Paper]?*

Law Society's response:

We welcome overall the proposed move to a more granular approach in relation to discretionary account managers to allow for them to be covered under the regime but in a tailored manner.

Our principal point on the appendix is the need to ensure that an "investment mandate" and "pre-defined model investment portfolio" (the gate issue for whether the appendix applies) are sufficiently clearly defined. We note that "the investment mandate may set out, among others, the types, risks and allocation of investments", and a "pre-defined model [investment] portfolio…may specify the proportion of the asset classes and markets and the risk profile of the selected portfolio". There will inevitably be portfolios on the margins in relation to whether they cross over into such a mandate or model, and we recommend that either a more robust and detailed definition is used to provide context and guidance to the market, or specific additional guidance (including FAQs) is published to clarify the issue, so as to avoid confusion in the market.

Subject to that important issue, we consider the new appendix to be a welcome amendment to the FMCC overall.

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.*

Law Society's response:

A six month post-gazettal transition period is in our view at the low end of what should be provided for, given the material internal and operational changes needed to comply with the extensive proposed amendments to the FMCC, as well as changes that may need to be made to client documentation.

While it is fair to say that a number of the proposed changes are more by way of codification of existing regulatory expectations, the policy changes, particularly for international organisations to fit into their global policies and procedures, should not be underestimated. We consider that a 9 month period would provide more certainty. The SFC can of course, in a similar manner to the implementation of the

recent client agreement changes, express its expectation that notwithstanding the longer lead time licensed intermediaries should roll out the relevant changes as swiftly as possible.

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?*

Law Society's response:

The Law Society has no comment.

Question 18: *Do you have any comments on the proposed disclosure requirement in relation to independence set out [in the relevant paragraphs of the Consultation Paper]?*

Law Society's response:

We consider the restriction on the use of the term "independence" to be appropriate, provided that the nature of "any links or other legal or economic relationships with product issuers which are likely to impair [the Fund Manager's] independence in respect of favouring a particular investment product, a class of investment products or a product issuer" can be expressed, by way of presumably guidance, in a more concrete manner, including examples. The current formulation is too uncertain.

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)?*

Law Society's response:

Enhancing disclosure: the primary issue is that of "trailer fees". The proposed disclosure is in our view a reasonable starting point. The difficulty that we note from the example is that the disclosure is highly assumption-specific. If the same assumption is used for all funds that would be confusing where the underlying facts do not accord with that assumption. Confusion would be created if the set of assumptions is changed for each fund to reflect its own individual position, then that would create an un-level playing field for comparisons across funds, more relevant in many respects for retail funds. We appreciate that variations in treatment are recognized to an extent.

The industry objection, referred to in the consultation paper, as regards commercial sensitivity would remain: we have no further comment from that perspective.

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 [in the relevant paragraphs of the Consultation Paper]? 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?*

Law Society's response:

See above.

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.*

Law Society's response:

Essentially the same comment as for the proposed changes to the FMCC. In any event, the implementation of the changes to the FMCC and Code of Conduct need to be synchronised.

The Law Society of Hong Kong
21 February 2017