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

Dear Sirs

We appreciate the opportunity to respond to the Securities and Futures Commission (the "**SFC**") Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency (the "**Consultation Paper**"). Our responses include the views of market participants from the asset management, hedge fund and private banking industries.

Before we respond to the questions in the Consultation Paper, we wish to highlight the following.

Applicability of the FMCC

It is proposed that persons to whom the revised Fund Manager Code of Conduct (the "**FMCC**") apply will also need to comply with the Code of Conduct for Persons Licensed by or Registered with the SFC (the "**Code of Conduct**").

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The FMCC was introduced as a standalone code of conduct applicable to fund managers specifically as a number of aspects of the Code of Conduct do not apply to fund managers. The proposal represents a change in the SFC's policy and regulatory approach towards fund managers, reasons for which the Consultation Paper does not explain.

Given that this proposal represents a policy change, it would be helpful for the SFC to explain the reasons for making such a change and to give market participants an opportunity to raise their comments.

Fund Level Regulations

The SFC specifically notes in the Consultation Paper that the focus of its regulations at the fund level remains on funds offered to the investing public in Hong Kong. This focus should be specified in the FMCC to reflect clearly that the application of the FMCC to private funds should be principles-based.

A number of overseas domiciled funds are currently subject to the oversight and regulation of their home regulators (for example, the CSSF in Luxembourg). Should there be a conflict between the home regulation and the revised FMCC in respect of the fund-level requirements, it is not clear which should prevail. We seek the SFC's further guidance on this.

We propose that if an overseas domiciled fund delegates some of the investment management responsibilities of a non-SFC authorised fund to a Hong Kong fund manager that does not propose to distribute such funds to Hong Kong investors by relying on one of the private placement safe harbours, the SFC should make it clear in the FMCC that such fund should not be subject to fund level regulations.

We also propose there should be clear carve-outs in the FMCC for funds whose investors are institutional professional investors or corporate professional investors (on the basis that corporate professional investors meet the assessment requirements to provide comfort that they are sufficiently knowledgeable and experienced). This is consistent with the Code of Conduct, where qualified investors are entitled to certain exemptions.

Set out below are our responses to each of the questions in the Consultation Paper.

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?**

Whilst we support the above proposal in principle, in our view there are certain aspects of the requirements which are not appropriate for discretionary account managers. We set out three examples below.

Discretionary account managers are required under the revised FMCC to provide information on discretionary accounts' securities lending, repo and similar over-the-counter ("**OTC**") transactions to discretionary account clients at least on an annual basis and upon request. However, a discretionary account manager and its client will typically agree and set out the information to be provided – as well as the frequency – in the investment management agreement between the parties. Hence it is not appropriate for the SFC to be prescriptive on

the types of information, as well as the frequency, which discretionary account managers need to provide to their clients.

The second example relates to the selection, appointment and continuing monitoring of custodians. It has been proposed in the revised FMCC that discretionary account managers should exercise due skill, care and diligence in the selection, appointment and ongoing monitoring of the custodians. However, it is market practice for discretionary account clients to directly appoint custodians for their assets (in some cases, they may be mandated by local laws to do so, such as the laws applicable to Qualified Domestic Institutional Investors), and for discretionary portfolio managers that operate within a private bank, the custodian is typically the bank itself or the bank's affiliates.

The third example relates to the requirement for discretionary account managers to, amongst others, maintain and implement effective liquidity management policies and procedures to monitor the liquidity risk of the discretionary account. However, discretionary portfolio managers that operate within a private bank would typically agree with their clients on the investment strategies to be followed (including the liquidity profile of the underlying assets) with respect to the discretionary accounts.

The above requirements should be carved out from the FMCC for discretionary accounts.

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.

The proposed enhancements fail to reflect the fact that (i) the governing body of the fund is a different body from the fund manager; and (ii) corporate governance matters should be reserved to the governing body of the fund.

The above is of utmost importance as whilst a fund manager is responsible for the day-to-day operation of the fund, investors and regulators expect the governing body of the fund to exercise independent oversight over the operation of the fund, such as monitoring of custodians and ensuring assets of the funds are valued in accordance with the fund's valuation policy.

It is therefore not appropriate to suggest that a fund manager can control the decisions of such governing body, even if it may have the power to appoint some of the directors (in the case of a fund structured as a corporate) or directors of the general partner (in the case of a fund structured as a limited partnership). Doing so would inevitably cause a fund manager to become a shadow director, because it forces the fund manager to impose its views on the board of directors or similar governing body.

Moreover, the concept of "de facto control" is confusing and fails to take into account the governance structure of different types of funds. The governance structures of the most common types of funds amongst investors in Hong Kong are as follows:

- for a fund structured as a corporate, the board of directors;
- for a fund structured as a limited partnership, the general partner; and
- for a fund structured as a unit trust, the trustee.

In all of the above structures, the directors, the general partner and trustee (as the case may be) may delegate investment management responsibilities to fund managers. However, the governing body still retains overall control over the fund. It is impossible to ignore these legal realities.

It is also unclear whether a sub-manager or a sub-adviser can be considered as having de facto control. For instance, some SICAV funds have a Hong Kong entity sub-managing offshore funds.

We note that one example of "de facto control" given by the SFC (in paragraph 15 of the Consultation Paper) is where the representatives of the fund manager and/or its affiliate(s) (our emphasis added) constitute a majority of the board of directors of the fund.

If the Hong Kong fund manager is appointed as a sub-manager to manage an allocated portion of a fund (or certain sub-funds of an umbrella fund) and its representative(s) do not sit on the board or governing body of the fund, it is not clear why the Hong Kong fund manager would then be considered as having de facto control over the operation of the fund, simply because the majority of the board of the fund is made up of employees from its affiliates (which is not uncommon in the international fund industry) – a company cannot control its parent company or sister subsidiaries.

Against this backdrop, we therefore propose instead that where the representatives of the fund manager and/or its Hong Kong subsidiaries (our emphasis added) constitute a majority of the board of directors of an overseas fund and where the fund manager and/or its Hong Kong subsidiaries act as the investment manager for such fund, such fund manager should be considered as having "de facto control" of the fund. However, this test only works for funds structured as a corporate and the general partner in a limited partnership structure.

We further propose the SFC specifies in the FMCC that the interpretation of the term "de facto control" should be principles-based. This is because in some cases, a combination of factors may suggest that fund managers have de facto control but in other cases, a combination of factors may suggest otherwise and it is not possible to list out these factors exhaustively; the results will be very facts and circumstances based.

Lack of clarity on the applicability of the FMCC to fund managers with "de facto control"

Whilst we agree that fund managers responsible for the overall operation of a fund or having de facto control of the oversight or operation of the fund should be subject to more onerous obligations, it is not always clear that the requirements in the FMCC apply to them.

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 principle, we support the proposals for fund managers to put in place a collateral valuation and management policy, collateral and haircut policy and cash collateral reinvestment policy (where the fund manager reinvests cash collateral received by the funds). However, some hedge fund managers have indicated they may need to adopt standard collateral and haircut policies specified by prime brokers (in order to trade with such prime brokers) and such terms may not be customised. We expect more clarification from the SFC with respect to the drafting, adoption and customisation of collateral and haircut policy through the publication of frequently asked questions and answers.

With discretionary accounts, a discretionary manager's role in the context of securities lending may be limited to providing assistance to the client and its custodian as required in order to facilitate the client's securities lending arrangements with third parties (with whom the manager has no contractual relationship). For this type of "client-directed" securities lending arrangement, we would appreciate the SFC's clarification that the discretionary manager is not considered to be "engaging in" securities lending for the purposes of the FMCC.

The term "similar OTC transactions" should be interpreted to be OTC transactions which achieve a similar economic effect as securities lending/repo transactions.

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?

Whilst we agree that fund managers should establish appropriate internal processes and procedures to ensure that haircut methodologies are set in accordance with the framework of the Financial Stability Board (the "**FSB**"), we expect more detailed clarifications from the SFC through the publication of frequently asked questions and answers.

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.

The goal of enhancing disclosure of the re-hypothecation of non-cash collateral to investors is to offer them a better understanding of the relevant risks and exposures of the fund. However, depending on the assumptions and methodologies adopted by fund managers (which may be widely diverging), amongst other factors, the estimates of the fund's risk exposures may be very different, even in respect of funds that adopt similar investment strategies. This raises questions about the usefulness of the disclosure, when differing methodologies make it difficult for investors to understand and compare the data generated by different fund managers.

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?

Whilst we agree that information disclosed in the offering document relating to securities lending, repos and OTC transactions is beneficial to investors, the minimum disclosure requirements should not be prescriptive – a principle-based approach should be adopted. The governing body of the fund is responsible for, and should be allowed to determine, the

information it wishes to disclose in the offering document (so long as the offering document contain adequate disclosure of relevant material information to allow investors to make an informed decision).

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

We agree with the SFC that proper segregation of fund assets is a fundamental principle for the safekeeping of fund assets. Protection of fund assets and the ability to identify asset ownership are necessary to maintain investor confidence and to protect against the loss or misuse of those assets.

However, we are concerned that the proposals blur the roles and responsibilities between different parties in the legal structures of the fund. In many cases the fund manager is not responsible for the appointment of the custodian and does not have a contractual or other formally documented relationship with the custodian. In particular, typically investors also expect a segregation of custody and management functions.

Where a fund is structured as a unit trust, depending on the terms of the trust deed, the trustee will be responsible for the appointment of the custodian and for exercising ongoing oversight over the custodian. In such a case, the fund manager is typically not involved with the custody arrangements (given the segregation of custody and management functions) and the fund manager should not be made responsible for this.

The proposals also create confusion with the requirements under the Code on Unit Trusts and Mutual Funds ("**UT Code**"), where the trustee is responsible for the safe keeping of assets and ensuring the proper segregation of assets, amongst other things. While the fund manager or management company may appoint the custodian, the duties to comply with the requirements applicable to the custody of assets by a trustee or a custodian are clearly stipulated under the UT Code.

It is unclear how the proposals will be implemented in practice when the roles and responsibilities of the trustee (or the client, where he/she appoints the custodian) and fund managers are not clearly delineated. There is a risk that the FMCC otherwise blurs some important legal structures. For reasons set out in our responses to question 2 above, we request the SFC to take into account the governance structures of the most common types of funds amongst investors in Hong Kong and make appropriate carve outs accordingly.

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

Liquidity risk management should be introduced for good corporate governance purposes. As some of the requirements may not be relevant to all fund types, the SFC is mindful that the extent of application of the liquidity management principles should be dependent on the nature, liquidity profile and asset-liability management of the fund and the specific characteristics and risks of the investment products. The fund manager should have discretion over which principles are relevant to the fund it manages; we agree that this is the correct approach.

We would recommend that sufficient time be allowed to ensure the Hong Kong regime aligns with other liquidity risk management regimes that are being implemented or discussed globally.

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?

We believe there is merit in developing principles for stress testing. Every fund will apply stress tests somewhat differently. Whilst some large fund managers may engage in highly sophisticated liquidity and redemption stress testing on a frequent basis, there may be a portion of the industry that does not have the scale to allocate sufficient resources to engage in extensive stress testing. We agree with the SFC's non-prescriptive guidance allowing fund managers to adopt a principles-based approach when conducting liquidity risk stress tests.

Given the ongoing global developments in the liquidity regime, we suggest that the SFC provides more flexibility on the setting of liquidity targets and stress testing thresholds to allow fund managers to design a global risk management framework taking into account other regimes' requirements. Similarly, regarding the SFC's expectation that stress test results should be reviewed by a committee responsible for liquidity risk management and/or senior management, we suggest that the SFC provides more flexibility to allow fund managers to adopt governance mechanisms that are proportionate to the liquidity risks the fund/account may face.

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

We support the SFC's proposals to enhance the disclosure of leverage of fund, a development consistent with measures introduced by major markets to enable monitoring by regulators and/or foster market discipline. From an investor protection perspective and for transparency reasons, we agree that it is appropriate for the fund manager to disclose leverage information of the fund it manages such that investors are made more aware of the fund's potential leverage. As leverage can be calculated in many different ways (see also our response to question 11), it is key that the basis of the leverage calculation is made clear to investors, otherwise the information may not be meaningful.

However, we think that the proposal to disclose maximum leverage of the fund is inappropriate. For public funds, we suggest disclosing the expected leverage of the fund rather than a specified maximum level. Given the different methods of calculating leverage, such a leverage figure would vary continuously and it would be impractical to monitor this subject to a hard cap. For private funds particularly funds with alternative strategies, investment restrictions are typically not prescriptive compared to public funds. We therefore believe the fund manager should retain flexibility in disclosing leverage, rather than requiring manager to disclose maximum or expected leverage.

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

We believe the fund manager should retain flexibility in determining the basis of calculation of leverage, as the appropriate approach to measuring leverage may vary depending on the

type of instrument involved and the purpose for which it is employed. There is no one-size-fits-all measure for different types of funds and asset classes.

The challenge with calculating leverage, as the SFC has pointed out, is that there is currently no general consensus on how leverage should be calculated. Specifically, the FSB has noted in its Recommendations to Address Structural Vulnerabilities from Asset Management Activities published on 12 January 2017 ("**Recommendations**") that there is an absence of consistent and accessible data on leverage across jurisdictions. The FSB further notes that leverage can be measured in numerous ways, and requires assumptions about the extent to which funds' off-balance sheet exposures should be considered in the leverage calculation.

We welcome the FSB's recommendation in the Recommendations that IOSCO should identify and develop consistent measures of leverage in funds to facilitate more meaningful monitoring of leverage for financial stability purposes, and help enable direct comparisons across funds and at a global level. We appreciate the SFC's continuing engagement with other regulators on the leverage framework to bring Hong Kong in line with global developments.

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

Interpretation

The new paragraph in the introduction to the FMCC: "[w]here 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" seems to suggest that this section only covers scenarios where the delegated manager manages a portion of the fund.

We suggest that the wording be revised to: "[w]here a Fund Manager is a delegate of another fund manager for the management of a *fund or* (our emphasis added) 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."

Functional Separation

The revised paragraph 1.3 of the FMCC provides that "[w]here a Fund Manager is undertaking or (our emphasis added) is part of a group of companies which undertake other financial activities such as advising on corporate finance, banking or broking (our emphasis added), it should ensure there is an effective system of functional barriers (Chinese Walls) in place to prevent the flow of information that may be confidential and/or price sensitive between the different areas of operations".

In the private wealth management sector, a "full service" private wealth manager typically offers brokerage, advisory and discretionary asset management services for clients. In this context, it is not practicable to separate the discretionary asset management and brokerage functions because clients may require both services and expect an integrated, holistic service from its private wealth manager, particularly given the importance placed on the personal nature of the relationship between each relationship manager and its clients.

Audited financial statements

The requirement to appoint an independent auditor to perform an audit of the financial statements is an existing requirement under UCITS and/or CSSF regulation. However, independent auditors are appointed by the board of directors, not the fund manager.

Fund portfolio valuation

For UCITs or Luxembourg funds whose investment management functions have been delegated to a Hong Kong manager, the Hong Kong manager will not have a say regarding the fund valuation principles nor can it be a voting member at the valuation committee. The authority lies with the board of directors.

Side letters

It has been proposed that where side letters have been entered into, the fund manager should disclose such fact and the material terms in relation to redemption in the side letters to all potential and existing fund investors. This is generally speaking not in line with international best practices or applicable laws governing the relevant fund which only require fund managers to disclose certain material terms of side letters to investors of the same share class. In addition, instead of using the term "side letter", the SFC should replace it with "where the Fund Managers have granted preferential treatment to investors, Fund Manager should do so fairly and in a transparent manner". This is because the drafting of the latter is more precise and also highlights the key purpose of this provision, which is to ensure appropriate disclosure of "preferential treatment" and that investors are treated fairly.

Side pockets

Paragraph 5.4.1 of the FMCC is limited to a fund manager who is responsible for the overall operation of a fund or has de facto control of the oversight or operation of the fund. However, paragraphs 5.4.2 and 5.4.3 do not contain such wording. We seek the SFC's confirmation that these sections do not apply to a Hong Kong fund manager acting in a sub-manager capacity only.

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?

"House account" means an account owned by a fund manager or any of its connected persons over which it can exercise control and influence. It would appear that the definition does not clearly exclude those accounts with both seed monies and internal/external client monies. While fund managers should exercise their fiduciary duties and act in the best interest of the clients (both internal and external clients), we are of the view that accounts with

internal/external client monies should be considered as "client accounts" and be treated fairly as the other clients. These accounts should be excluded from the definition of "House account".

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

Clifford Chance and industry participants have no particular observations on this question.

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

Please refer to our responses to question 1 above.

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.

In our view, this transition period is too short given that industry participants need to conduct gap analysis, draft new policies and procedures, provide new disclosures, update or change their existing processes, enhance their operational systems, establish corresponding internal controls and monitoring policies and to provide training to their front line staff, amongst others. We believe one year is more appropriate.

Moreover, it is common for regulated funds in EMEA/US to adopt an annual prospectus update cycle (this is in turn driven by the fact that these funds are often registered for sale in many jurisdictions across the globe hence subject to multiple regulators' oversight, including with respect to prospectus amendments).

We would also suggest the SFC to confirm the changes do not have retrospective effect. This is important as a number of the proposed changes may touch on the fund products themselves or discretionary account mandates. Discretionary client agreements are typically subject to heavy negotiation between discretionary account managers and their clients and both parties would want the agreed terms to continue until the termination of the mandate to avoid disruption to both the discretionary account managers' business operations and clients' experience. Practically speaking, members would not be able to impose such fundamental changes unilaterally.

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?

We welcome the SFC's approach of focussing on greater transparency and disclosure to investors rather than a complete ban of commissions to financial advisers from fund companies in return for selling or recommending their investment products.

We agree with the SFC that a "pay-for-advice" model would not suit Hong Kong, when the majority of investors are not prepared to pay a large sum of money for financial advice.

Whilst we support the two-pronged approach, some intermediaries will find the projected value of the monetary benefits challenging to implement, given that the value of such services might not be known on an ex ante basis and could vary each time.

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

We suggest that the SFC clarify whether the status of "independence" can be disclosed generically to cover a wide range of funds or whether the disclosure is required on a per-fund basis which will incur significant administrative cost.

The wording in paragraph 10.2(b) of the Code of Conduct may give rise to confusion where the product issuer and the intermediary are entities belonging to the same group. The current wording stipulates that the "independent" licensed or registered person "should not have any links or other legal or economic relationships with product issuers...". Intra-group entities may act independently despite their group relations and the wording should reflect the possibility of intra-group setups.

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)?

We are supportive of the enhanced disclosure requirements allowing investors better access to information for decision making. It is important that investors are able to weigh up the relative costs, performance and risk of individual funds. Comparable data between funds will also allow investors to assess the relative value of one fund over another.

The key challenge in this area is to develop good practice in ensuring consistency of the disclosure methodology, especially when there is an increasing number of funds that are sold on a cross border basis. Calculation of the trailer fee is complex and difficult and the methodology adopted often varies across different funds. The complex, technical nature of the fee table disclosures are likely to inhibit certain investors' willingness and ability to make good use of the information provided.

In certain global fund settings, the fund manager will appoint a regional distributor where it will share a part of its regional distribution fees with the local distributor. In such circumstances, it is unclear what a local Hong Kong distributor is expected to disclose when it is only receiving a portion of distribution fees and whether a pro-rata disclosure applies.

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?

We welcome the SFC's proposals to enhance transparency and disclosures to investors aligning the Hong Kong market with international regulatory developments in this area. Disclosures play an important role in helping investors make sound investment decisions and evaluate the investments they own. Even investors who do not themselves read disclosures

can benefit indirectly if improved transparency leads to beneficial market competition. We believe the goal of disclosure would be to enhance the investors' understanding of the costs they bear when they invest in a fund and the impact of those costs on total accumulation over the lifetime of the investment.

As the maximum dollar amount disclosed is only indicative, based on assumptions and may not be the exact amount that the intermediary will actually receive from the fund manager, disclosing dollar amounts does not add much value to the investor but becomes onerous for the intermediary to do the calculation. The range of monetary benefits receivable disclosed one-time or periodically (annual) (if concluded disclosure is a requirement) should provide investors with sufficient information and transparency and is in line with the requirement on the disclosure of quantifiable benefits.

As part of a longer term effort to improve disclosures, we agree with the SFC that investor education plays an important part of effective disclosures. We encourage the SFC to continue exploring ways to provide context for cost information in order to improve investor understanding of the impact of those costs.

We also request the SFC to clarify the disclosure of trailer fees where discretionary managers invest funds-of-funds.

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.

In our view, this transition period is too short given that industry participants need to conduct gap analysis, draft new policies and procedures, provide new disclosures, update or change their existing processes, enhance their operational systems, establish corresponding internal controls and monitoring policies and to provide training to their front line staff, amongst others. We believe one year is more appropriate.

Should the SFC wish to discuss any of our comments please do not hesitate to contact

Yours faithfully

Clifford Chance