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Our ref FM/OPEN/-1/IHCY
Your ref

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

By E-Mail

Dear Sirs

Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency (the "Consultation")

We are grateful for the opportunity to submit written comments on proposals discussed in the Consultation.

Please accept the enclosed submission by Simmons & Simmons which sets out our responses to questions in respect of the Fund Manager Code of Conduct in the Consultation.

We hope our comments are helpful. Should you have any queries please do not hesitate to contact

Yours faithfully

Simmons & Simmons

CONSULTATION PAPER ON PROPOSALS TO ENHANCE ASSET MANAGEMENT REGULATION AND POINT-OF-SALE TRANSPARENCY (the "Consultation Paper")

Submission by Simmons & Simmons in respect of the Fund Manager Code of Conduct Questions

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?***

   We agree with the proposed clarification. We suggest, from a drafting perspective, that the proposed revised Fund Manager Code of Conduct (the "Revised FMCC") incorporates a reference to provisions of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the "Code of Conduct") on exemptions available to Discretionary Account Managers when dealing with clients who are Professional Investors.

   Currently the Revised FMCC only refers to the exemptions for Discretionary Account Managers under "Client Agreements" in Appendix 1 of the Revised FMCC. On the other hand, paragraph 6.1 of the Revised FMCC (*Provision of Information*) appears to overlap to a large extent with paragraph 8.1 of the Code of Conduct, which would be exempt under paragraph 15.5 of the Code of Conduct when a licensed or registered person deals with Professional Investor clients. It is not clear whether paragraph 6.1 of the Revised FMCC intends to introduce additional requirements for Discretionary Account Managers when dealing with clients who are Professional Investors.

   On the premise that it is not the SFC's intention to remove Code of Conduct exemptions by introducing the Revised FMCC, we suggest that a reference be added in Appendix 1 of the Revised FMCC to clarify that certain exemptions apply under the Code of Conduct when a Discretionary Account Manager deals with certain types of investors. This would help readers' understanding of the interaction between the Revised FMCC and Code of Conduct, which would be especially useful to new managers or overseas managers establishing Type 9 licensed corporations in Hong Kong.

   Please also see our response to question 15.

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.***

   We agree that some of the proposed enhancements are not applicable to all Fund Managers. However as there is a wide variety of structures and arrangements, especially for private funds, it would be useful if the SFC could provide guidance by giving examples of structures that it considers as the Fund Manager having (and not having) overall control or de facto control of the operation of a fund. Such examples in respect of private funds could address the most typical structures – for example where voting control in respect of the Fund is held by individual principals rather than the Fund Manager or where significant seed investors have special veto rights and/or powers to board (or equivalent) representation.

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?***

We do not feel that a general requirement, applicable to Fund Managers of all types of funds, would be appropriate. In summary, in respect of OTC derivatives, funds and Fund Managers of sufficient size would be expected to be (or become subject in future) to collateral related requirements as a result of the regulatory regimes applicable to their counterparties or brokers (which require the posting and delivery of collateral on a two-way basis).

By way of further explanation, as a result of recent international regulatory requirements, in particular in respect of OTC derivatives (such as Dodd Frank in the US, EMIR in the EU and the relevant Hong Kong legislation), funds and Fund Managers are obliged, and will in future be obliged, to agree to certain collateral provisions and agreements (including with respect to haircuts, timing of margin calls and related matters) with their counterparties and brokers in a form approved by the relevant regulatory body (often being the regulatory body of the fund or Fund Manager's broker or counterparty). Accordingly, such funds and Fund Managers would not have discretion to put in place their own policies as they will be dictated to by the applicable regulatory requirements. Likewise, such funds or Fund Managers would be unlikely to be able to agree alternative or additional terms with their counterparties and brokers (with respect to collateral valuation and margin requirements) that go beyond the regulatory requirements in place.

With respect to similar rules being applicable in respect of securities lending and repo arrangements, we note that there is no current general equivalent to the OTC derivative margin obligations in respect of EMIR and Dodd Frank (by way of example) and therefore to impose such an obligation on these transaction types in respect of Fund Managers when not more widely applicable may result in funds managed from Hong Kong and Fund Managers facing higher thresholds than similar managers in other jurisdictions.

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 responses to question 3 above.

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.***

Given that funds not authorised by the SFC are usually only offered to professional investors in Hong Kong, we agree that the requirement to disclose details of non-cash collateral re-hypothecation is sufficient to enable investors to understand the relevant risks and exposures to the fund.

Specific guidance, e.g. a prohibition on re-hypothecation of non-cash collateral, similar to that for SFC-authorised funds, would be over-prescriptive and amount to unnecessary fund level regulation. Institutional Professional Investors (as defined in 15.2 of the Code of Conduct) should know what they are doing. Other categories such as Corporate Professional Investors and Individual Professional Investors are subject to the assessment requirements of 15.3A of the Code of Conduct by any SFC licensed corporation.

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?***

(A) Private Funds

(i) *hedge funds*

FAQ 21 of the SFC's FAQ on the Code on Unit Trusts and Mutual Funds sets out disclosure requirements for SFC-authorised funds regarding securities lending, repos and other OTC transactions. Will the disclosure requirements applicable to non-SFC-authorised funds be the same as that under FAQ 21, and will the requirements be incorporated in paragraph 3.13.8 of the Revised FMCC or set out in a FAQ?

(ii) *private equity funds*

We note that these requirements are unlikely to be relevant in the context of private equity funds as these are not the sort of instruments a typical private equity fund would invest in.

(B) Retail Funds

The SFC currently requires issuers of SFC-authorised funds to make disclosures in offering documents regarding securities lending, repos and other OTC transactions. FAQ 21 of the SFC's FAQ on the Code on Unit Trusts and Mutual Funds sets out disclosure requirements regarding such transactions. Please can the SFC kindly clarify (i) if changes will be introduced to the current FAQ 21, or will issuers of SFC-authorised funds be required to comply with both FAQ 21 and the further FAQ to be issued, and (ii) if existing disclosures in the offering documents need to be amended, and if so, if the changes require prior approval by the SFC as a Chapter 11.1 of the Code on Unit Trusts and Mutual Funds (the "UT Code") change.

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

(A) Private Funds

(i) *hedge funds*

Paragraph 4.1.2 of the Revised FMCC seems to suggest that a Fund Manager should arrange for the appointment of an independent custodian, unless it adopts a self-custody arrangement. Are there types of funds that will not be allowed to adopt a self-custody arrangement, e.g. based on the type of investments they hold, or is the Fund Manager free to choose a self-custody arrangement for any fund (subject to the Fund Manager's licensing conditions)?

Private funds may also take the form of unit trusts. As discussed under (B) below, guidance as to Fund Manager's obligations with regards to trustees is necessary. Please consider clarifying the drafting of the Revised FMCC to reconcile requirements on custody of assets with a unit trust structure.

As the SFC will be aware, in most unit trust structures, the trustee has responsibility for custody but will normally delegate custody, often to another group entity. Is the Fund Manager to be liable for such delegation? This is not the approach adopted by the UT Code.

(ii) *private equity funds*

It is common for private equity funds to adopt self-custody arrangements. As the nature of the investments held by private equity funds are predominantly in the nature of (i) unlisted shares registered in the name of the fund or its general partner but evidenced by share certificates (in private companies) or (ii) entries in land registers or title deeds to land, and (iii) cash, any sort of procedure for custody and safekeeping is relatively simple and more importantly safe (whilst being cost effective). The procedures suggested in the Consultation Paper are not going to be relevant. We recommend that the SFC clarifies that, depending on the nature of assets, independent custody (by a separate entity or separate function of the manager) may not be required and that the Fund Manager can adopt a risk-based approach.

(B) Retail Funds

For SFC-authorised funds which are unit trusts, custody of assets is typically entrusted to the trustees of the funds by Chapter 4.5(a)(i), (ii) and (iii). The Consultation Paper and the Revised FMCC, as currently drafted, only refer to "custodians". If the requirements on custody of fund assets are intended to also apply to collective investment schemes in the form of unit trusts, please consider clarifying the drafting to reconcile requirements on custody of assets with a unit trust structure. Please consider including references to trustees, similar to that in the UT Code, to help Fund Managers understand their obligations with regards to funds that are unit trusts. For example, the status of the trustee is primarily documented in the trust deed. Does the trust deed constitute a "custodian agreement" as required under the Revised FMCC?

The UT Code and relevant FAQs impose obligations on trustees of unit trusts in respect of the selection, appointment and ongoing monitoring of nominees, agents and delegates. Please clarify if the Revised FMCC is intended to impose new obligations on Fund Managers with regards to the appointment and monitoring of trustees beyond the current UT Code requirements. There is ambiguity in areas such as the following:

- Is the Fund Manager required to exercise due skill, care and diligence in the selection, appointment and ongoing compliance of custodian, notwithstanding that the custodian is appointed by the trustee? This would also mean both the Fund Manager and the trustee have monitoring obligations (under different sets of rules).

- If the Fund Manager is expected to monitor the trustee (i.e. if the trustee is treated as "custodian"), this would go beyond the requirements in the UT Code, especially given that the trustee is itself governed by the UT Code.

The Revised FMCC appears to turn the principles of trust law upside down. In a unit trust, the trustee delegates investment management to the Fund Manager. Our concern is that the Revised FMCC will confuse the robust unit trust model which has served Hong Kong investors well and will undermine the clarity of legal relationships reflected in the UT Code.

(C) Discretionary Accounts

It is noted that the standards for custody of assets set out under the IOSCO report *Standards for the Custody of Collective Investment Schemes' Assets* cover only collective investment schemes, whereas requirements under the Revised FMCC extend to custody of assets for discretionary accounts.

In the commonly adopted external asset manager (known as "EAM") arrangement between banks and Discretionary Account Managers, custody of discretionary accounts rests with a bank that appoints the Discretionary Account Manager to provide asset management service. The clients are very often clients of the bank introduced by the bank to the Discretionary Account Manager. In such cases, the Discretionary Account Manager is not responsible for the overall operation of the discretionary account but only in providing discretionary management service. The Discretionary Account Manager will often be subject to a SFC licensing condition that it will not hold client assets. As such, we suggest that Discretionary Account Managers should therefore not subject to the custody of assets requirements under the Revised FMCC. If the Revised FMCC is interpreted in a way that the Discretionary Account Manager will be responsible for monitoring the bank, it will be difficult to for the Discretionary Account Manager (being the de facto appointee) to perform its obligations and to demonstrate compliance. Moreover it is illogical where the clients are pre-existing clients of the relevant bank.

In addition, please can the SFC clarify if Discretionary Account Managers may adopt a self-custody arrangement (assuming it is not subject to a licensing condition prohibiting it from holding client assets)?

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

(A) Private Funds

(i) *hedge funds*

Although it is indicated in the Consultation Paper that the extent and frequency of stress testing may vary depending on the nature of the relevant fund, private funds have very different investment strategies and redemption policies. As a general proposition, for funds which only accept investment from sophisticated investors, provided risk is adequately disclosed, there should be flexibility in how Fund Managers manage liquity risk. Such funds and their investors are not comparable to retail funds where the SFC has rightly identified liquidity risk management as a concern given retail investors.

(ii) *private equity funds*

In particular, for close-ended funds or private equity funds which have fixed terms or event-driven redemptions, we query the need for regular assessments of liquidity or stress testing as they are, by their nature, not affected by liquidity events. Moreover illiquidity is the primary risk accepted by investors choosing to commit to closed-end funds, often for periods of 7 to 10 years. In that context, it is difficult to see the logic behind treating such funds in the same way as open ended-funds.

(B) Retail Funds

Retail funds are currently expected to comply with the requirements set out in the SFC's *Circular to management companies of SFC-authorized funds on liquidity risk management* (the "Liquidity Risk Circular"). Our reading of the Consultation Paper is that Fund Managers of SFC-authorised funds who currently comply with the Liquidity Risk Circular will not be required to amend disclosure in offering documents or introduce new policies by virtue of the Revised FMCC. Please can the SFC clarify this.

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?

Fund Manager should decide the liquidity management measures and tools based on the type of fund and investment. The SFC should also recognise the type of investors and the level of disclosure as mitigating factors to minimise unnecessary compliance burden. If the SFC suggests any particular measures, such measures may be seen as minimum requirements, which may not be appropriate for all types of funds.

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

(A) Private Funds (hedge funds and private equity funds)

We consider it appropriate for Fund Managers to seek to ensure disclosure of the maximum leverage of funds which it controls in their offering documentation.

(B) Retail Funds

We believe that SFC-authorised funds are currently required to disclose the maximum leverage to investors under the UT Code and we assume the Revised FMCC is not intended to change or elaborate on the UT Code requirements.

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

We have no comments on how leverage should be calculated or the best method of calculation. We recommend that any future guidance should not prescribe the method of calculation of leverage. Disclosure on the method of calculation should provide investors with sufficient information on the calculation of leverage and this should be a commercial matter insofar as private funds are concerned.

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

(A) General comment on the drafting of the Revised FMCC

We recommend that the third paragraph under "Introduction" to the Revised FMCC be amended as follows (by adding the underlined words):

"For the avoidance of doubt, all licensed or registered persons should also comply with the requirements (subject to applicable exemptions) set out in other applicable codes and guidelines in force from time to time, including the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) and the Management, Supervision and Internal Control Guidelines for Persons Licensed by or Registered with the SFC (Internal Control Guidelines)."

(B) Fund portfolio valuation

We note that paragraphs 5.3.6 to 5.3.7 of the Revised FMCC imposes requirements on fund portfolio valuation, which overlap with the SFC's *Circular to Management Companies and Trustees/Custodians of SFC-authorized Funds - Relating to Fair Valuation of Fund Assets* (the "Fair Valuation Circular"). If managers of SFC-authorised funds are expected to refer to both the Fair Valuation Circular and the Revised FMCC for SFC authorised funds, please consider referring to the Fair Valuation Circular in the Revised FMCC. Please also clarify if managers of private funds are expected to take the Fair Valuation Circular into consideration.

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 have no comments on these questions.

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

We do not have comments on the suggested techniques and procedures.

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

"Additional requirements applicable to Discretionary Account Managers" – point 1: *"These minimum requirements do not apply to Institutional Professional Investors..."*

Referring to 15.4(b)(i) of the Code of Conduct, we suggest changing the above wording to *"The requirement of a written agreement (Discretionary Client Agreement) does not apply to Institutional Professional Investors..."*

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.

We believe the transition period should be at least 9 months.

If the Revised FMCC is introduced, Fund Managers (especially private fund managers) will have to review and consider if they control the relevant funds and if so, redraft the offering documents of their funds and consider (and possibly renegotiate) the custodian arrangements of such funds (which may potentially lead to changes, including notifications to existing and/or prospective investors) as well as adopt additional policies and revise compliance manuals.

Discretionary Account Managers will need to review and consider the relevant discretionary account agreements. Unlike Fund Managers with regards to funds, the revisions may need investor consent. Discretionary account agreements may therefore have to be re-entered, which may require negotiation with existing clients and the relevant banks, brokers and/or custodians.

Managers will also require time to understand and digest the obligations imposed under the Revised FMCC. Aside from the fund level regulation imposed by the Revised FMCC, from a SFC licensing perspective it will possibly be necessary for each Fund Manager/Discretionary Account Manager to consider their business plan and refile this with the SFC. In addition for many Fund Managers it may be advisable for them to take an additional compliance staff whose recruitment may take time.

Taken together, as well as the need for the SFC to clarify and set out its intended approach in terms of implementing these changes, a transition period of 6 months is unlikely to be sufficient.