LEGAL UPDATE

The Revised Code on Unit Trusts and Mutual Funds

On 6 December 2018 the Securities and Futures Commission ("**SFC**") issued the consultation conclusions ("**the Consultation Conclusions**") on proposed amendments to the Code on Unit Trusts and Mutual Funds. The revised Code on Unit Trusts and Mutual Funds is now in force with effect from 1 January 2019 with a transition period of 12 months for existing SFC authorized funds and operators. In this publication, we look into the background of the amendments and the extent of such changes.

Background

Unit trusts and mutual funds constitute a large portion of the financial products authorized by the SFC for offering to the Hong Kong public ("**SFC authorized funds**"). These SFC authorized funds are governed by the Code on Unit Trusts and Mutual Funds ("**UT Code**") which was last updated in June 2010.

In view of international regulatory developments in relation to public funds after the global financial crisis, and also local development of Hong Kong as an international asset management center (such as the development of mutual recognition of funds arrangement with various jurisdictions), the SFC conducted a holistic review of the UT Code to update the regulatory regime for SFC authorized funds and address risks posed by financial innovation and other market developments. The proposals were set out in a consultation paper issued in December 2017 ("**the Consultation Paper**").

Upon considering the comments from industry stakeholders, the SFC completed the consultation and issued the Consultation Conclusions containing the finalised revised UT Code.

Key Amendments to the UT Code

The key areas where there are changes are:

1. Strengthening requirements for key operators of SFC authorized funds (namely management companies, trustee and custodians)
2. Providing greater flexibility and enhanced safeguards for SFC authorized funds' investment activities (particularly in relation to derivatives, securities lending, repo and reverse repo transactions)
3. Introducing new fund types such as active ETFs.

Key Operators

- Minimum capital requirement for management companies is increased from HK$1 million to HK$10 million, and multinational management companies can now group resources and expertise together to meet the key personnel requirements (two key personnel each with 5 years of investment experience in managing public funds).

- Trustees and custodians are subject to enhanced obligations to align with the standards imposed by the International Organization of Securities Commissions (IOSCO) particularly in relation to appointment of sub-custodians
- Trustees and custodians are required to appoint an independent auditor to periodically review its internal control and system. Such scope and level of review is expanded and extended.

Permitted Investments

- Core investment requirements as set out in chapter 7 of the UT Code apply to all SFC authorized Funds. These requirements are now modernized and include securities lending, sale and repurchase (repo) and reverse repurchases transactions ("**Securities Financing Transactions**").
- New diversification restrictions relating to securities and cash deposits within the same group is imposed to enhance spread of investments.
- There is also clarification of the term "illiquid assets", in which a SFC authorized fund can invest subject to a maximum limit of 15% of its NAV.
- In relation to loans and borrowings, SFC has introduced restrictions on how much a SFC authorized fund can conduct such activities. Funds are prohibited from engaging in lending (excluding permitted reverse repo transactions and investments in fixed income securities), guarantee and other activities which may lead to direct or contingent liabilities or obligations.

Use of Derivatives

- Historically, SFC authorized funds are regulated by two broad categories: (1) chapter 7 plain vanilla funds, and (2) chapter 8 specialized funds. Regarding the use of derivatives, plain vanilla funds can only use futures, options and warrants for limited purposes, while chapter 8.9 derivatives funds may use derivatives extensively for investment.
- In the Consultation Paper, it was proposed that plain vanilla funds shall be allowed greater flexibility to invest in derivatives up to 50% of its net asset value. SFC authorized funds with derivatives investments exceeding the 50% limit calculated using the commitment approach would be classified as derivative funds and subject to enhanced distribution requirements.
- Some participants voiced concerns about this methodology because there are some instances where the use of derivatives do not necessarily make the fund riskier, e.g. the use of derivatives for bond funds to manage interest rate and credit risks and may not fall squarely as hedging. Upon considering industry participants' feedback regarding the limit and the calculation methodology, SFC revised the methodology in the Consultation Conclusion to include more exceptions.
- After the issuance of the Consultation Conclusions, SFC further issued the new 'Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds' ("**the Derivative Guide**") on 17 December 2018 to provide basic information and general guidance to market practitioners on the use of financial derivative instruments, including the calculation of net derivative exposure.
- This clarified the calculation methodology for a fund's derivative investments to exclude the use of derivatives which would not result in incremental leverage at the fund portfolio level. Accordingly, a fund with a net exposure arising from its derivatives investments exceeding 50% of its NAV, after excluding derivatives used for hedging etc., would be regarded as a derivative fund.
- Existing SFC authorized funds which will continue to be offered to the public in Hong Kong must now produce a product key facts statement with enhanced disclosure about derivatives

investments by 1 January 2020, although SFC encourages fund managers to adopt such disclosures before the deadline.
- There will also be a new column in the list of SFC authorized funds in SFC's website to indicate whether each fund is or is not a derivative fund.

Money Market Funds

- Requirements applicable to money market funds such as permitted assets, repo transactions, portfolio maturity limits, minimum liquid asset level, safeguards for amortized cost will be tightened to align those with IOSCO recommendations.
- The definition of 'money market funds' is revised to 'a scheme which invests in short-term and high quality money market instruments and seeks to offer return in line with money market rates', such that funds that present the characteristics of a money market fund or which are presented as having similar investment objectives (regardless of how they are named or marketed) would also be subject to applicable requirements.

New fund type

- Listed open ended funds (i.e. actively managed exchange traded funds) are introduced and now included as a type of SFC authorized funds. Previously the UT Code catered for passively managed ETFs which track the performance of indices or benchmarks. However, noting the growth of active ETFs in various overseas jurisdictions and market interest, active ETFs are now included to offer more investment choices to investors.

Operational matters and ongoing disclosure and reporting

- To align with standards and practices published by IOSCO, the SFC also amended requirements applicable to funds operations and management relating to valuation, fees and expenses, liquidity management and termination of funds. These are areas the SFC has also recently enhanced in the updated Fund Manager Code of Conduct that SFC licensed managers are required to comply with.

Application to UCITS Funds

- A large portion of authorized funds in Hong Kong are UCITS funds domiciled in Luxembourg, Ireland and UK. Previously, UCITS funds are authorized in Hong Kong under a streamlined process, with certain assumptions and deemed to be compliant with the relevant provisions in the UT Code.
- In this respect, SFC issued a new 'Application of the Code on Unit Trusts and Mutual Funds on UCITS funds' on 17 December 2018, which sets out the relevant provisions in the UT Code that are applicable to UCITS funds for better transparency and clarity.

Effective Date and Transitional Arrangements

The new UT Code has taken effect on 1 January 2019 with a transition period of 12 months for existing SFC authorized funds and operators.

The SFC also updated the various forms, checklist and confirmations relating to the SFC authorised funds that reflected the changes in the new UT Code for use with effect from 1 January 2019.

Remarks

When the Consultation Paper was first released, industry participants were generally receptive to the proposed changes, except the original proposal on evaluating derivatives exposure. Given the majority of SFC authorized funds are UCITS funds, the main concern was that they use a very different method for calculating derivatives exposure and assessing the related risks. After forming a specifics task force with major fund associations, the SFC reached a consensus with the industry and allowed for the use of derivatives under certain circumstances to be excluded from the calculation of a funds' net derivative exposures, such as netting, hedging and risk mitigation; cash flow management; market access or exposure replication; and investment in conventional convertible bonds. These are now clarified in the Derivative Guide.

Given the extensive amendments to the UT Code, and the updates to other related SFC codes/ guidelines (such as the inclusion of certain types of cryptocurrencies as 'securities' defined under SFO, the amendments to the Fund Manager Code of Conduct), industry participants should adopt a holistic approach in assessing whether they are compliant with the updated requirements and consider whether any operational, procedural or systematic changes should be implemented.

Contact Details

If you like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual contact at our firm.

Vivien Teu **Managing Partner** **Vivien Teu & Co LLP** Tel: (852) 2969 5316 vivien.teu@vteu.co	**Christina Suen** **Senior Associate** **Vivien Teu & Co LLP** Tel: (852) 2969 5362 christina.suen@vteu.co