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BRIEFING

REVISIONS TO THE FUND MANAGER CODE OF CONDUCT – THE COUNTDOWN BEGINS

BACKGROUND AND OVERVIEW

In November 2017, the Securities and Futures Commission ("**SFC**") published its Consultation Conclusions on certain proposals that would result in changes to the Fund Manager Code of Conduct (the "**FMCC**") and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the "**Code of Conduct**"). These changes represent some of the most significant regulatory changes, at least in the past few years, affecting anyone who conducts any form of asset management business in Hong Kong. The regulatory objectives of these changes are to align Hong Kong's asset management regulations with ever-changing (and typically more onerous) international regulatory standards by enhancing mechanisms for investor protection as well as greater transparency. The key dates to note are as follows:

- 17 August 2018 – amendments to the Code of Conduct become effective
- 17 November 2018 – the revised FMCC becomes effective

The changes may potentially result in changes to how asset management businesses are conducted in Hong Kong as well as resulting in changes to be made to the various agreements and documentation used by asset management firms in the course of their businesses. These regulatory changes will have an impact on asset management businesses to a varying degree and scope depending on the exact nature of the business and their current *modus operandi*. The changes will impact businesses that are engaged in managing retail funds, those managing private funds (including hedge funds and private equity funds) as well as anyone who manages assets by way of a discretionary account.

KEY CHANGES

One of the more important new concepts to be introduced is the term 'fund manager who is responsible for the overall operation of a fund'. This is an important concept because some sections of the revised FMCC are only applicable to those fund managers that are responsible for the overall operation of a fund. Whilst this may represent an extension of the SFC's regulatory reach, the exact limit of the extension is not clear because in some circumstances, it is uncertain whether a fund manager is "responsible for the overall operation of a fund". The SFC has provided some examples of where a

fund manager falls within the ambit and where a fund manager falls outside of it. However, the examples provided by no means cover the full spectrum of the various scenarios that may occur in real life.

The revised FMCC also clarifies who the client of the fund manager is. Historically there have been some industry debates as to whether the fund manager's client is the fund or whether the investors of the fund can also be construed to be its clients. The revised FMCC clearly distinguishes between the two and, although this clarification is helpful, it also extends the fund manager's various regulatory obligations to the fund investors where the revised FMCC specifically says so.

Changes that Impact on all Fund Managers Whether or Not Responsible for the Overall Operation of a Fund

The SFC expects fund managers to have in place the following policies that should be consistent with the requirements in the FMCC and the SFC's FAQ. Such policies must be formally documented (for example, in the fund manager's compliance manual) and also reviewed regularly.

- **Securities Lending, Repos and Reverse Repos - Collateral / Haircut Policies**
    - A collateral valuation and management policy that includes certain minimum valuation and margin requirements;
    - A collateral and haircut policy to determine the types of acceptable collateral and the methodology to calculate haircuts. Fund managers are not obligated to state specific numerical haircut floors and have the flexibility to design their own haircut methodologies; and
    - A cash collateral reinvestment policy to ensure sufficient, and to manage, liquidity of the assets held in the cash collateral reinvestment portfolio to meet reasonable foreseeably recalls of cash collateral and to manage associated liquidity risks.

- **Conflicts of Interests** – to effectively identify and manage any potential or actual conflicts of interest, fund managers should ensure that appropriate safeguards and measures are implemented and that any of its organizational and administrative arrangements assure, for example, that all transactions are conducted in good faith on an arm's length basis and are commercially in the best interest of the fund. Disclosure of any material interest or conflict to fund investors is also mandatory.

- **Risk Management** – fund managers should establish and maintain effective risk management policies and procedures that implement the SFC's new requirements contained in the FMCC to ensure the identification, quantification and adequate management of, as well as the sufficient allocation of time to, risks the fund manager and the fund are exposed to. These policies and procedures should be reviewed and enhanced whenever necessary to ensure the fund manager can continuously manage the risks effectively. Appendix 2 to the FMCC also specifies suggested risk-management control techniques and

procedures for the management of market, liquidity, issuer and counterparty and operational risks that fund managers should take into account.

Changes that Impact on Fund Managers who are Responsible for the Overall Operation of a Fund

- **Leverage** – fund managers are required to disclose the expected maximum leverage it may employ on behalf of the fund and the basis of calculation of such leverage. As the SFC has not given a specific method and acknowledges that there may be variation in the method depending on the fund, the fund manager has the flexibility to develop its own calculation methodology for calculating the expected maximum leverage so long as it is reasonable and prudent and takes into account its investor base.

- **Third Party Delegation -** all fund managers must note that for any outsourcing or delegation of duties to a third party in relation to the fund, including to prime brokers, auditors and/or custodians, the SFC expects that the fund manager acts with due skill, care and diligence in the selection, appointment and ongoing monitoring of the third party. This includes, but is not limited to, ensuring the third parties are in good financial standing, examining their policies and procedures and monitoring their competence in carrying out their duties in relation to the fund regularly and on an ongoing basis to ensure the third parties' continued competence and compliance with the FMCC. The fund manager remains responsible for any delegation; its responsibilities cannot be delegated.

- **Custodian -** fund managers will also need to ensure that the custodian is functionally independent from the fund manager and is properly qualified to ensure the proper segregation (unless held in an omnibus client account) and safeguarding of the fund assets. The SFC has set out certain requirements and considerations in the FMCC as guidance for the fund manager when assessing the appropriateness of the custodian for the performance of its functions. Alternatively, where self-custody is adopted, the fund manager should ensure that all relevant requirements under the SFO are complied with and should specifically disclose the existence of such self-custody arrangement and the additional safeguards that have been put in place to mitigate any potential conflict of interest to the fund investors.

- **Liquidity** – fund managers need to take into account various requirements and considerations specified in the FMCC in order to monitor the liquidity risks of the fund effectively. The SFC requires that assessment and monitoring of liquidity risks of the fund should be conducted through liquidity stress testing on an ongoing basis by the fund manager; the extent and frequency of which should be determined through the consideration of the nature and liquidity profile of the fund and the availability of appropriate liquidity management tools. The SFC also requires that any preferential treatment, in the form of side letters or otherwise, given to certain investors should be disclosed to all relevant potential and existing fund investors, including the disclosure of all material terms in relation to redemption in the side letters.

- **Fund Valuation -** fund managers should put in place appropriate valuation policies and procedures (which should be reviewed at least annually) in accordance with the general principles specified in the FMCC to ensure that the performance and valuation methodologies are consistent for similar types of fund assets.

- **Side Pockets –** fund managers need to disclose to fund investors whenever there is a creation and operation of any side pockets.

DISCRETIONARY ACCOUNT MANAGEMENT

Although it has widely been accepted as industry practice that discretionary account managers fall within the scope of the FMCC, the existing FMCC stated that it applies to 'persons whose business involves the management of funds' thereby creating some technical uncertainties as to whether managers of discretionary accounts fall within the scope of the FMCC. The revised FMCC clarifies this technical uncertainty by explicitly stating that discretionary account managers also fall within the scope of the FMCC and prescribes additional obligations in relation to discretionary account managers.

Appendix 1 to the revised FMCC expressly disapplies certain provisions in the FMCC for discretionary account managers, including with respect to: liquidity (to the extent as specified in the Appendix), auditors, termination, side pockets, valuation frequency, net asset value calculation and pricing and offers of investment. However, it specifies further minimum contents requirements in addition to the minimum content that must already be included in each client agreement set out in paragraph 6.2 of the Code of Conduct. This gives additional safeguards to clients that are neither 'Corporate Professional Investors' nor 'Institutional Professional Investors' in accordance with the Code of Conduct.

AMENDMENTS TO THE CODE OF CONDUCT

In addition to the changes to the FMCC, the Consultation Conclusions also make revisions to the Code of Conduct in relation to the disclosure of monetary and non-monetary benefits received and/or receivable by the licensed person and disclosure of the licensed person's independence status to clients.

Disclosure of Monetary / Non-Monetary benefits

A licensed person must now make certain disclosures regarding the monetary and non-monetary benefits received or receivable as specified in the revised Code of Conduct on a transaction basis before or at the point of entering into a transaction with a client in relation to the distribution of investment products where:

- it explicitly receives monetary and/or non-monetary benefits from a product issuer;
- it enters into a back-to-back transaction; and/or

- monetary benefits received or receivable by it are not quantifiable prior to or at the point of entering into a transaction.

Independence

The Consultation Conclusions introduce an obligation for a licensed person to disclose whether or not it represents itself as being independent (or the use of a similar terms). Whether the licensed person shall be deemed as being independent depends on whether it receives fees, commissions, or any monetary benefits paid or provided (directly or indirectly) by any party in relation to a distribution of investment products to clients and/or whether it has any "close links" (as defined in the Consultation Conclusions) or other legal or economic relationships with product issuers, or receives any non-monetary benefits from any party, which are likely to impair its independence. In relation to such disclosure, the SFC has provided standard disclosure statements in Schedule 9 to the revised Code of Conduct with respect to a licensed person's representation which should be communicated by a licensed person to a client, along with the basis of such representation, before or at the point of entering into any transaction.

CONCLUSION

Whilst the revisions to the FMCC clarify certain aspects of the FMCC which may have caused confusion and inconsistent application in the past, some of the revisions also create new uncertainties as to its scope of application. This is particularly the case for fund managers of private equity funds who may find themselves faced with far reaching uncertainties as to how the revised FMCC may be applied to them. This is also the case, though maybe to a lesser extent, to securities firms or brokerage firms who offer discretionary account management services as an incidental activity to their businesses in Type 1 regulated activities. Although it is expected that the SFC will issue further FAQ and Guidelines in relation to the revisions to the FMCC, firms in the business of managing assets would be well advised to err on the side of caution and follow the spirit of the regulatory changes where there are uncertainties.

Given the deadline for implementation is approaching, any firm involved in managing assets will need to start considering the implications of the changes on their existing policies and documentation (eg compliance manuals, client agreements (including investment management agreements), service provider agreements (including custodial agreements), fund offering documentation and to assess whether any amendments may be necessary.

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Relevant links:

Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts
http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=16CP5

SFC's FAQ on the Fund Manager Code of Conduct
http://www.sfc.hk/web/EN/faqs/intermediaries/supervision/fund-manager-code-of-conduct/2017-11-16.html#1

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