



**Consultation Paper
on Proposed Amendments to the
Code on Unit Trusts and Mutual Funds**

The Law Society's Submissions

The Securities and Futures Commission ("SFC") in December 2017 issued a consultation paper on "Proposed Amendments to the Code of Unit Trusts and Mutual Funds" ("Consultation Paper"). In response thereto, the Law Society provides the following submissions on the consultation questions posed.

Capitalized terms used but not defined herein have the meanings assigned to them in the Consultation Paper.

Question 1: Do you have any comments on the proposed increased minimum capital for management companies?

Law Society's response:

No comments.

Question 2: Do you have any comments on the proposals to provide flexibility for well-established fund management groups to leverage group investment expertise and experience?

Law Society's response:

We approve of the further flexibility which aligns with the way in which fund management groups carry out their activities.

Question 3: Do you have any comments on the proposals regarding the enhanced obligations of trustees and custodians?

Law Society's response:

Noting the extension of scope and enhanced level of the periodic auditor review of the internal controls and systems of trustees and custodians, and the purpose of bank regulation (essentially, deposit taking), we suggest including some flexibility, possibly by italicized note, to enable other new business types to have the opportunity to act as trustee/custodian in the future. We note however that as at today, the institutions that are willing to carry out the trustee/custodian role under the Code on Unit Trusts and Mutual Funds ("UT Code") will likely only be banking institutions or affiliates thereof.

We have no comments on the proposals regarding the further obligations on trustees and custodians set out in paragraph 26 of the Consultation Paper.

Question 4: Do you have any comments on the proposals to enhance the periodic reviews of the internal controls and systems of trustees and custodians?

Law Society's response:

No comments.

Question 5: What other measures do you think are appropriate to strengthen the regulations for trustees and custodians of public funds in Hong Kong?

Law Society's response:

We regard the proposals in paragraphs 26 and 27 of the Consultation Paper, together with the proposed amendments to Appendix G to the UT Code, to be appropriate. We suggest efforts be concentrated on assisting the independent auditor on its compliance monitoring role. This may include circulars and training aimed at independent auditors and trustees and custodians and the provision of SFC personnel to respond to queries raised by trustees, custodians or independent auditors.

Question 6: Do you have any comments on the proposal to introduce an overall limit on derivatives investments for a plain vanilla public fund? Do you consider the proposed 50% limit appropriate? Please explain your views.

Law Society's response:

No comments.

Question 7: Do you have any comments on the proposed enhanced disclosures regarding derivatives investments in the fund's KFS and financial reports?

Law Society's response:

No comments.

Question 8: Do you agree with the proposed framework for Securities Financing Transactions? Please explain your views.

Law Society's response:

We agree with the concern to ensure that risk relating to uncollateralised securities lending is managed, and so we agree with the introduction of additional safeguards.

Question 9: Do you consider indemnification by securities lending agents is a necessary and appropriate safeguard? Please explain your views.

Law Society's response:

We query whether securities lending agents should be required to indemnify a fund against counterparty default. At present, there are a number of securities lending agency models. The requirement to indemnify would favour some models over others. We question whether regulation should be used to reduce securities lending agency choice available to the funds. We would expect the tool to mitigate counterparty default to be collateralisation, rather than recourse to a third party.

Question 10: Do you consider an overall transaction limit should be imposed on Securities Financing Transactions (other than the additional safeguards proposed)? Please explain your views (with any suggested overall transaction limit, if applicable).

Law Society's response:

We suggest that collateralisation should be the risk mitigation tool rather than requiring an overall transaction limit.

Question 11: Do you think that the proposed collateral requirements are sufficient to safeguard investor interests? What additional criteria should be considered?

Law Society's response:

We regard the proposed requirements to be sufficient.

Question 12: Do you agree with the proposed disclosure requirements concerning collateral? Please explain your views.

Law Society's response:

We would suggest a general disclosure, based on an SFC suggested form disclosure, to inform investors, with funds permitted (but not obliged) to give further details as applicable to their circumstances.

Question 13: Do you have any comments on the proposals on investment in other funds?

Law Society's response:

No comments.

Question 14: Do you agree with the proposal to require a structured fund to be subject to 100% collateralisation?

Law Society's response:

We agree with the proposal, in particular noting the market perception of exchange-traded funds ("ETFs") as being products with a similar risk profile to holdings of the underlying.

Question 15: Do you agree with the proposed requirements for money market funds? Please explain your views.

Law Society's response:

We agree to the inclusion of parameters for money market funds, although express no view on the actual limits.

Question 16: Do you agree with the proposed amendments to the requirements for unlisted index funds and passive ETFs using index tracking strategies which substantially invest in derivatives? Please explain your views.

Law Society's response:

We agree with the amendments in light of the different risk profiles between physical and synthetic ETFs.

Question 17: Do you agree with the proposed enhanced diversification requirements for indices? Please explain your views.

Law Society's response:

No comments.

Question 18: Do you agree with the proposed arrangement for setting up listed and/or unlisted units or share classes for index funds and passive ETFs? Please explain your views.

Law Society's response:

No comments.

Question 19: Do you agree with the other proposed amendments related to unlisted index funds and passive ETFs under Chapter 8.6 of the UT Code?

Law Society's response:

No comments.

Question 20: Do you agree with the proposed requirements for listed open-ended funds? Please explain your views.

Law Society's response:

We agree that active ETFs should be permitted. We have no comments on the proposed requirements.

Question 21: Do you agree with the proposed requirements for closed-ended funds? Please explain your views.

Law Society's response:

We agree that a closed-ended fund that is traded at a significant discount to net asset value ("NAV") should not be permitted to be characterised as a collective investment scheme as defined in the SFO (see Chapter 8.11(c) of the UT Code). This is because the realisation of value at (or close to) NAV is a defining characteristic of a collective investment scheme compared to other types of investment company.

Question 22: Do you agree with the proposed amendments to the provisions in the UT Code relating to operational requirements and financial reporting? Please explain your views.

Law Society's response:

Paragraph 10.2B(c) of the UT Code: In respect of the obligation for a management company to compensate the scheme for any loss incurred due to incorrect pricing, we suggest clarifying what the loss which is to be compensated for would be. Loss to purchasing and redeeming investors is covered by paragraph 10.2(B)(a). We would not expect compensation to cover any consequential losses. Compensation should be limited to the immediate remedial step. In most circumstances, that will be to adjust the NAV to reflect the correct value, although monetary compensation could occur if the scheme had entered into portfolio trades on at an incorrect price due to a pricing error. We suggest including a note to paragraph 10.2(B)(c), or a signpost if the point is to be dealt with in FAQs.

Question 23: Do you agree with the proposed streamlining of specialised schemes in the UT Code? Please explain your views.

Law Society's response:

We have no objection to the proposed amendments.

Question 24: Do you agree with the proposed consequential amendments to the MPF Code? Please explain your views.

Law Society's response:

No comments.

Question 25: Do you agree with the proposed consequential amendments to the PRF Code? Please explain your views.

Law Society's response:

No comments.

Question 26: Do you agree with the proposed consequential amendments to the ILAS Code? Please explain your views.

Law Society's response:

No comments.

Question 27: Do you agree that a minimum initial subscription by investors to be consistently applied to all highly leveraged funds? Do you consider the proposed US\$50,000 or the equivalent threshold appropriate? Please explain your views.

Law Society's response:

We regard a consistent approach between funds to be appropriate. We do not have a particular view on the threshold amount.

The change to minimum initial subscription should not however affect existing investors who are below that threshold.

Question 28: Do you agree that the requirement on disclosure of the purpose of, and expected maximum leverage arising from, derivatives investments should be consistently applied to all SFC-authorized funds? Please explain your views.

Law Society's response:

We agree there should be a consistent approach.

Question 29: Do you agree with the proposed implementation timetable for the proposed amended UT Code? If not, please set out your reasons and what you think is an appropriate transition period.

Law Society's response:

We suggest providing for a general 12 month transition period for all amendments that require changes to existing schemes or existing scheme operators.

As currently drafted, the specific transitional provisions are complicated and may

require immediate changes to existing schemes (depending upon the particular factual circumstances applying to a scheme). For example, there is no grace period for an existing scheme whose trustee/custodian does not fulfil the Chapter 4 requirements. Changing the definition of “substantial financial institution” (paragraph 3.13 in Chapter 3 of the UT Code) would also result in potential scheme changes. The same applies to paragraphs 5.1 and 5.7 in Chapter 5 of the UT Code for self-managed schemes.

If the SFC believes that all existing schemes and operators already comply with those provisions, there will be no downside, taking a practical perspective, to the SFC applying such a transition period to those existing schemes and operators. The transition period would not apply to new schemes or new operators.

Question 30: Do you agree with the proposed implementation timetable for the proposed amended MPF Code? If not, please set out your reasons and what you think is an appropriate transition period.

Law Society’s response:

See our response to Question 29.

Question 31: Do you agree with the proposed implementation timetable for the proposed amended PRF Code? If not, please set out your reasons and what you think is an appropriate transition period.

Law Society’s response:

See our response to Question 29.

Question 32: Do you agree with the proposed implementation timetable for the proposed amended ILAS Code? If not, please set out your reasons and what you think is an appropriate transition period.

Law Society’s response:

See our response to Question 29.

Further Law Society Comments

Set out below are comments arising from a review of the proposed changes to the Codes.

Paragraph 4.5(a)(iii) of the UT Code: we note the requirement for a custodian to be liable for all its delegates (including through the custody chain). We defer to industry participants about whether this will likely have a pricing impact.

Paragraph 4.5(a)(iv) (and Appendix G, paragraph 8.A(d)(16)): we question whether segregation of the property of the scheme and the persons listed should extend to cash? This would mean that a custodian bank could not itself accept a deposit of cash. We suggest clarifying the point as a custodian authorized institution should be able to accept the cash deposit.

Paragraph 7.11D: we consider clarifying that the prohibition on quantifiable monetary benefits does not extend to benefits that are received in the capacity as a shareholder in the underlying scheme or management company. Certain management groups will have subsidiary management companies.

Paragraph 7.28(b): we consider permitting counterparties that are not substantial financial institutions if the derivative instruments are fully collateralized.

Paragraph 7.34: we suggest clarifying as this concept does not work well in the context of a reverse repurchase transaction.

Paragraphs 8.6(a), (a)(a): Under paragraph (a), an “index fund” is an unlisted index fund; although under paragraph (a)(a) an ETF (which is listed) is also an “index fund”. Consider amending the language to delineate between listed and unlisted.

Appendix G, paragraph 8D: insert ‘whether’ at the end of the first paragraph.

Appendix G, paragraph 8E: redundant text to be removed (see the words ‘the auditor is required to issue’ in item (a) and the words ‘the auditor should issue’ in item (b)).

**The Law Society of Hong Kong
27 February 2018**

