

AIMA FUND MANAGER TRAINING - Fund Manager Code of Conduct (“FMCC”) SFC Consultation Conclusions

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7 December 2017





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Fund Manager Code of Conduct (“FMCC”)

- **SFC Consultation: 23 November 2016**
- **SFC Consultation Conclusions: 16 November 2017**
- **Amendments to FMCC effective 12 months from gazettal**

Fund Manager Code of Conduct (“FMCC”)

(Cont’d)

Applicability

- **Type 9 licensees (asset management):**
 - i. **Retail funds**
 - ii. **Private funds**
 - iii. **Discretionary accounts**

- **No extra-territorial application to overseas managers**

Overall Operation of a Fund

- **Certain provisions of FMCC only applicable to fund managers responsible for “overall operation of a fund”**
- **SFC has removed reference to “defacto control” and introduced the concept of “responsibility for overall operation of a fund”**
- **Fact-based review: who in substance is responsible for overall operation of the fund**
- **SFC to issue FAQ re what constitutes “responsible for overall operation of a fund”**

Overall Operation of a Fund

(Cont'd)

When a fund manager is responsible for overall operation of a fund the following provisions of FMCC apply:

- 3.12 : Leverage disclosure to investors**
- 3.13.7 : Securities lending disclosure to investors on annual basis**
- 3.13.8 : Securities lending, repo and reverse repo policies to be disclosed to investors**
- 3.14.1 : Establishment of liquidity management policies and procedures and disclosure to investors re: liquidity risks, tools etc**
- 3.14.2 : Disclosure of side letters / any preferential treatment**
- 3.16 : Fund termination must take due account of best interests of investors and disclosure of termination provisions**

Overall Operation of a Fund

(Cont'd)

- 4.1.2 : Responsible for appointment of independent custodian**
- 4.2.1 : Must exercise due skill and care in appointment and ongoing monitoring of custodian**
- 4.3.1 : Must ensure a formal custody agreement is executed which sets out responsibilities and liability of custodian**
- 4.3.3 : Must monitor custodian's ongoing compliance**
- 4.4.1 : Custody arrangements and risks must be disclosed to investors**
- 5.2.2 : Responsible for appointment of independent auditor**
- 5.3.1 : Responsible for independent valuation and ongoing monitoring of valuation agent**

Overall Operation of a Fund

(Cont'd)

- 5.3.5 : Frequency of valuation and dealings to be disclosed to investors**
- 5.4.1 : Disclosure of any side pocket arrangements**
- 5.5.1 : Ensure fund's NAV is calculated in accordance with fund's constitutive documents**
- 5.5.2 : Detect / prevent / correct any pricing errors and compensate investors in respect of any material error**
- 6.1 : Disclose to investors details of fund manager's business address, licensing conditions and financial conditions of fund manager (upon request)**

Overall Operation of a Fund

(Cont'd)

8.1 : Disclosure of fees and charges

8.2 : Provide periodic transaction / statement reports

Provisions Applicable to Fund Managers Generally

- 1.3 : Functional separation unless not reasonably practicable**
- 1.7 : Risk management: Establishment of risk management policies and procedures**
- 1.10 : Delegation: must exercise due skill, care and diligence in section of 3rd party delegates**
- 2.1.1 : Personal account dealing: employees must disclose at least semi-annually (previously annually)**
- 3.13 : Securities lending policies and procedures by reference to SFC guidance in FMCC**
- 3.15 : Any material non-compliance must be identified and reported to SFC**

Reporting Obligations to SFC – Ongoing and on Request

9.1.2 : Fund managers must respond promptly and in a co-operative manner to any SFC requests for information

9.1.3 : All information must be complete and not misleading

9.1.3 : Obligation to update the SFC if any information requires updating

Requirements relevant to Discretionary Accounts

SFC have clarified that the following requirements in FMCC do not apply to Discretionary Account Managers:-

- **Liquidity management**
- **Termination**
- **Side pockets**
- **Auditors**
- **Valuation frequency**
- **NAV calculation**

Additional Requirements applicable to Discretionary Account Managers

- **Obligation to enter into a client agreement and minimum contents requirements unless exempted under Code of Conduct (i.e. institutional PIs and corporate PIs who have passed CPI assessment test)**

- **Minimum contents of client agreement to include:**
 - **appointment provisions of fund manager**
 - **Client's investment policy and objectives (asset classes, geographical spread, risk profile of portfolio, prohibited investments, performance benchmark (if any))**
 - **Fees payable**
 - **Consents to soft commissions / cash rebate**
 - **Custody arrangements if provided by fund manager or its associate**
 - **Details of periodic reporting to client**

Thank you for your participation

Any Questions?



AIMA FUND MANAGER TRAINING - Recent SFC Guidance for Type 9 Asset Managers

Jane McBride, Partner & Head of SFC Licensing, Compliance & Regulatory Team
7 December 2017





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- 1. Licensing**
- 2. Manager-In-Charge Regime**
- 3. Private Fund / Managed Account Structuring**
- 4. Common Instances of Non-Compliance by Authorised & Private Asset Managers**
- 5. AML / CDD / KYC**
- 6. SFC Regulatory Sandbox**
- 7. Initial Coin Offerings**
- 8. Unbundling of Trade Commissions / MiFID II**
- 9. Online Fund Distribution**

1. LICENSING

- **Incidental Type 1 Powers (15 September 2017 Circular)**
- **Backdoor licensing (2 June 2017 Circular)**
- **RO “relevant industry experience” (29 September 2017 Circular)**
- **Timing**
- **Individual Substantial Shareholder Applications (2 June 2017)**
- **PRC Individuals**
- **Asset Management Competence Generally (23 June 2017 Circular)**
- **New Corporate Licences / Additional RA – Org Charts to include MIC information**





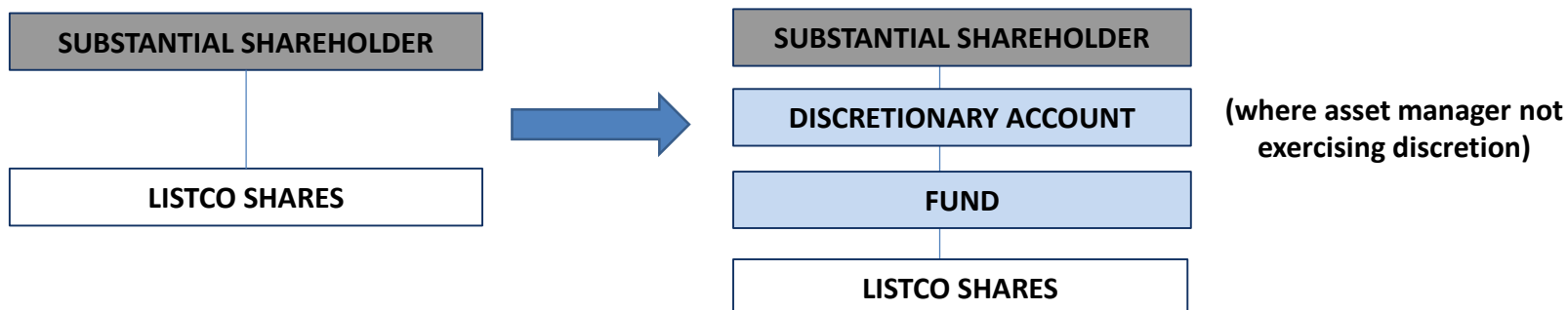
2. MANAGER-IN-CHARGE REGIME

- **Regime now in effect: 17 July 2017**
- **SFC “generally expects” OMO / KBL MICs to be ROs**
- **Recent Deacons work**
 - **SFC feedback - segregation back / middle vs front office jobs**
 - **Training on potential personal liability of MICs**
 - **Corporate governance questions**
 - **If one MIC reports to an MIC or there are 2 MICs – need to separate the responsibilities**
- **We expect SFC to focus on OMO / KBL MICs (and not on Compliance MICs)**
- **Point of MIC regime is stamp-out ROs–for–hire and identify who is in control (Ashley Alder speech– 3 July 2017 – see Deacons article)**
- **OMO ROs seem to need front office experience despite flexibility provided for in MIC circular (16 December 2016)**



3. PRIVATE FUND / MANAGED ACCOUNT STRUCTURING – 31 JULY 2017 CIRCULAR

- SFC “*will not hesitate to take action against any licensed corporations and their management*” (including MICs)
- Examples of “questionable” practices - structure may conceal the listco shareholding
 - i. “discretionary account” holders with sizable concentrated stock positions / asset manager not exercising investment discretion
 - ii. related party acquisitions / disposals of listco shares by buy/sell notes
e.g. listco shareholders selling shares to funds and investing in fund





3. PRIVATE FUND / MANAGED ACCOUNT STRUCTURING – 31 JULY 2017 CIRCULAR

- iii. relationship between fund investors / discretionary account holders and investee listcos e.g. where they are substantial shareholders, directors or affiliates of the listco
- iv. director of asset manager was director / CEO of investee listco
- *“SFC warns that asset managers should not turn a blind eye to dubious arrangements and transactions proposed by their clients. They should critically examine arrangements and transactions, including performing proper client due diligence, and take appropriate steps to avoid being implicated in any market misconduct or other illicit activities”*
- SFC also discussed concerns about liquidity risk management practices of such firms – see FMCC Consultation Conclusions



4. COMMON INSTANCES OF NON-COMPLIANCE BY AUTHORISED & PRIVATE ASSET MANAGERS (15 September 2017 Circular)

- **Cash rebates** - conflict of interest where manager gets rebate from transaction
- **Suitability** – Funds and Mandates must be suitable
- **Liquidity risk** – Firms must be able to meet redemption / withdrawal requests
- **Fair valuation of assets** – assets should be valued at fair and reasonable price
- **Best execution** – conflict of interest because of benefits brokers provide - examples of non-compliance:
 - CEO no day-to-day involvement - yet more votes than others and many orders going to brokers with more attractive soft dollar arrangements
 - trader allocating majority of trades to broker with lowest score
 - post-trade reviews not documented
 - policies not specify minimum number of quotes for bond trades



4. COMMON INSTANCES OF NON-COMPLIANCE BY AUTHORISED & PRIVATE ASSET MANAGERS (15 September 2017 Circular)

- Complex structures – SFC may prosecute manager even though the Type 9 firm does not exercise discretion
- Paragraph 12.5 SFC notifications – Must report breaches by clients of market misconduct obligations
- Fair order allocation – Must pre-record intended basis of allocation where orders across multiple accounts only **partially** filled or where managing house and client accounts
- Investment restriction compliance
 - need proper systems for restrictions which can't be coded, “eye-balling” by investment team not sufficient
 - traders should not be able to override investment restriction violations
- Insider dealing:
 - compliance needs to do red flag monitoring
 - need internal policies re use of “expert network” firms



5. AML / CDD / KYC

SFC Circular 26 June 2017

- **Amendments to AMLO wef 1 March 2018**
- **In advance of HK's 2018/2019 FATF evaluation**
- **Changes:**
 - **definition of “beneficial owner” will change to “more than 25%” in all situations so that generally (i.e. unless high risk) only need to identify and verify 25% BOs**
 - **Related Foreign Financial Institutions – group companies will be able to handle CDD checking for SFC licensed corporations if they are locally regulated and the requirements are similar (and comply with rest of s.18 in Schedule 2)**
- **SFC left door open for licensed corporations to take advantage of future advances in technology as and when providers can get SFC comfortable**



5. AML / CDD / KYC

SFC Circular 11 October 2017

- **AML Guideline to be formally amended but effective immediately - address verification requirements removed so address proof no longer required**
- **Specifically:**
 - **For individual investors now only required to collect their residential addresses**
 - **Similar for trustees (of trust investors)**
 - **For corporate investors, you don't need to verify any of the corporate details – just collect the registered address and the address of the principal place of business of the company**
 - **Beneficial owners – collect residential address only**
 - **Even in high risk situations don't need to verify addresses of directors or signatories**



6. SFC REGULATORY SANDBOX

SFC Circular 29 September 2017 – Corporate licence applications (new applicants and additional RA) - Firms may apply to “enter” a sandbox:

- Licence applications approved subject to special licensing conditions
- Purpose – to facilitate application approvals while firm’s internal controls etc. are still being developed
- Delivery of the financial services and firm’s internal control systems are examined and monitored on an ongoing basis by the SFC in a confined regulatory environment - “the sandbox”
- Once SFC satisfied – can apply to have the conditions removed, and then services can be expanded and provided to the HK public; i.e. the firm “exits the sandbox”
- Licence can still be revoked when firm is in “sandpit”
- RO “relevant industry experience” Circular 29 September 2017
- Contact SFC Fintech Contact Point to discuss

6. SFC REGULATORY SANDBOX – Features



☐ Eligibility

- fit and proper and FRR compliance
- innovative technologies
- genuine and serious commitment to use of Fintech

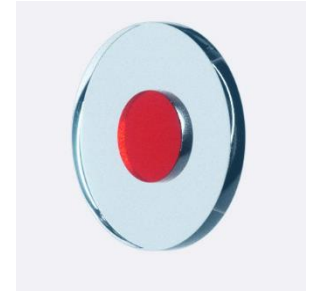
☐ Licensing conditions

- ☐ limited types of clients and maximum exposure per client

☐ Ongoing closer monitoring and supervision by SFC

☐ Investor protection measures and full disclosure of sandpit

☐ Exit permitted when firm can demonstrate that its technology is reliable and fit for purpose and its internal control procedures adequately address the risks identified



7. INITIAL COIN OFFERINGS (5 Sept 2017 Circular)

- **Digital tokens offered or sold as part of ICO may be securities under SFO:**
 - If only “virtual commodities”, won’t be securities and no licensing
 - Some ICOs have “securities” terms and features ie SFO licensing regime applies
 - SFC has not banned ICOs, digital tokens or cryptocurrency exchanges themselves
- **“Securities” Terms and Features**
 - ICO digital tokens represent equity or ownership interests in a corporation > shares > securities
 - Where digital tokens are used to create or acknowledge a debt or liability owed by issuer > debenture > security
 - If token proceeds are managed collectively by the ICO operator to invest in projects to enable token holders to participate in a share of the returns provided by the project > collective investment scheme > securities

8. UNBUNDLING OF TRADE COMMISSIONS / MiFID II

- **SFC no plan to require unbundling of commissions as per European MiFID II Directive (because SFC not want to do anything to discourage research)**
- **MiFID II Directive – not part of HK regulation – but if chose to comply in connection with HK as well for operational efficiency reasons – SFC not going to object**



9. ONLINE FUND DISTRIBUTION



- **Consultation ended 4 August 2017**
- **Waiting for Conclusions and Guidelines**
- **12 month roll-out period**
- **Of most interest to authorised fund managers**

Thank you for your participation

Any Questions?

