

REGULATORY INTELLIGENCE

Navigating the "New Normal" – the fallout from COVID-19 for Hong Kong asset managers and financial institutions

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The COVID-19 pandemic has caused significant disruptions to numerous industries and sectors on a worldwide scale in an unprecedented manner. The asset management industry, like so many other business sectors, has proven far from immune to the impact of the health crisis. This alert aims to provide an overview of several key items that Hong Kong-based fund managers and financial markets participants with an office in or exposure to Hong Kong or Asia may wish to take into consideration as they navigate the challenges presented by this outbreak.

Provisions in fund documents and regulatory obligations impacting liquidity and related internal liquidity risk management policies

Gating/Suspensions/Side Pockets

Firms should ensure that they are familiar with the following provisions of their fund documents:

The types of assets your funds are invested in will dictate the types of stress your fund is experiencing right now. You should be familiar with the gating and suspension criteria in your fund documents and the likelihood of this criteria applying to your current circumstances.

In what circumstances can you impose a redemption gate and how do these provisions operate?

Do your documents provide for an investor level gate or does it apply at the feeder fund/master fund level?

You should also ensure that you are familiar with any obligations that might exist to notify regulators of suspensions or the creation of redemption gates and your notification obligations to investors.

You should familiarize yourself with your ability to side pocket assets pursuant to your documents and the regulatory requirements that exist around doing so both in the domicile of your fund and in accordance with the regulations that the fund management company is subject to (for example, the Fund Manager Code of Conduct (FMCC) in Hong Kong).

The Securities and Future Commission (SFC) in Hong Kong has issued several circulars regarding liquidity risk management in recent years. The FMCC dictates at Section 3.14 various onerous requirements relating to liquidity risk management. It is important that Hong Kong asset managers adhere to these responsibilities.

If your organization manages authorized funds, it will also be subject to the Circular to Management Companies of SFC-Authorized Funds on Liquidity Risk Management issued by the SFC in July 2016. Authorized funds should also be aware of their obligations to notify the SFC of significant redemptions.

Margin Calls/Haircuts/Netting Off of Exposure

Many prime brokerage agreements and ISDA Master Agreements contain termination provisions that permit a prime broker to close out all outstanding trades with a fund counterparty and to net off their exposure to such counterparty in the event that the net asset value of the fund goes below a certain level. Where funds have borrowed against securities that they hold they may now be facing margin calls as the value of these securities decline.

In addition, prime brokers and other counterparties may decide to be more stringent regarding the types of securities they will accept as collateral given that such securities may be becoming illiquid or hard to value or the spreads on such assets are widening. Prime brokers may be applying significantly larger haircuts to collateral.



You should assess whether any of the events of default or termination events as those terms are defined in your prime brokerage agreements and ISDA Master Agreements are likely to be triggered and communicate with your prime broker to try to address these issues before they become a problem.

Valuation Issues

With the market going into distress, assets may become illiquid, spreads may widen and your fund's existing valuation policies may not be appropriate in all respects. You should carefully review the valuation policies set out in fund documents together with any related internal policies.

If investments can no longer be properly valued in accordance with the fund's established valuation rules, the investment manager or fund directors may need to deviate from the fund's established valuation methodologies or resort to price overrides as permitted by the fund documents.

SFC Type 9 licensed fund managers must ensure that they handle any price deviation or override in compliance with the Fund Manager Code of Conduct. The fund manager will need to ensure that the reason for the price deviation or override is documented, providing a description of the method used to determine the appropriate price and ensure that a functionally independent party (e.g., the fund's auditor) performs a review of the price deviation or override.

Problems faced by private equity fund managers

Private equity fund managers may find that they need to deal with defaulting limited partners whose liquidity position is such that they are unable to honor capital calls that they have committed to. It is important that such managers and the directors (or alternative governing bodies) of the general partner of the relevant funds are fully familiar with the provisions of the limited partnership agreement governing defaults and are aware of what steps may be taken to penalize such limited partners and of any flexibility that might apply in applying such provisions. Proper consideration will need to be given to the interests of all of the limited partners in the fund. Private equity fund managers and the directors of the general partner of such funds should also be aware of the circumstances in which a limited partner may be excused from honouring a capital call and the conditions that such limited partner needs to fulfil in order to be excused.

Potential Use of Force Majeure Provisions

It would be worthwhile to re-examine any force majeure provisions in your service provider agreements, such as administration agreements, investment management agreements/sub-investment management agreements, custody agreements and technology service provider agreements. A force majeure provision is a form of contractual relief that allows contractual parties to be discharged of their contractual obligations or to evade liability upon the occurrence of a specified event which is outside of the parties' control. As a force majeure provision is a creature of contract, its interpretation will depend on its drafting. The following features of the force majeure provision should be considered in determining whether it has been activated:

Triggering events: There will usually be a list of events, the occurrence of which will put the provision into operation. Determine if the COVID-19 outbreak can be construed to be covered under the list of triggering events. Many force majeure events refer to "outbreak of disease" or "pandemic."

Reporting obligations: Consider what the party wishing to avail of the force majeure provision is required to do (e.g., mode of report and timeline for reporting) in order to take advantage of its protection.

Consequences of activation: Analyze if the performance obligations of the relevant party will be suspended, revoked or otherwise modified and how long the provision would be activated for and what your "Plan B" would be to have such services performed in the event that the force majeure clause was relied upon by the entity currently tasked with providing such services.

Insurance: Do you have any insurance policy that could assist in paying for any loss arising to you or the fund if such force majeure provision was relied upon and do you need to notify the insurance company?

Notification obligations: Consider your obligations to notify investors, your regulator or the regulator of the fund.

Initiatives taken by relevant regulators

Securities and Futures Commission



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Despite operational challenges faced by market participants as a result of the COVID-19 outbreak, the SFC reminded licensed corporations, SFC licence applicants and market participants that in general, they are expected to make all reasonable efforts to maintain "business as usual" in relation to meeting their regulatory obligations as well as all regulatory filing, reporting and other deadlines. Nonetheless, the SFC noted that if a market participant is confronted with specific difficulties, it should promptly reach out to its usual contact at the SFC to communicate such difficulties.

The SFC and the Stock Exchange of Hong Kong have jointly given some relief to listed companies to allow for some flexibility in compliance with their reporting requirements.

On 27 March 2020, the SFC issued a circular reminding intermediaries to act in the best interests of their clients and to exercise extra care when making a solicitation or recommendation or managing investment portfolios for their clients in the current volatile market environment.

Intermediaries are reminded to comply with existing suitability obligations under the Code of Conduct for Persons Licensed by or Registered with the SFC, which involves conducting appropriate product due diligence (including taking into account any deterioration in credit quality or liquidity and market and industry risks relating to the COVID-19 outbreak), giving due consideration to the client's particular circumstances and providing the client with sufficient explanation about the investment product.

Securities and Exchange Commission

The U.S. Securities and Exchange Commission (SEC) has adopted a teleworking arrangement and remains operational. The SEC has monitored the market and engaged with market participants to assess the impact of COVID-19 and has issued multiple statements and guidance to provide market participants with assistance and relief in relation to regulatory obligations where required. Such guidance generally provides for regulatory flexibility in light of the fact that financial markets participants are experiencing operational obstructions, travel restrictions, restrictions on in-person meetings and large gatherings etc.

For example, the SEC issued an order on March 13, 2020, providing relief for registered investment advisers and exempt reporting advisers in respect of their filing obligations. The relief provided in the order was subsequently extended and modified by an order dated March 25, 2020. The new order allows a registered investment adviser or exempt reporting adviser affected by circumstances related to the effects of COVID-19 to file its Form ADV or Form PF, as applicable, and deliver its brochure as soon as practicable, but no later than forty five (45) days after the original filing or delivery due date which is on or after March 13, 2020, but on or prior to June 30, 2020. To rely on the new order, the registered investment adviser or exempt reporting adviser must promptly email the SEC and disclose on its public website that it is relying on the order. The requirement to publicly post that an adviser is relying on the new order however could have such a negative effect on its business that it may discourage many advisers from relying on this relief.

Financial Conduct Authority

The Financial Conduct Authority (FCA) has instructed its staff to work remotely. This has some impact on its responsiveness and the helpdesk query services. The FCA has postponed certain activities which are not critical to the protection of consumers and the integrity of the market in the short term. The FCA has also rolled back its routine supervisory oversight interactions, in particular in-person meetings, and will only contact firms on business-critical requests and responses to the current situation.

The FCA expects firms to take reasonable steps to prepare for challenges arising from the outbreak in particular by making use of their business continuity plans. Firms are expected to be clear and transparent and to provide strong support and services to customers. Firms should handle complaints promptly and should target to resolve any complaint within 8 weeks. The FCA also expects firms to manage their financial resilience and their liquidity actively. If a firm believes that it will encounter difficulties, it should contact the FCA immediately.

Changes with respect to SFC-authorized funds to address stress in the bond markets



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In light of extreme market volatility and adverse liquidity conditions, the SFC has issued further guidance for managers, trustees and custodians of SFC-authorized funds on 25 March 2020 and 27 March 2020 about its expectations on the use of liquidity management tools. The SFC has stepped up its monitoring of authorized funds and has asked managers of such funds to pay particular attention to valuation issues, the need for fair value adjustments and the use of appropriate liquidity risk management tools.

Some managers of authorized-funds have an existing authority to adjust the new asset value and consequently the redemption price for redeeming investors by up to a stated percentage (ie. the "swing factor") to reflect the costs that arise from widening spreads on the asset prices that are being liquidated to facilitate that redemption request. This helps to appropriately allocate the fund's cost of effecting redemptions to the redeeming investors while ensuring that remaining investors are treated fairly.

Due to the effects of COVID-19, the SFC is permitting managers to increase the swing factor beyond the maximum percentage of the net asset value/redemption price set out in an authorized funds' offering documents as a temporary measure without prior SFC approval, subject to certain conditions. Authorized funds which do not disclose an existing swing pricing mechanism but wish to use start using such mechanism will need to discuss this with the SFC separately. The SFC has stated that the amount of anti-dilution levy applied to an investor may also exceed the disclosed maximum level as a temporary measure without prior SFC approval if the same conditions are satisfied.

Business continuity plans for licensed corporations in Hong Kong

In light of the spread of COVID-19 and in response to the government's and medical experts' advice to practice social distancing, many firms have adopted alternative work arrangements, including work from home policies. This means that business continuity plans (BCPs) have kicked into action. This is an opportune time for firms to review and test whether their BCPs are fit for purpose to ensure that their businesses can continue to operate with minimal disruption.

The SFC's requirements with respect to BCPs

The requirement to have an effective BCP in place for financial institutions that are licensed with the SFC is nothing new. The SFC has set out its expectations for licensed corporations to have proper BCPs in place in various codes and guidelines.

Paragraph 36 of the Appendix to the Management, Supervision and Internal Control Guidelines for Persons Licensed By or Registered with the Securities and Futures Commission provides that as part of a licensed corporation's operational controls and risk management, a firm should implement an effective business continuity plan appropriate to the size of the firm to protect it from the risk of interruption to its business continuity.

Paragraph 2 of Section E in Appendix 2 to the Fund Manager Code of Conduct provides that a fund manager should establish, implement and maintain a business continuity and transition plan.

Recommendations on BCP implementation

Throughout the years and in times of prior pandemic outbreaks, such as SARS and the human swine influenza, the SFC has issued circulars providing guidance to licensed corporations on how to implement effective BCPs. In the face of the current COVID-19 outbreak, the following recommendations provided by the SFC with respect to previous pandemics can similarly provide useful guidance to firms in devising their BCPs:

Oversight of BCP

Assign at least one senior staff member to identify critical systems and functions, activate the BCP at the appropriate time and oversee the business recovery process.

Establish a clear command and communication structure for crisis management.

Employee safety and office arrangements

Observe guidance provided by the Department of Health to maintain a clean and healthy working environment.



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Encourage employees to maintain good personal hygiene and to take precautionary measures to prevent infections.
Establish an alternative site office, make split team arrangements and/or enable employees to work from home (including setting up different critical operational teams for them to work at compatible remote premises where feasible).
Communicate with employees about the business continuity process.
Assess the impact of a high level of absentees from the office and loss of key employees and establish back-up arrangement for key employees.

Coordination with third parties

Communicate with clients and counterparties about the business continuity arrangements.
Ensure that service providers to whom certain functions are outsourced have implemented appropriate contingency plans.

Infrastructure capabilities and back-ups

Ensure that there is sufficient IT infrastructure capacity to support contingency measures for a prolonged period.
Ensure that there is adequate capacity of electronic channels in case of increased demand for online and self-service options.
Safeguard and backup vital business and transaction data, physical files and tapes.

[Complaints Procedure](#)

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