

# Investment Management Alert

**Akin Gump**  
STRAUSS HAUER & FELD LLP

## Amendments to the Code on Unit Trusts and Mutual Funds

January 23, 2019

### Key Points

- The revised UT Code came into effect on 1 January 2019, with a 12-month transition period for compliance by funds currently registered with the SFC.
- Revised regulatory standards will impact all SFC-authorised funds and the fund managers of SFC-authorised funds.
- The updates to the registered fund regime in Hong Kong should broaden the variety of registered investment products available to the Hong Kong public and should significantly increase the number of ETFs registered in Hong Kong.

### Introduction

On 6 December 2018, the Securities and Futures Commission (SFC) released its consultation conclusions on proposed amendments to the Code on Unit Trusts and Mutual Funds (“UT Code”) (the “Consultation Conclusions”). The purpose of the revisions was to update the regulatory regime for SFC-authorised funds and address risks posed by financial innovation and other market developments. The Consultation Conclusions follow the *Consultation Paper on Proposed Amendments to the Code on Unit Trusts and Mutual Funds* (the “Consultation Paper”) published on 18 December 2017. The modernisation of the UT Code is the latest in a string of SFC initiatives to promote Hong Kong as an international asset management center, as evidenced by the SFC’s ongoing initiatives on promoting mutual market access (i.e., the SFC’s memoranda of understandings with China, France, Luxembourg, Switzerland and the United Kingdom on the mutual recognition of funds).

### Amendments to the UT Code - Overview

The revised UT Code (the “Revised UT Code”) modernizes the regulatory regime of Hong Kong retail collective investment schemes (“funds”) and creates new opportunities for financial innovation and market development in Hong Kong. The main amendments contained in the Revised UT Code relate to:

### Contact

#### Anne-Marie Godfrey

anne-  
marie.godfrey@akingump.com  
Hong Kong  
+852 3694.3040

#### Tamilia Chiu

tamilia.chiu@akingump.com  
Hong Kong  
+852 3694.3037

1. Strengthening requirements for key operators of the fund.
2. Providing greater flexibility in permitted investments for plain-vanilla equity and bond funds in particular with respect to investments in derivatives for nonhedging purposes.
3. Enhancing existing requirements for money market funds.
4. Enhancing existing requirements for unlisted index funds and index tracking exchange traded funds.
5. Permitting registration of active Exchange Traded Funds (ETF).
6. Codifying the requirements for registering closed-ended funds.
7. Enhancing operational and disclosure requirements relating to valuation and pricing, termination of a fund and financial reporting.
8. Removing references to Chapter 8.3 (warrant funds), Chapter 8.4A (futures and options funds) and Chapter 8.5 (guaranteed funds).

## Key Operators

Management Companies

### Minimum Capital Requirements

The minimum capital requirements for management companies has been increased from HK\$1 million to HK\$10 million. The SFC has clarified that investment delegates are not subject to this minimum capital requirement.

### Investment Expertise and Experience

Previously, management companies and their delegates were required to have at least two key personnel who were dedicated full-time staff possessing at least five years of investment experience in managing public funds with reputable institutions. To enable management companies to leverage group resources and expertise from different offices, the Revised UT Code provides that the key personnel requirement can be fulfilled if the management company (and its delegates) (a) belong to a well-established fund management group; and (b) are able to demonstrate that, on a group-wide basis, they possess the requisite experience and resources, as well as an appropriate oversight system to administer public funds (i.e., a fund management group of at least five years of establishment in managing public funds and with good regulatory records).

Trustee and Custodian

The Revised UT Code enhances the general obligations of trustees and custodians to align with standards by the International Organisation of Securities Commissions (IOSCO) on the custody of fund assets with those in other major overseas jurisdictions.

In addition, the Revised UT Code expands the scope and enhances the level of review of the internal controls and systems of trustees and custodians through stricter annual audit reviews, including requiring the independent auditor to (i) include the auditor's opinions on the design suitability and operational effectiveness of the controls in its

review; and (ii) report to the management of the trustee/custodian any control issues identified and provide recommendations for improvement.

## Chapter 7 / Chapter 8 Funds

The core investment requirements for more plain-vanilla equity and bond funds contained in Chapter 7 of the UT Code (“Core Investment Requirements”) have been updated and modernized to include provisions governing securities lending, sale and repurchase (repo), and reverse repurchase (reverse repo) transactions (collectively, “Securities Financing Transactions”) and provide greater flexibility (up to 50 per cent of the fund’s net asset value (NAV)) for investment in derivatives.

### Diversification Requirements

The Core Investment Requirements have been amended to enhance the diversification requirements by introducing (i) a group limit of 20 per cent of a fund’s NAV for investments in, or exposure to, entities within the same group; and (ii) a separate diversification limit of 20 per cent of a fund’s NAV for cash deposits with the same entity (or entities within the same group), except the 20 per cent limit may be exceeded in the following circumstances: (A) after the launch of a fund and before the fund is fully invested, (B) prior to the merger or termination of the fund, and (C) upon receipt of subscription proceeds pending investment and when cash is held for settlement of redemption and other payment obligations.

### Loans and Borrowings

The Revised UT Code lowers the maximum borrowing of a fund from 25% of the fund’s total NAV to 10% of the fund’s total NAV. For the avoidance of doubt, this limit on borrowing excludes Securities Financing Transactions that may lead to direct or contingent liabilities or obligations, as discussed further below.

### Derivative Investments

The SFC recognizes that financial innovation and changing investment needs have led to the increased use of financial derivative instruments (FDI) by funds. To provide funds with greater flexibility in their investment strategy, the Revised UT Code expands the types of FDIs in which funds may invest by removing the restriction that Chapter 7 funds may invest in only futures, options and warrants), and it increases the overall limit (up to 50 per cent of the fund’s NAV) in which Chapter 7 funds (plain-vanilla equity and bond funds) may use FDIs.

Where a fund invests more than the 50 per cent limit in derivative investments (e.g., a Chapter 8.7 fund (FDIs of more than 100 per cent) or a Chapter 8.9 fund (FDIs up to a limit of 100 per cent)), the fund will be regarded as a derivative product subject to the enhanced distribution requirements under 5.1A and 5.3 of the Code of Conduct for Persons Licensed by or Registered with the SFC.

In the Consultation Paper, the SFC proposed that this limit be calculated using the Commitment approach however, after industry feedback that this approach would negatively impact funds that use FDIs extensively for efficient portfolio management purposes, the SFC revised the calculation methodology for a fund’s derivative investments to be based on the fund’s net derivative exposure<sup>1</sup>, which would exclude the use of FDIs that do not result in incremental leverage at the fund portfolio level.

## **Disclosure to Investors**

To enhance transparency for investors and the industry, a new column has been added in the list of funds shown on the SFC website that indicate whether a fund is or is not a derivative fund. This is determined by the management company based on the net exposure arising from the fund's FDI investments.

All funds must disclose in the product key facts statement (KFS) the purpose of, and expected maximum leverage arising from, FDIs. The SFC has expressed that the maximum leverage amount disclosed is a hard cap and cannot be exceeded under normal market conditions.

## **Counterparties**

The Revised UT Code imposes requirements on the counterparties in the over-the-counter (OTC) derivative transactions, in particular, requiring (i) that the counterparty be a substantial financial institution; (ii) that a fund's net exposure to a single counterparty in OTC derivatives transactions be limited to 10 per cent of the fund's NAV; and (iii) that the aggregate value of a fund's net exposure to an OTC derivatives counterparty, together with the fund's other investments be subject to (1) a single entity limit of 10 per cent of the fund's NAV and (2) a group limit of 20 per cent of the fund's NAV.

## **Asset Coverage**

A fund must, at all times, be able to meet all of its payment delivery obligations under all derivatives transactions.

## **Securities Financing Transactions**

In recognition of the increasing global trend of funds entering into SFTs for the purpose of enhancing yield or managing liquidity, the SFC has introduced explicit provisions in Chapter 7 of the Revised UT Code to permit management companies to engage in SFTs, provided that (i) it is in the investor's best interest; (ii) associated risks have been properly mitigated and addressed; (iii) the counterparties are subject to ongoing prudential regulation and supervision; (iv) the fund has at least 100 per cent collateralisation in respect of the transaction to ensure that there is no uncollateralised counterparty risk exposure arising from such SFT; (v) all revenues from the transaction are returned to the fund; and (vi) the fund is able, at all times, to recall the securities or the full amount of cash subject to the transaction, or to terminate the transaction.

## **Collateral Provided by OTC Derivatives Counterparty**

The Revised UT Code enhances the collateral requirements in order to reduce counterparty risk arising from OTC derivatives instruments and SFTs, which will apply to all funds, and not just structured funds. The new requirements include requiring that collateral be subject to a prudent haircut policy, restrictions on reinvestment of collateral and prohibition of certain assets from being used as collateral.

## **Investment in Other Funds**

Chapter 8.1, relating to unit portfolio management funds (commonly known as "fund of funds"), has been removed from the Revised UT Code, and these funds will be classified as Chapter 7 funds and subject to the requirements under the Core Investment Requirements in Chapter 7.

The definition of a feeder fund has been amended to mean a fund that may invest 90 per cent or more of its NAV in a single fund (i.e., the master fund).

A look-through approach will be adopted for feeder funds investing in a master fund (i.e., a feeder fund that invests into a money market fund must also comply with the Chapter 8.2 requirements).

## Money Market Funds

The Revised UT Code enhances the requirements for money market funds to align with the relevant IOSCO Policy Recommendation for Money Market Funds issued in October 2012. The key changes are as follows:

1. Definition: The definition of a money market fund has been revised to mean a fund that invests in short-term, high-quality money market instruments and that seeks to offer returns in line with money rates.
2. Permitted Assets: Money market funds may invest in only short-term deposits; high-quality money market instruments (e.g., government bills, certificates of deposit, commercial paper, short-term notes and bankers' acceptances); and money market funds authorised by the SFC or regulated in a comparable manner.
3. Repo Transactions: Money market funds are subject to additional restrictions relating to repo and reverse repo transaction, in addition to the Core Investment Requirements relating to SFTs.
4. Portfolio Maturity Limits: A money market fund must maintain a portfolio with a weighted average maturity not exceeding 60 days (reduced from 90 days) and a weighted average life not exceeding 120 days.
5. Minimum Liquid Asset Levels: Money market funds must maintain (i) at least 5 per cent of its NAV in daily liquid assets and (ii) at least 15 per cent of its NAV in weekly liquid assets.
6. Amortised Cost Accounting and Constant NAV: Money market funds offering a stable/constant NAV or adopting amortised cost accounting for valuing the fund's assets will be considered by the SFC on only a case-by-case basis.

## Unlisted Index Funds and Index Tracking Exchange Traded Funds (ETFs)

The main changes in relation to authorising/ongoing requirements for index funds and passive ETFs are as follows:

1. Requirements for Funds that Adopt Hybrid Index-Tracking Strategies through Derivatives Investments: Since a number of passive ETFs use a hybrid of physical and synthetic replication strategies to track underlying indices by investing in derivatives investments, the Revised UT Code provides that, if an index fund's net derivative exposure exceeds 50 per cent of its NAV, the index fund must also (in addition to complying with the requirements under Chapter 8.6 of the UT Code) comply with the requirements in 8.8 of the UT Code (applicable to structured funds).

2. Enhancing the “Broadly Based” Requirement for an Underlying Index: One of the key criteria for the acceptability of an index is that it should be broadly based. The Revised UT Code reduces the concentration limit of an index with a single constituent security weighting from 40 per cent down to 20 per cent (or 35 per cent in exceptional market conditions).
3. Enhanced Disclosure Requirements for Securities Financing Transactions by Passive ETFs: Where SFTs that are undertaken by a passive ETF exceed 50 per cent of the ETF's NAV, the passive ETF must disclose certain information on the SFT to investors on an ongoing basis.
4. Listed and Unlisted Share Class for Index Funds and Passive ETFs: The SFC has introduced a new structure to the Hong Kong market whereby index funds may have unlisted and/or listed units or share classes within a single fund pursuing the same investment strategy. Such structures would be subject to consultation with the SFC, the dealing arrangements and risks associated with both unit/share classes must be clearly disclosed in the offering documents, and investors in both classes must be treated fairly. The unlisted class and the listed class must comply with the requirements for index funds and passive ETFs, respectively, in Chapter 8.6.

## Active ETFs

The Revised UT Code introduces a new Chapter 8.10 in the UT Code for listed open-ended funds (also known as “active ETFs”), which is a new product in the Hong Kong market. An active ETF is a fund that is listed and traded on The Stock Exchange of Hong Kong Limited (SEHK), which is actively managed. Unlike a passive ETF, an active ETF does not track the performance of an index or a benchmark.

The regulatory requirements for active ETFs have the following key features:

1. Dealing: Active ETFs can be dealt in both the primary and secondary markets. Active ETFs will be listed on the SEHK (the secondary market) for trading, and retail investors can buy/sell active ETF units/shares on the SEHK platform. The active ETF units/shares will be created in the primary market through participating dealers buying and selling unit/shares directly from the Active ETF. Unlike with UCITS Active ETFs, the SFC does not mandate that units purchased on a secondary market must be permitted to be sold directly back to the Active ETF where the stock exchange value varies significantly from the NAV of the Active ETF.
2. Investment Restrictions: Investment restrictions follows the Core Investments Requirements set out in Chapter 7 of the UT Code.
3. Benchmark: Where an active ETF makes reference to a benchmark, it must be disclosed in the fund's offering documents.
4. Portfolio Transparency: An active ETF must publish full portfolio information to the public on a monthly basis within one month. Active ETFs are expected to provide full portfolio information or proxy basket to participating dealers and market makers on a daily basis before trading commences.

5. Dissemination of Trading Information: Active ETFs must update and publish their indicative NAVs per unit or share every 15 seconds during trading hours on the SEHK.
6. Market Makers: Active ETFs must comply with the market maker requirements for passive ETFs (e.g., at least one market maker for units/shares for each trading counter and at least one market maker that will provide at least three months' notice prior to terminating market making arrangements).
7. Listed and/or Unlisted Classes: Subject to consultation with the SFC, an active ETF may have unlisted and/or listed unit/share classes.
8. Naming of Active ETFs: The SFC requires ETFs to clearly disclose in the KFS disclosure box whether the ETF is active or passive.

## Closed-Ended Funds

Closed-ended funds cannot be redeemed from at the option of an investor and are typically used to invest in relatively less liquid assets or restricted markets. The Revised UT Code codifies the existing requirements applicable to closed-ended funds seeking SFC's authorization. The new Chapter 8.11 dealing with closed-ended funds sets out the following regulations:

1. Investment Restrictions: The requirements of Chapter 7 and/or Chapter 8 must generally be complied with, although some flexibility from strict compliance with Chapter 7 and/or Chapter 8 (for example, with respect to the holding of illiquid investments) may be allowed, taking into account the fund's closed-ended nature and investment strategy. The applicant will need to consult with the SFC on any dispensation to be sought.
2. Widely Held: The fund must be listed and traded on the SEHK and must have procedures and mechanisms in place for the fund to be widely held having regard to the requirements under the Hong Kong Listing Rules<sup>2</sup> including having adequate shareholder spread.
3. Trading Discount: The fund must have measures and mechanisms to address any prolonged significant discount of its trading price on the SEHK to its NAV (i.e., provide specified redemption windows to allow holders to redeem their units/shares at NAV).
4. Disclosure: The fund's last closing NAV must be published on the fund's website at such times and in such manner as may be acceptable to the SFC, given the nature of the fund's investments.
5. Redemptions, Takeovers and Mergers: Any form of redemption, takeover or merger must be carried out in a manner that is fair and equitable to all holders.

## Operational Matters and On-going Disclosure and Reporting Requirements

The SFC has also amended certain operational and disclosure requirements relating to valuation and pricing, termination of a fund and financial reporting.

## **Streamlining of Specialised Schemes in the UT Code**

In light of the amendments to the Core Investment Requirements in Chapter 7, the SFC has removed Chapter 8.3 (warrant funds) and Chapter 8.4A (futures and options funds) from the UT Code. Such funds, depending on their investment strategies and risk profiles, should comply with the requirements under either Chapter 8.9 (funds with extensive derivatives investments) or Chapter 8.7 (retail hedge funds).

The Revised UT Code also removes Chapter 8.5 (guaranteed funds). The requirements for guarantors and disclosures in offering documents for funds with guaranteed features have been consolidated into the Core Investment Requirements in Chapter 7.

## **Application of Amendments to UCITS Funds**

The revised UT Code continues to maintain the current streamlined measures for processing authorisation applications for UCITS funds. UCITS funds are not exempt from the enhanced KFS disclosures and will be required to disclose the purposes of, and expected maximum net derivative exposure arising from, FDIs, which will require UCITS to calculate its derivative exposure using the SFC's methodology in addition to the calculation methodology already used.

## **Conclusion**

The amendments to the UT Code were gazetted on 1 January 2019, and became effective on that day.

The enhancements to the UT Code have received general support from the industry and are expected to further align Hong Kong's regulatory regime and investment product offering with international standards and boost growth in the retail fund industry. The amendments provide greater investment flexibility and broaden the variety of product offerings available to Hong Kong investors, such as active ETFs and closed-ended funds. With the change in the SFC's treatment on using FDIs, we expect to see the SFC authorising funds that it has historically been reluctant to authorise. Management companies, trustees and custodians of existing SFC-authorised funds should be prepared to make changes to their fund offering documents, constitutive documents, and internal compliance policies and procedures in order to comply with these new regulatory standards before 1 January 2020. If changes are being made by existing funds solely to comply with the Revised UT Code, prior approval from the SFC and advanced notice to investors will not be required.

The full text of the Consultation Conclusions can be accessed via the link below:

<https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=17CP>

8

---

<sup>1</sup> To calculate the net derivative exposure, the derivative positions acquired by the fund for investment purposes are converted into the equivalent position in the underlying assets of the derivative instrument. Netting, hedging and risk mitigation; cash flow management; market access or exposure replication; and investment in conventional convertible bonds are excluded from the calculation of the fund's net derivative exposure.

---

<sup>2</sup> This is currently at least 300 holders with no holders holding 30% or more of the votes exercisable at any general meeting of the fund.