

## **Frequently Asked Questions on the Implementation and Transition Arrangements of the Code on Unit Trusts and Mutual Funds (Effective on 1 January 2019)**

This FAQ is prepared by the Investment Products Division and aims to provide information to market practitioners concerning the implementation and transition arrangements of the Code on Unit Trusts and Mutual Funds effective on 1 January 2019 (“revised UT Code”). Applicants are encouraged to contact the relevant case team in the Investment Products Division of the Securities and Futures Commission (the “SFC”) if in doubt on any specific issues arising from the application/interpretation of the UT Code. Please note that each application for authorization is considered on a case-by-case basis.

For the purpose of this FAQ, UCITS funds means (i) Undertakings for Collective Investment in Transferable Securities (UCITS) domiciled in France, Luxembourg, Ireland and the Netherlands, and (ii) collective investment schemes domiciled in the United Kingdom authorized as UK UCITS.

The information set out below is not meant to be exhaustive. This FAQ may be updated and revised from time to time. This FAQ is only for general reference. Compliance with all the requirements in this FAQ does not necessarily mean an application will be accepted or authorization will be granted. The SFC reserves the rights to exercise all powers conferred under the law.

*Notes: (1) For ease of reference, collective investment schemes that are generally known as unit trusts or mutual funds are referred to as “funds” in the following FAQ.*

*(2) For the purpose of this FAQ, “existing fund(s)” refers to funds which are authorized by the SFC as at the effective date of the revised UT Code and funds which applied for the SFC’s authorization prior to such date and are subsequently authorized by the SFC.*

	Question	Answer
<b>General</b>		
1.	The revised UT Code will become effective on 1 January 2019 (“Effective Date”). Will there be any transition period for existing funds?	<p>A 12-month transition period (“Transition Period”) from the Effective Date ending on 31 December 2019 will be provided for existing funds and existing management companies and trustees/custodians.</p> <p>With effect from the Effective Date, the revised UT Code and the enhanced KFS disclosures for derivative investments (see Question 4 below) will apply to new funds with new management companies and new trustees/custodians with immediate effect.</p> <p>For further details on the implementation and transition arrangements, please refer to the implementation schedule as set out in the revised UT Code.</p>
2.	Will SFC’s prior approval and advance notice to investors be required for changes made to comply with the revised UT Code?	<p>If changes are made by existing funds to comply with the revised UT Code and there are no material changes to the funds’ investment objectives, policies or strategies, prior approval from the SFC and advance notice to investors will generally not be required.</p> <p>However, management companies should provide necessary updates to the holders of the funds regarding the changes made to the funds as soon as reasonably practicable (whether by a specific notice or in the financial report of the funds) for holders’ appraisal of the funds and their investments. A summary of the changes (including the reason(s) and description of the change, implications to the funds and the resulting impact on investors) is expected to be provided to keep holders informed and enable them to appraise the position of the funds.</p>
<b>Offering documents</b>		
3.	If the funds’ offering documents are revised to comply with the enhanced disclosures requirements under the revised UT Code, will these amendments be subject to the prior approval by the SFC?	Where changes to the offering documents of the existing funds are made to reflect the enhanced disclosures and contents requirements necessary for compliance with the revised UT Code, SFC’s prior approval and advance notice to investors will generally not be required (further see Question 8 below). The updated offering documents should be filed with the SFC in accordance with 11.1B of the revised UT

	Question	Answer
		<p>Code.</p> <p>After the Transition Period and with effect from 1 January 2020, existing funds must comply with the enhanced disclosures requirements on offering documents set out in the revised UT Code.</p> <p>Some of the enhanced disclosures requirements on the offering documents under the revised UT Code are codification of existing requirements or practices. As such, during the Transition Period, existing funds shall continue to comply with the existing disclosures requirements set out in the relevant circulars and guidance (such as the Guide on Practices and Procedures for Application for Authorization on Unit Trusts and Mutual Funds (“Application Guide”), frequently asked questions etc.) published by the SFC, which may be updated from time to time. Non-exhaustive examples include existing disclosures requirements regarding liquidity risk management and valuation policies and procedures of the funds, where existing funds are expected to be in compliance with these requirements.</p>
<b>Key facts statements (“KFS”)</b>		
4.	For the enhanced KFS disclosure for derivative investments (including the fund’s net derivative exposure (“NDE”)), will there be any transition period for compliance?	<p>Yes, the Transition Period will apply whereby existing funds (including UCITS funds) which will continue to be offered to the public in Hong Kong must produce a KFS with the enhanced disclosures for derivative investments with effect from 1 January 2020 (i.e. after the expiry of the 12-month transition period from the Effective Date).</p> <p>The revised templates for KFS are available at the SFC website via the following link <a href="https://www.sfc.hk/web/EN/regulatory-functions/products/list-of-publicly-offered-investment-products/products-key-facts-statements.html">https://www.sfc.hk/web/EN/regulatory-functions/products/list-of-publicly-offered-investment-products/products-key-facts-statements.html</a>.</p>

	Question	Answer
4A.	<p>If an SFC-authorized UCITS fund, which currently discloses that the fund may use derivatives extensively for investment purposes, wants to update the KFS to reflect the fund's NDE of up to 50% of the fund's net asset value, will SFC's prior approval or advance notification to investors be required?</p>	<p>Under the existing practice and during the Transition Period, if an SFC-authorized UCITS fund's use of derivatives for investment purposes (as represented and disclosed in the KFS) changes from an extensive manner to a non-extensive extent which will result in the revision of the disclosure in the KFS, one-month's prior notice is expected to be provided to investors.</p> <p>The NDE calculation provides clarity on, among other things, the circumstances where use of derivatives may be excluded from the NDE of an SFC-authorized fund. In updating the KFS, if an existing SFC-authorized UCITS fund (which have disclosed that the fund may use derivatives extensively for investment purposes) states that the fund's NDE is up to 50% of the fund's net asset value, SFC's approval for revising / updating the KFS reflecting the fund's NDE is not required. In this case, in order to provide transparency to the investors, prior notification (generally of 1 month) is expected to be provided to investors. The notice to investors should contain necessary information to enable investors to appraise the fund's position (e.g. any change to the fund's use of derivatives and investment strategy, any impact on the risk profile of the funds, etc.).</p> <p>For the avoidance of doubt, if the KFS for an existing SFC-authorized UCITS fund discloses that the fund may use derivatives extensively for investment purposes but the fund's derivative leverage is not extensive where a limit (e.g. of up to 40%, 50% calculated using the commitment approach under the UCITS regime) has already been clearly disclosed in the existing offering document of the fund, no SFC's prior approval or advance notice to investors will be required in updating the fund's KFS to disclose the fund's NDE of up to 50%.</p>
5.	<p>For existing funds, can fund managers produce updated KFS with the enhanced disclosures for derivative investments (Enhanced KFS) in advance of the expiry of the Transition Period?</p>	<p>Yes, notwithstanding the Transition Period, fund managers are encouraged to and may produce an updated KFS for their funds as soon as reasonably practicable.</p> <p>The funds' NDE to be disclosed in the KFS should be calculated in accordance with the requirements and guidance issued by SFC which may be updated from time to time. The SFC has published a <a href="#">Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds</a> ("Derivative Guide") to provide guidance to the industry.</p>

	Question	Answer
<b>Constitutive documents</b>		
6.	<p>If the funds' constitutive documents are revised to comply with the enhanced contents requirements under the revised UT Code, will these amendments be subject to the prior approval by the SFC? Will advance notice be required to be given to the holders of the funds?</p>	<p>Where changes to the constitutive documents are made to reflect the enhanced disclosure and content requirements necessary for compliance with the revised UT Code, SFC's prior approval and advance notice to investors will generally not be required. The updated constitutive documents should be filed with the SFC in accordance with 11.1B of the revised UT Code. Enhanced disclosures that may fall under this nature include revisions of the constitutive documents to reflect the investment restrictions as set out in Chapter 7 of the revised UT Code for an umbrella fund (further see Question 8 below). In this connection, any material changes to the investment objectives, policies or strategies of the sub-funds thereunder however will still be subject to the SFC's prior approval in accordance with 11.1 of the revised UT Code.</p> <p>By the end of the Transition Period, existing funds must comply with the enhanced contents requirements on constitutive documents as set out in the revised UT Code.</p>
7.	<p>Under 6.15(f) of the revised UT Code, increase in the maximum fees paid to the management company, trustee/custodian or directors of the scheme and imposition of other types of fees have been removed as circumstances where general meetings should be called. Does it mean that the funds' constitutive documents must be revised to reflect the revised provisions in the revised UT Code?</p>	<p>Existing funds are not required to adopt the revised provisions in the revised UT Code to reflect the deletion of 6.15(f)(iii) and (iv) of the previous UT Code. Where management companies of existing funds intend to adopt the revised UT Code provisions in constitutive documents in this connection, no prior approval from the SFC is required but they are expected to obtain holders' approval and to provide notifications to holders in accordance with the terms set out in the constitutive documents and the disclosures in the offering documents of the funds (if applicable). Management companies should seek legal advice where appropriate.</p> <p>One-month's prior notice is generally expected to be given to holders before the changes to take effect. Management companies must also ensure that the constitutive documents and the offering documents (if applicable) are properly amended to reflect the revised provisions and file the revised documents with the SFC in accordance with 11.1B of the revised UT Code.</p>
<b>Investment: Requirements, limitations and prohibitions</b>		
8.	<p>Will SFC's prior approval be required if an</p>	<p>See answers to Questions 3 and 6 above.</p>

	Question	Answer
	<p>existing fund adopts the revised investment requirements and limitations as set out in the revised UT Code?</p>	<p>In the case where the fund takes the opportunity to make changes to its investment objectives, policies or strategy, the management company will need to assess whether such changes are material that may fall under 11.1(c)(i) of the revised UT Code. If such changes are material, SFC's prior approval will need to be obtained and one month's prior written notice is normally expected to be provided to holders. The revised offering documents as a result of such changes should be submitted to the SFC for prior authorization.</p>
<b>Operational requirements</b>		
9.	<p>Chapter 11 of the revised UT Code regarding scheme changes, notifications and reporting will take immediate effect from the Effective Date.</p> <p>Will there be any updated application or filing forms that are required to be submitted in support of the applications or filing of scheme changes and revised offering documents? Will SFC publish further guidance regarding the SFC's approval and notification to investors' requirements in relation to scheme changes under 11.1 of the revised UT Code?</p>	<p>The revised Chapter 11 of the revised UT Code has codified the existing streamlined measures adopted by the SFC in handling post-authorization matters including scheme changes (with further clarification of the requirements for the notification of investors).</p> <p>Yes, to facilitate implementation, relevant updated application and filing forms that are required to be submitted in support of scheme changes and revision of offering documents have already be posted on the SFC's website under the section "<a href="#">Investment products: Forms &amp; checklists</a>".</p> <p>Also, a set of updated frequently asked questions have been prepared by the Investment Products Division which are posted on the SFC's website under the section "<a href="#">FAQs: Publicly offered investment product</a>" to provide further guidance to the industry in respect of the requirements under the revised UT Code.</p>
<b>Fund's derivative exposure</b>		
10.	<p>An SFC-authorized fund is required to disclose its NDE in the KFS by the expiry of the Transition Period.</p> <p>How should the NDE be calculated?</p>	<p>The SFC has published the <a href="#">Derivative Guide</a> which provides guidance on the calculation methodology for the NDE for SFC-authorized funds, as well as examples, which may be updated from time to time. Chapter 3 of the Derivative Guide sets out the steps that should be applied when calculating the NDE of a fund. Management companies are expected to exercise professional judgement in determining and monitoring the NDE disclosed in the KFS on an ongoing basis.</p>

	Question	Answer
11.	<p>The derivative exposure of an SFC-authorized fund may occasionally go beyond the threshold (e.g. NDE of up to 50% of the fund's net asset value) as disclosed in the fund's KFS due to temporary surges/spikes in the derivative positions caused by active positions taken by the fund managers on behalf of the fund for investment opportunities or due to market movements ("Temporary Surges in Derivative Positions").</p> <p>What is SFC's expectation on fund managers in monitoring Temporary Surges in Derivative Positions?</p>	<p>In monitoring the derivative exposure of an SFC-authorized fund under its management, the management company should ensure that Temporary Surges in Derivative Positions are properly managed and the following conditions must be met:</p> <ul style="list-style-type: none"> <li>(a) the relevant active derivative positions are entered on a temporary or short-term basis, in line with the fund's investment strategies (including the strategy in using derivatives) and in the best interests of the fund and its investors; and</li> <li>(b) there should be no material adverse change to the overall risk profile of the fund; and</li> <li>(c) the derivative exposure of the fund should not constantly or persistently exceed the disclosed NDE in the fund's KFS for prolonged period(s); and</li> <li>(d) the management company should take necessary steps to reduce the fund's derivative exposure to the threshold as disclosed in the fund's KFS as soon as reasonably practicable.</li> </ul>
12.	<p>In calculating the NDE, can the fund manager exclude the exposure from the fund's investment in standard "pass through" asset-backed securities or mortgaged-backed securities with payment of cash flows from the underlying pool of assets?</p>	<p>Chapter 4 of the <a href="#">Derivative Guide</a> contains guidance on the calculation of NDE in relation to asset-backed securities ("ABS") and mortgaged-backed securities ("MBS") stating that, depending on the structure, ABS and MBS may or may not be regarded as derivatives.</p> <p>Paragraph 4.1 under Section B of Chapter 4 of the Derivative Guide provides that "<i>if the income and hence the value of an ABS or MBS come directly from the cash flows generated from the underlying pool of assets (i.e. with reference to this Question 12, the ABS or MBS fully "pass-through" the cash flows from the underlying assets), such ABS or MBS is considered as a securitization of its underlying assets and is not deemed as embedding derivatives</i>". Accordingly, investments by a fund in ABS or MBS in this nature would not be required to be included in the NDE calculation.</p> <p>For the avoidance of doubt, the SFC is of the view that synthetically structured ABS or MBS (not falling under the Excluded Circumstances (as defined in the Derivative Guide)) should be included in the NDE calculation.</p>



	Question	Answer
13.	<p>If an SFC-authorized fund may invest in debt instruments with loss-absorption features, does the fund manager need to take into account the fund's investments in LAP in the NDE calculation?</p>	<p>Debt instruments with loss-absorption features (“LAP”) may adopt different structures with different features. A LAP may or may not be a derivative instrument. Management companies should exercise their own professional judgement in determining whether the LAP invested by their SFC-authorized funds have embedded derivatives. The use of derivatives under the Excluded Circumstances (as defined in the <a href="#">Derivative Guide</a>) may be excluded from the calculation of the NDE.</p> <p>Unless otherwise falling under the Excluded Circumstances, derivatives that are embedded in a financial instrument should be included in the calculation of the NDE. In calculating the NDE, Note (1) of 7.26 of the revised UT Code provides that “<i>for the purpose of calculating the net derivative exposure, the positions of financial derivative instruments acquired by a scheme for investment purposes are converted into the equivalent position in the underlying assets of the financial derivative instruments, taking into account the prevailing market value of the underlying assets, the counterparty risk, future market movements and the time available to liquidate the positions</i>”. It is noted that management companies may, after taking into account all such relevant factors, exercise professional judgement to determine that there could be negligible NDE arising from the embedded derivative of a LAP subject to ongoing assessment and monitoring.</p> <p>Please refer to questions 14 and 15 below which set out guidance on the disclosure requirements if an SFC-authorized fund may invest in LAP and the scope of LAP, respectively.</p>
<b>Debt instruments with loss-absorption features (“LAP”)</b>		
14.	<p>Can an SFC-authorized fund invest in LAP<sup>1</sup>? Are there any investment limits? What are the disclosure requirements?</p>	<p>If an SFC-authorized fund may invest in LAP, proper disclosure should be made in the offering document stating the following (as currently provided under the Application Guide):</p> <p>(i) the types / examples of LAP to be invested and the fund's expected total</p>

<sup>1</sup> See question 15 below for the scope of LAP.



	Question	Answer
		<p>maximum investment / exposure in LAP (with reference to its NAV) in the KFS (e.g. up to [x]%, not more than [x]% etc.); and</p> <p>(ii) the risks associated with investments in LAP in the offering document (including, where LAP investments may be substantial, the KFS as well).</p> <p>In general, if a fund may invest in 30% or more of its NAV in any particular type of asset class(es) or investments or markets (in this case, LAP), the associated risks are expected to be highlighted in the section headed “What are the key risks” in the KFS.</p> <p>Management companies should exercise professional judgement to ensure that the disclosed types / examples of LAP and threshold are fair, balanced and not misleading on an ongoing basis. A management company should also put in place suitable and adequate risk management and control systems to monitor, measure and manage all relevant risks (in this case, including risks associated with LAP) in relation to its SFC-authorized funds.</p> <p>Generally, we adopt a disclosure-based approach regarding funds’ investments in LAP subject to compliance with applicable structural, disclosure, diversification, liquidity and other requirements under the UT Code. The SFC will review each fund application holistically. For a fund product which may invest in LAP of more than 50% of its NAV<sup>2</sup>, the SFC will take into account the circumstances of each case, including product design, target markets, experience and risk management systems of the management company and international regulatory standards and practices before granting authorization. Management companies are encouraged to consult the SFC in advance if in doubt.</p>
15.	What types of debt instruments fall within the scope of LAP?	LAP is intended to capture debt instruments with features of contingent write-down or contingent conversion to ordinary shares on the occurrence of the following: (a)

<sup>2</sup> Circular dated 30 October 2018 issued by the HKMA and the frequently asked questions issued by HKMA on 8 July 2019 (together “HKMA Circular/FAQs”) set out, among other things, the requirements regarding the sale and distribution of funds with LAP investments of more than 50% of a fund’s NAV by registered institutions to professional investors only.

	Question	Answer
		<p>when a financial institution is near or at the point of non-viability; or (b) when the capital ratio of a financial institution falls to a specified level<sup>3</sup>. These include:</p> <ul style="list-style-type: none"> <li>(i) debt instruments that meet the qualifying criteria to be Additional Tier 1 Capital or Tier 2 Capital under the Banking (Capital) Rules. The same principle applies to debt instruments issued under an equivalent regime of non-Hong Kong jurisdictions<sup>4</sup>; and</li> <li>(ii) external LAC debt instruments under the Financial Institutions (Resolution) (Loss-absorbing Capacity Requirements – Banking Sector) Rules; and debt instruments issued under a regime of non-Hong Kong jurisdictions which implements the Financial Stability Board’s standards for “Total Loss-absorbing Capacity Term Sheet”.</li> </ul> <p>“Non-preferred senior debt instruments” (may be named as “Tier 3” in some jurisdictions) and senior or subordinated debt instruments issued by a holding company of a financial institution which fall within the above circumstances will be in-scope LAP.</p> <p>For the avoidance of doubt, instruments in the legal form of equities (including ordinary shares and preferred shares) and all types of deposits (including certificate of deposits) are excluded.</p>
16.	<p>Existing SFC-authorized funds may already have disclosed the fund’s investments in certain LAP such as contingent convertible bonds and/or non-preferred senior debt instruments.</p> <p>In light of the scope of the LAP as further clarified in question 15 above, will fund managers be allowed time to update the funds’ offering documents regarding LAP investments?</p>	<p>With effect from 1 January 2020, all SFC-authorized funds must adopt the definition as clarified in question 15 above in disclosing a fund’s investments in LAP.</p> <p>In light of the impending effective date, management companies of existing SFC-authorized funds are expected and urged to review and carry out assessment regarding their funds’ existing and expected LAP investments, and to update the disclosures in the funds’ offering documents (including KFS) based on the scope as set out in question 15 above as soon as possible.</p>

<sup>3</sup> Reference had been made to the HKMA Circular/FAQs.

<sup>4</sup> Debt instruments under this paragraph (i) are collectively referred to as “AT1/T2 debt instruments” in the HKMA Circular/FAQs.

	Question	Answer
		<p>For the fund's offering documents accompanied by notice to investors containing the necessary updates/information on the fund's LAP investments based on the definition set out in question 15 above, the management companies shall update the disclosures in the fund's offering documents as soon as reasonably practicable and at the earliest opportunity.</p> <p>Management companies are further reminded of the requirements that SFC-authorized funds must issue an up-to-date offering document, which should contain the information necessary for investors to be able to make an informed judgement of the funds. In particular, the KFS shall contain information that enable investors to comprehend the key features and risks of the fund.</p>
17.	<p>In view of the further guidance regarding the scope of LAP provided in question 15 above, does the fund manager need to take into account the fund's investments in LAP in the calculation of the NDE?</p>	<p>Please refer to answer to question 13 above.</p>
18.	<p>Will SFC's prior approval be required if an existing SFC-authorized fund's offering document is revised to comply with the disclosures requirement on LAP investments based on the clarified definition of LAP provided in questions 14 and 15 above?</p>	<p>The management companies should perform an assessment as to whether the fund's investments in LAP constitutes material changes falling under 11.1(c)(i) of the revised UT Code resulting from the clarified definition of LAP set out in question 15 above. If so, it shall comply with the SFC's approval and notification to investors (generally expected to be 1-month prior notice) requirements regarding scheme changes.</p> <p>Revised fund's offering documents reflecting scheme changes falling under 11.1(c)(i) of the revised UT Code are subject to SFC's prior approval.</p> <p>Management companies are reminded of their obligations to provide holders of their SFC-authorized funds with reasonable prior notice, or inform holders as soon as reasonably practicable of any information concerning the funds which is necessary to enable holders to appraise the position of the funds pursuant to 11.1B of the revised UT Code.</p>

	Question	Answer
<b>Investment in other funds</b>		
19.	<p>Can a Chapter 7 Fund<sup>5</sup> invest in an underlying fund with an NDE exceeding 50% of the NAV of the underlying fund? What will be the requirement if the NDE of the underlying fund is not available?</p>	<p>For the purposes of Note (3) to 7.11B of the UT Code, a Chapter 7 Fund may, subject to the spread of investments requirement, invest in an underlying fund with an NDE exceeding 50% of its NAV if such underlying fund is:</p> <ul style="list-style-type: none"> <li>(i) an SFC-authorized fund (except for hedge funds under 8.7 of the UT Code); or</li> <li>(ii) an eligible scheme<sup>6</sup> which is not authorized by the SFC.</li> </ul> <p>In this case, investment by a Chapter 7 Fund in any single underlying fund mentioned in (i) and (ii) above should not be more than 30% of its NAV.</p> <p>For the avoidance of doubt, a Chapter 7 Fund may also invest not more than 10% of its NAV in non-eligible schemes and not authorized by the SFC pursuant to 7.11 of the UT Code (even where the NDE is not available).</p> <p>The SFC will review each fund application holistically, taking into account the circumstances of each case. For a Chapter 7 Fund which proposes to invest more than 30%<sup>7</sup> of its NAV in any underlying fund with an NDE exceeding 50% of such underlying fund's NAV, the SFC would assess the overall NDE level of the fund on a case by case basis.</p>

*Last updated: 28 February 2020*

<sup>5</sup> Please refer to Question 3 of the [Frequently Asked Questions on the Code on Unit Trusts and Mutual Funds](#) for details.

<sup>6</sup> "Eligible scheme" refers to (i) UCITS schemes domiciled in Ireland and Luxembourg or (ii) UK UCITS and, in accordance with their home regulations, such schemes may adopt the commitment approach or value-at-risk approach in monitoring the derivative exposure or risk of the scheme.

<sup>7</sup> Under 7.11A of the UT Code, the value of a Chapter 7 Fund's investment in unit or shares in each underlying SFC-authorized fund or eligible scheme may not exceed 30% of its total NAV, unless the underlying fund is authorized by the SFC, and the name and key investment information of the underlying fund are disclosed in the offering document of the Chapter 7 Fund.