SECURITIES AND FUTURES COMMISSION
證券及期貨事務監察委員會

Consultation Conclusions on Proposed Amendments to the Code on Unit Trusts and Mutual Funds (UT Code)

17 and 18 January 2019

Investment Products Division

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Glossary of key terms

- **Revised UT Code**
  - the revised UT Code which is effective from the Effective Date
- **Effective Date**
  - 1 January 2019, the effective date of the revised UT Code
- **12-month transition period**
  - a period of 12 months from the Effective Date to 31 December 2019
- **Existing schemes**
  - (i) schemes authorized by the SFC as at the Effective Date; and (ii) schemes which applied for SFC's authorization prior to the Effective Date and are subsequently authorized by the SFC
- **Existing operators**
  - (i) management companies which were managing SFC-authorized schemes as at the Effective Date; and (ii) trustees/custodians which were acting as the trustee/custodian of SFC-authorized schemes as at the Effective Date
- **New schemes**
  - schemes which applied/apply for SFC's authorization on or after the Effective Date (i.e. new fund applications submitted on or after the Effective Date)
- **New operators**
  - (i) management companies which were not managing any SFC-authorized schemes as at the Effective Date; and (ii) trustees/custodians which were not acting as the trustee/custodian of any SFC-authorized schemes as at the Effective Date
- **Net derivative exposure**
  - has the meaning as defined in 7.26 of the revised UT Code

Introduction

- **Consultation paper** on proposed amendments to the Code on Unit Trusts and Mutual Funds (UT Code) issued on 18 December 2017
- **Consultation conclusions paper** issued on 6 December 2018
  - Revised UT Code became effective on 1 January 2019 (Effective Date)
  - A 12-month transition period for existing schemes and existing operators
- **Guidance issued/updated**
  - To enhance transparency and provide guidance to the industry on SFC's expectation on compliance
  - To streamline and simplify forms and checklists
  - Published documents
    - *(New)* FAQs on the Implementation and Transition Arrangements of the Revised UT Code (Implementation FAQs)
    - *(New)* Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds (SFC Derivative Guide)
    - *(New)* Application of the UT Code on UCITS funds
    - *(New)* KFS template for active ETFs
    - *(Updated)* Guide on Practices and Procedures for Application for Authorization of Unit Trusts and Mutual Funds
    - *(Updated)* Five existing KFS templates
    - *(Updated)* Three existing circulars, 13 sets of existing FAQs, and forms and checklists (including a new confirmation on derivatives)

Revised UT Code and transition period

- **A new scheme with a new management company and a new trustee/custodian**
  - Compliance with the revised UT Code with immediate effect from the Effective Date
- **Existing schemes and existing operators**
  - A 12-month transition period for compliance with the new requirements
- **New money market funds (managed by new or existing operators)**
  - Compliance with 8.2 of the revised UT Code
- **Appointment of new operator(s) for existing schemes**
  - Relevant requirements under the revised UT Code will apply:
    - New management companies
      - Chapter 5: management companies (e.g. the minimum capital requirement of HK$10 million (or its equivalent in foreign currency))
    - New trustees/custodians
      - Chapter 4: trustees/custodians
      - Appendix G: review on internal controls and systems of trustees/custodians

Changes made by existing schemes, offering documents and constitutive documents

- **Changes made by existing schemes, changes and revisions of offering documents and/or constitutive documents to comply with the requirements or reflect the enhanced disclosure and contents requirements under the revised UT Code**
  - In general, no SFC's prior approval and advance notice to investors are required if:
    - changes/revisions are made to comply with the revised UT Code; and
    - there are no material changes to the scheme's investment objectives, policies or strategies
  - Management companies should provide necessary update to the holders of the schemes regarding the changes/revisions as soon as reasonably practicable (whether by a specific notice or in the financial report of the scheme)
  - See Questions 2, 3 and 6 of the Implementation FAQs
- **6.15(f) of the revised UT Code**
  - 6.15 of the revised UT Code sets out matters for which a general meeting should be called by a scheme
  - Existing schemes are not required to adopt 6.15(f) of the revised UT Code to reflect the deletion of 6.15(f)(iii) and (iv) from the preceding UT Code
  - For an existing scheme which intends to adopt 6.15(f) of the revised UT Code:
    - no prior approval from the SFC is required; and
    - holders' approval and advance notification to holders (generally a 1-month prior notice) are excepted to be obtained and provided by the scheme
  - See Question 7 of the Implementation FAQs

Management companies and investment delegates

- **Key personnel (KP)**
  - KP must dedicate sufficient time and attention in the management of a scheme [5.5(b) of the revised UT Code]
    - An individual may be designated as the KP for one or more management companies and/or investment delegates
    - See Question 8B of the UT Code FAQs
  - Public fund experience of the KP may be satisfied on a group-wide basis [5.5(a) of the revised UT Code]
    - Applicable to management companies and/or investment delegates belonging to well-established fund management groups
  - Existing management companies and/or investment delegates for existing schemes may leverage on these flexibilities with immediate effect
    - SFC's prior approval and notification to investors are not required
      - Existing management company: (i) with at least 5 years experience in managing SFC-authorized funds and (ii) belongs to a well-established fund management group managing public funds in AIR for at least 5 years
    - Management companies' obligation to ensure compliance with the relevant requirements – consult the SFC if in doubt

Management companies and investment delegates (cont'd)

- A new fund management group which intends to use or rely on group investment expertise and experience
  - Information to demonstrate compliance (e.g., corporate structure, AUM, experience in managing public funds, etc.)
- Forms and checklists have been updated to reflect the flexibility for fund managers with multi-national presence to leverage group resources in meeting the public fund investment management experience requirements for KP

Trustees / custodians

- **Enhanced review of internal controls and systems (Appendix G of the revised UT Code)**
  - To further strengthen the ongoing monitoring on trustees / custodians by expanding and enhancing the scope and level of the review
    - To raise the level of independent auditor's review to cover (i) design suitability and (ii) operating effectiveness
  - Filing deadline of the review report: six months after the end of the review period
- **Engagement of third parties to carry out functions or operations in relation to the funds**
  - Trustees / custodians to exercise reasonable care to ensure that the internal controls and systems of the third parties are properly designed and operate effectively
  - The accountability of trustees / custodians to the funds and investors is not diminished and the obligations are duly discharged
  - See Question 11C of the UT Code FAQs
- **Existing trustees / custodians of existing schemes**
  - 12-month transition period for compliance with the enhanced review of internal controls and systems under Appendix G of the revised UT Code
    - Compliance of the enhanced Appendix G for the review period starting on or after 1 January 2020
  - For reviews conducted in accordance with the Appendix G of the preceding UT Code during the 12-month transition period
    - Filing of the review report with SFC within four months from the end of the review period (in accordance with the Appendix G of the preceding UT Code)

Investment requirements

- **Adoption of the core investment requirements under Chapter 7 of the revised UT Code**
  - Changes to the fund's investment objectives, policies or strategy
    - Management companies need to assess whether such changes are material which fall under 11.1(c) of the revised UT Code
  - See Question 8 of the Implementation FAQs
- **Derivatives investments**
  - Investment limit based on net derivative exposure
    - Chapter 7 (plain vanilla funds): 50% of a fund's net asset value (NAV)
    - Chapter 8.9 (funds with extensive derivatives investments): 100% of a fund's NAV
  - Circumstances that may be excluded from the calculation of the net derivative exposure:

    (a) netting, hedging and risk mitigation

    (b) cash flow management

    (c) market access or exposure replication *[Note: This is not applicable to passively managed index funds (including ETFs) and structured funds]*

    (d) investment in conventional convertible bonds
  - See the SFC Derivative Guide

Derivatives investments – Enhanced KFS disclosure

- **Enhanced disclosure on derivatives investments in the KFS**
  - SFC-authorized funds (including UCITS funds) offered to the public in Hong Kong
  - Existing schemes: the KFS must be updated with the enhanced disclosure from 1 January 2020 (i.e. by the expiry of the 12-month transition period)
- **KFS illustrative template**

Use of derivatives / investment in derivatives *(please refer to Note 1 below)*

[Note 1: By the expiry of the 12-month transition period from the effective date of the revised Code on Unit Trusts and Mutual Funds (i.e. with effect from [1] January 2020), this section must be included with the required disclosures set out below for a fund that will continue to be offered to the public in Hong Kong (including UCITS funds) on or after such date.*
**The revised Code on Unit Trusts and Mutual Funds ("UT Code") will become effective on 1 January 2019.]*

The fund will not use derivatives for any purposes.

Or

The fund's net derivative exposure may be [up to 50%] / [more than 50% but up to 100%] / [more than 100%] of the fund's net asset value.

[Note 2: The term "net derivative exposure" has the meaning as defined in 7.26 of the UT Code and should be calculated in accordance with the requirements and guidance issued by the SFC which may be updated from time to time. A "Guide on the Use of Financial Derivative Instruments for Unit Trusts and Mutual Funds" published by the SFC is available at the SFC website.]

Derivatives investments – Enhanced KFS disclosure (cont'd)

- **Revised KFS to reflect the enhanced disclosure**
  - Fund managers are encouraged to produce the updated KFS for their existing schemes as soon as reasonably practicable
  - Filing form for notice of scheme change(s) falling within 11.1B of the revised UT Code
    - Confirmation on Use of Derivatives for Unit Trusts and Mutual Funds to be submitted
- **Existing schemes – disclosure requirements during the 12-month transition period**
  - See the updated Guide on Practices and Procedures for Application for Authorization of Unit Trusts and Mutual Funds

Derivatives investments – Changes in the use of derivatives

- **Approval and notification**
  - SFC's prior approval and advance notification to investors (generally 1-month prior notice)
    - The fund's net derivative exposure will change from not more than 50% of the fund's NAV to exceeding 50% of the fund's NAV (or vice versa)
    - The fund's net derivative exposure will change from not more than 100% of the fund's NAV to exceeding 100% of the fund's NAV (or vice versa)
    - *(For UCITS funds during the 12-month transition period, if applicable)* The fund proposes to effect a scheme change whereby the fund may use derivatives for investment purposes extensively (from non-extensive use of derivatives for investment purposes) (or vice versa)
  - Advance notification to investors (generally 1-month prior notice)
    - The fund may use derivatives for investment or other purposes where the net derivative exposure will be up to 50% of the fund's NAV (from not using derivatives for any purposes) (or vice versa)
      - SFC's prior approval is not required
  - FAQ 5 of Post Authorization FAQs will be further updated

Derivatives investments – Transparency on SFC website

- **List of derivative funds / not derivative funds on SFC website**
  - From 1 January 2019, a new column is added in the list of SFC-authorized funds to indicate whether a fund is or is not a derivative fund
  - During the 12-month transition period, denotation is based on existing requirements (and, if available, the net derivative exposure of the funds) and the following:
    - SFC's general expectation on classification taking into account the disclosure in the fund's KFS regarding the fund's use of derivatives; and
    - management companies' confirmation for posting on the SFC website
  - SFC will refrain from posting the fund classification on the SFC website if we do not receive confirmation from the management companies
  - On the expiry of the 12-month transition period, management companies must calculate the net derivative exposure and disclose in the fund's KFS

Scheme changes and notification

- **Chapter 11 of the revised UT Code takes effect on 1 January 2019**
- **Changes falling under 11.1 of the revised UT Code that require SFC's prior approval**

(a) changes to constitutive documents (other than changes that have been certified by the trustee/custodian as provided under 6.7 or approved by holders or changes which do not require prior approval from the Commission);

(b) changes of ~~key operators (including~~ the trustee/custodian, management company, ~~and its~~ investment delegates and Hong Kong ~~representative)~~ Representative, and their regulatory status ~~and controlling shareholder~~;

(c) (i) material changes in investment objectives, policies and restrictions of the scheme (including expansion in the purpose or extent of use of financial derivative~~s~~ instruments for investment purposes [see 7.26])~~,~~;

(ii) ~~fee structure,~~ introduction of new fees and charges, or increase in fees and charges payable out of the property of the scheme or by the investors (other than an increase within the permitted maximum level as disclosed in the Hong Kong Offering Document [see Note(3) to 11.1A]); and

(iii) material changes in dealing arrangements, ~~and~~ pricing arrangements or distribution policy of the scheme; and

(d) any other changes that may ~~materially prejudice~~ have a material adverse impact on holders' rights or interests (including changes that may limit holders' ability in exercising their rights).

- **Notification to holders**
  - Notice requirements under 11.2 of the revised UT Code
    - Information necessary for investors to appraise the position of the scheme
    - Changes falling under 11.1 and 11.1B of the revised UT Code

Scheme changes and notification (cont'd)

- Reasonable notice period should be provided to holders for scheme changes to a fund
  - Nature and materiality of scheme changes

    (i) Prior notification: e.g.

    - ❖ Increase in fees exceeding the permitted maximum level as disclosed in the Hong Kong offering document (11.1)
    - ❖ Increase in fees within the permitted maximum level as disclosed in the Hong Kong offering document (11.1B)
    - ❖ Changes in distribution frequency and/or rate of dividend payments (11.1B)

    (ii) Post notification: e.g.

    - ❖ Elaboration on the ancillary investment strategy (11.1B)

Financial reports

- **Enhanced disclosure requirements in the financial reports (Appendix E of the revised UT Code)**
  - Enhanced transparency to investors on the fund's financial performance and portfolio information, e.g.:
    - Derivatives usages and investments
    - Securities financing and borrowing transactions
    - Collateral holdings
    - Soft dollar arrangements
    - Transaction costs
- **Existing schemes**
  - 12-month transition period for compliance with the enhanced disclosure requirements on the financial reports under Appendix E of the revised UT Code
    - Compliance of the enhanced Appendix E for the financial period starting on or after 1 January 2020

Some questions and answers

1. Concentration and diversification investment limits

(i) Single entity and group concentration limits [7.1 and 7.1A of the revised UT Code]

- (i) Securities (e.g. equities, bonds, fixed income instruments, money market instruments, etc.); (ii) exposure from underlying assets of derivatives; (iii) net counterparty exposure from OTC derivatives; (iv) collateral received; (v) exposure arising from collateral re-investments; and (vi) counterparty exposure from guarantor
- Cash deposits are not subject to 7.1 and 7.1A (see below)
- Money market instruments (e.g. commercial papers, certificate of deposits) should comply with 7.1 and 7.1A
- An ETF structured as a sub-fund of an umbrella fund would be considered as a separate entity
  - Subject to the 10% single entity concentration limit under 7.1
  - ETFs would not generally be considered as “entities within the same group” under 7.1A

(ii) Cash deposit limits [7.1B of the revised UT Code]

- Cash deposits made with the same entity or entities within the same group
- For example, (i) cash residing in the custodian account with Bank A (as the custodian of the fund) and (ii) cash deposit placed by the fund manager with Bank B (which is of the same group as Bank A) as a deposit taking company, the 20% group limit will apply to the aggregate cash deposits of the fund with Bank A and Bank B

Some questions and answers (cont'd)

2. **Investments in government and other public securities [7.5 of the revised UT Code]**
   - Investments issued by government or public authorities (OECD or non-OECD)
   - The funds' offering documents should contain clear and accurate disclosure regarding the funds' strategies and the associated risks in order to enable investors to appraise the position of the funds
     - See the updated Guide on Practices and Procedures for Application for Authorization of Unit Trusts and Mutual Funds regarding the disclosure requirements for SFC-authorized funds (e.g. exposure to securities issued by a sovereign issuer below investment grade etc.)
3. **Investments in commodities [7.10 of the revised UT Code]**
   - Investments by SFC-authorized funds: securities and financial products
   - Commodities previously accepted by the SFC: gold, silver and platinum
     - Appropriate safeguards (e.g. liquidity, valuation, custody arrangement)
4. **A feeder fund investing in a money market fund as the master fund [7.12 and 8.2 of the revised UT Code]**
   - To adopt a "see-through" approach
   - The feeder fund should comply with 7.12 and 8.2 of the revised UT Code

Some questions and answers (cont'd)

5. Derivatives investments

(i) Disclosure of net derivative exposure in the KFS

- The expected maximum net derivative exposure should be derived from an assessment made under normal market conditions based on the fund's investment objective and strategy
- Management companies should take into account circumstances or strategies where the fund may take positions (including tactical positions) via derivatives in determining the fund's net derivative exposure
- Tactical positions may include fund managers taking certain positions for their funds via derivatives in cases of change in the market conditions or investment opportunities considered by the fund managers
- Fund managers are not expected to take active positions on the use of derivatives which exceed the disclosed net derivative exposure. Management companies should be prudent in determining their funds' net derivative exposure and making the disclosure in the KFS accordingly

(ii) To-be-announced contracts (TBAs)

- TBAs are derivatives by nature [3.7A of the revised UT Code]
  - TBAs as access instruments to mortgage-backed securities which are securitization of a pool of underlying assets
- See the SFC Derivative Guide on market access / exposure replication for excluding from the net derivative exposure calculation

Some questions and answers (cont'd)

(iii) Duration netting

- Under UCITS regime, a UCITS fund may use interest rate derivatives for duration hedging or to adjust the portfolio duration
- For the purpose of calculating the net derivative exposure, UCITS funds may net the exposure arising from interest rate derivatives fully or partially in compliance with the duration netting rules as set out in the CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk
- Residual exposure arising from duration netting, if any, could not be further excluded from the net derivative exposure calculation as netting, hedging or risk mitigation arrangements

Appendix: Updated FAQs (questions updated)

FAQs (last updated on 17 Dec 2018)	Questions updated
Application Procedures for Authorization of Unit Trusts and Mutual Funds under the Revamped Process	Questions 5A, 5A1 and 12
Code on Unit Trusts and Mutual Funds (UT Code FAQs)	Questions 1, 3, 4, 6, 8, 8A, 8B (new), 10, 11, 11A, 11C (new), 13, 16A, 16B, 16C (new), 18-21, 23-26, 27A, 27B, 28-32, 34C and 36
Exchange Traded Funds and Listed Funds	Questions 1-9, 12,13 (new), 14 (new) and 15 (new)
Leveraged and Inverse Products	Questions 1A (new), 2, 5, 6 and 20 (new)
SFC Authorization of UCITS Funds	Questions 1, 1A (new), 2-5, 7 and 8
Mainland-Hong Kong Mutual Recognition of Funds	Section A: Questions 10 and 12 Section C: Question 3 Section D: Question 4A Section H: Questions 1, 3

Appendix: Updated FAQs (questions updated) (cont'd)

FAQs (last updated on 17 Dec 2018)	Questions updated
Post Authorization Compliance Issues of SFC-authorized Unit Trusts and Mutual Funds	Section 1: Questions 1-21 *(moved to the Frequently Asked Questions on Revamped Post Authorization Process of SFC-authorized Unit Trusts and Mutual Funds or section 2 of Frequently Asked Questions on Post Authorization Compliance Issues of SFC-authorized Unit Trusts and Mutual Funds)* Section 2: Questions 2, 3, 3A, 3C, 4, 5, 7, 8, 8A (new), 9, 9A (new), 10-12, 14, 15, 16B1, 19, 20 and 22
Revamped Post Authorization Process of SFC-authorized Unit Trusts and Mutual Funds *These FAQ were revised based on section 1 from the preceding Frequently Asked Questions on Post Authorization Compliance Issues of SFC-authorized Unit Trusts and Mutual Funds*	Questions 2, 3A, 16 and 17

Note: The following FAQs have also been updated to reflect references to the revised provisions of the revised UT Code, cross references to applicable FAQs and stylistic changes:

- Advertising Materials of Collective Investment Schemes Authorized under the Product Codes
- France-Hong Kong Mutual Recognition of Funds
- Switzerland-Hong Kong Mutual Recognition of Funds
- United Kingdom-Hong Kong Mutual Recognition of Funds

Thank you.

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