HKSFA 25th Anniversary
香港財經分析師學會
THE HONG KONG SOCIETY OF FINANCIAL ANALYSTS

28th February 2017 Sent by Email and by Post

Securities and Futures Commission
35/F Cheung Kong Center
2 Queen's Road Central
Hong Kong

Dear Sirs/Madams,

Re: Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency

The Hong Kong Society of Financial Analysts (HKSFA), one of the largest investment professional bodies in Hong Kong, has the pleasure to submit its views on the Securities and Futures Commission's Consultation Paper on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency. HKSFA has over 6,000 members, many of whom are investment professionals working in the asset management industry. It is regrettable that the Commission did not include HKSFA in its soft consultation with industry bodies prior to the issuance of the consultation paper. The Society believes the proposed changes, especially in the first part of the consultation, will have a significant impact on the development of the Hong Kong's asset management business, and hence on the investment professionals based in Hong Kong.

At first glance, there seems to be some confusion about the purpose of tightening the regulation of fund managers. This possibly stems from the mingling of the improvement in investor protection with the enhancement of financial stability. One would logically question what went wrong in Hong Kong in terms of investor protection that has led to the proposed tightening, which will inevitably increase the cost of doing asset management business in Hong Kong. To what extent did fund managers in Hong Kong contribute to global financial instability in the past? What are the specific steps that authorities should be taken to address the related shortcomings, if any? In the world of preventive measures, one would need to consider the probability of the worst happening and the effectiveness of those measures that are designed to prevent it from happening. In other words, for a holistic response to the consultation paper, practitioners would welcome the Commission to provide them with the aforementioned information. Furthermore, a separation of the proposed measures under investor protection with those under financial stability would result in a clearer discussion about the proposals.

Overall, HKSFA agrees with the measures that are taken to improve investor protection, but has reservation about the approach taken to safeguard international financial stability. The latter would put undue pressure on fund managers, in particular, on the operation cost of a small fund manager set-up.

The attempt to incorporate the responsibilities of safeguarding financial stability into the Fund Manager Code of Conduct (FMCC) is debatable. So far, the principle-based FMCC seems to have served the asset manager industry well and does not require a major overhaul. Safeguarding financial stability is a tall order that requires tremendous efforts and coordination from cross-sector cross-country authorities. Hong Kong is a small player in terms of ensuring the stability of the global financial market. Hence, it can afford to wait for a clearer development regarding the effectiveness of the new measures emerged from the big players. However, if the authorities believe Hong Kong should take some precautionary measures in that respect, to be in line with other financial regimes, it is better served to group those under a separate regulation or guidance. As the primary business of a fund manager is managing portfolio for investors, breaching the FMCC is regarded as a serious misconduct on the part of the fund manager. Safeguard financial stability is supposed to be the primary task of the regulatory authorities, and as such, fund manager should play a secondary role in that respect and the cost of its compliance with the new measures should be minimized as much as possible.

In the consultation paper published by the Financial Stability Board in June 2016 on proposed policy recommendations to address structural vulnerabilities from asset management activities, four key issues were discussed, three of which are relevant to the SFC's consultation paper, namely, (1) liquidity mismatch between fund investment assets and redemption terms and conditions for fund units, (2) leverage within funds, and (3) securities lending activities of asset managers and funds.

For the liquidity mismatch issue, the FSB's discussion and recommendations were focused on open-ended funds. However, in the SFC proposal, the enhanced FMCC covers public funds and private funds, as well as managed accounts with some measures exempted. Apparently, one is inclined to think if there is any alternative way of implementing the related measures of financial stability, for instance, based on product type, rather than a blanket requirement under the enhanced FMCC. In addition, the FSB recommended that new measures should be carried out proportionately to size, investment strategies and asset class holdings.

For the leverage issue, the FSB acknowledged the difficulties of coming up with a global uniform measurement for leverage and was undecided on whether the new regulation should be risk-based or rule-based. A target for completing the studies was set by the end of 2018. In the meanwhile, it is worthwhile to keep the new measures on leverage reporting as simple as possible until such consensuses are to be reached.

For securities lending activities, the FSB's focus was on those asset management companies acting as agent lender, the one which will indemnify clients on losses arising from lending activities. It acknowledged that there was little issue for funds that were beneficial owner in the lending activities. The new SFC regulation should, therefore, focus on agent lenders in terms of safeguarding financial stability.

The SFC's new requirements on custodian may create practical and cost issues for small private funds and private equity funds. More thought should be given to improve the new requirements.

The HKSFA is supportive of the general idea on inducements/commission as it would promote transparency and better protect retail investors from misleading information and/or sales tactics. The SFC's adoption of a two-prong approach to address conflicts appears to be reasonable. It provides intermediaries with the flexibility to adopt a pay-for-advice model or provide enhanced disclosure in cases where fees may result in a potential conflict of interest. In our view, transparency in fee disclosure with regards to conflicts of interest would enhance investor protection. However, some of the suggested measures in the proposal to address the issues are overcomplicated and would not stand from any cost-benefit analysis. It is hoped that the new regulation should focus on the essentials that allow investors to make a judgement on the "independence" of the fund advisors.

For the specific questions posted by the consultation, our response is included under the Appendix.

Yours sincerely,
For and on behalf of
The Hong Kong Society of Financial Analysts

Frederick Tsang, CFA
Co-chair, Advocacy Committee

Claudius Tsang, CFA
Co-chair, Advocacy Committee

Appendix: Response to the Specific Questions

Question 1:
Do you have any comments on the proposed clarification that the FMCC applies to the business activities carried out by fund managers which would include the management of discretionary accounts?

Feedback:
As there are material operational differences between management of funds and discretionary accounts, while we appreciate irrelevant paragraphs have been carved out in the draft FMCC, having a separate code for discretionary portfolio managers would enhance readability and be more reflective of unique business nature of discretionary portfolio management. We propose this round of amendments to be limited to fund managers only but not managers of discretionary accounts at this stage.

Question 2:
Under the current proposal, some of the proposed enhancements are not applicable to all Fund Managers but only to those responsible for the overall operation of a fund or having de facto control of the oversight or operation of the fund. Do you agree with such an approach? If so, do you have any views on which of the proposed enhancements should only be applicable to those Fund Managers who are responsible for the overall operation of a fund or have de facto control of the oversight or operation of the fund? Please explain your views.

Feedback:
We propose that definition of 'de facto control' to be elaborated for the avoidance of doubt.

Question 3:
Do you have any comments on the above proposals which will be applicable to a Fund Manager which engages in securities lending, repo and similar OTC transactions on behalf of the funds it manages?

Feedback:
We propose that definition of 'similar OTC transactions' to be further elaborated for the avoidance of doubt.

Question 4:
Do you have any views or comments on the proposal that Fund Managers should design their haircut methodologies which should reflect the standards set by the FSB in its recommendations9?

Feedback:
We propose flexibility to be given.

Question 5:
Is the requirement to disclose details of non-cash collateral re-hypothecation sufficient to enable investors to understand the relevant risks and exposures to the fund? Please explain your views.

Feedback:
Yes, and this can be supplemented by more investor education in general.

Question 6:
Do you have any comments on the proposed requirements on reporting to fund investors? In particular, do you have any comments on the minimum disclosure requirements proposed?

Feedback:
No particular comment.

Question 7:
Do you have any comments on the above proposals regarding custodian and safe custody of fund assets?

Feedback:
The SFC proposes to codify in the FMCC current requirements governing the safety of client assets to expressly require that fund assets should be segregated from the assets of the Fund Manager, and, unless they are held in an omnibus account, also segregated from the assets of affiliates and other clients of the Fund Manager while retaining

the general principle that fund assets entrusted to a fund manager should be properly safeguarded. For non-omnibus client account, the Fund Manager may use one custodian bank account to hold the cash of multi funds/trust/clients. Under the proposed point no. 38, each fund/trust/client has to have its asset, in this case cash, and be segregated from the assets of other clients. This will increase the account opening time and cost, pulling back the efficiency of Hong Kong as a financial hub. Greater investors' protection is achieved, but at the expense of the whole industry in terms of cost and efficiency. We have great reservation on this point.

For discretionary portfolio managers where banks are acting as custodians, there already prudential safeguards exercised by banking regulators.

Question 8:
Do you have any comments on the above proposals regarding liquidity risk management?

Feedback:
Agree for open-ended fund managers but not as applicable for discretionary portfolio managers where banks are acting as custodians. There are already prudential safeguards exercised by banking regulators.

Question 9:
Do you have any suggestions on any particular liquidity management measures which a Fund Manager should put in place for effective liquidity management, for example, in terms of setting liquidity targets or stress testing?

Feedback:
Agree for open-ended fund managers but not as applicable for discretionary portfolio managers where banks are acting as custodians. There are already prudential safeguards exercised by banking regulators.

Question 10:
Do you consider it appropriate for Fund Managers to disclose the maximum leverage of the fund it manages to fund investors?

Feedback:
Agree for fund managers but not as applicable for discretionary portfolio managers where banks are acting as custodians. There are already prudential safeguards exercised by banking regulators.

Question 11:
Do you have any comments on how leverage should be calculated?

Feedback:
No particular comment in this regard.

Question 12:
Do you have any comments on the other amendments proposed to the FMCC?

Feedback:
No particular comment in this regard.

Question 13:
Under the existing requirement, where a client's order has been aggregated with a house order, the client's order must take priority in any subsequent allocation of partially filled orders. Are there any circumstances where it is in the best interests of clients to aggregate their orders with house orders? What are those circumstances which justify that they are in the best interests of clients? Are there any circumstances in which an institutional professional investor should be able to request pro rata allocation of aggregated but partially filled orders, on the terms specified by such an investor? What are those circumstances? Does the investor who request pro rata allocation have concerns that the flexibility can be abused by the licensed manager?

Feedback:
It would be helpful to define what 'house order' is.

Question 14:
Do you have any comments on the suggested risk-management control techniques and procedures as set out in Appendix 2?

Feedback:
The SFC proposes to codify in the FMCC current requirements governing the safety of client assets to expressly require that fund assets should be segregated from the assets of the Fund Manager, and, unless they are held in an omnibus account, also segregated from the assets of affiliates and other clients of the Fund Manager while retaining the general principle that fund assets entrusted to a fund manager should be properly safeguarded. For non-omnibus client account, the Fund Manager may use one custodian bank account to hold the cash of multi funds/trust/clients. Under the proposed point no. 38, each fund/trust/client has to have its asset, in this case cash, and be segregated from the assets of other clients. This will increase the account opening time and cost, pulling back the efficiency of Hong Kong as a financial hub. Greater investors' protection is achieved, but at the expense of the whole industry in terms of cost and efficiency. We have great reservation on this point.

For discretionary portfolio managers where banks are acting as custodians, there already prudential safeguards exercised by banking regulators.

Question 15:
Do you have any comments on the requirements set out in Appendix 1?

Feedback:
Refer to response in Question no. 1

Question 16:
Do you think a 6-month transition period following gazettal of the final form of the amendments to the FMCC is appropriate? If not, what do you think would be an appropriate transition period and please set out your reasons.

Feedback:
6 months would not be sufficient, taking into account the need to review the changes and perform assessment of implementation requirements, system enhancements, UAT, actual implementation and training, etc. We propose 18-24 months.

Question 17:
What is your view on a pay-for-advice model for Hong Kong? Do you have any comments on our suggested approach to addressing the inherent conflicts of interest arising from receipt of commissions by intermediaries from other parties including product issuers?

Feedback:
Pay-for-advice model does not seem to be the main stream. Suggested approach appears overly complicated and not balanced from a costs benefits standpoint.

Question 18:
Do you have any comments on the proposed disclosure requirement in relation to independence set out above?

Feedback:
Proposed disclosure requirement appears overly complicated and not balanced from a costs benefits standpoint, especially in situations where intermediaries do not seek to claim being "independent". To cover not just "independent" but also words to that effect would add uncertainty in the compliance. We propose to limit the requirement to situation where "independent" status is being claimed.

Question 19:
Do you have any comments on the enhanced disclosure proposed with regard to monetary benefits received or receivable by intermediaries that are not quantifiable prior to or at the point of entering into a transaction (and in particular, in relation to specific types of investment products)?

Feedback:
Proposed approach appears overly complicated and not balanced from a costs benefits standpoint.

Question 20:
Do you have any comments on the suggested manner of disclosure of trailer fees (in the context of funds) set out in the sample disclosure above? Do you have any other suggestions to ensure the disclosure of non-quantifiable monetary benefits relating to other types of investment products will be clear, fair, meaningful and easily understood by investors?

Feedback:
Proposed approach appears overly complicated and not balanced from a costs benefits standpoint. In addition, the SFC should clarify that the intermediary can make such estimates on a best effort basis, and that certain degree of inaccuracies may be accepted as long as the disclosure is made in good faith and is not materially misleading. We propose that intermediaries are required to disclose the existence and provide details upon client's request.

Question 21:
Do you think a 6-month transition period following gazettal of the final form of the amendments to the Code of Conduct is appropriate? If not, what do you think would be an appropriate transition period and please set out your reasons.

Feedback:
Six months would not be sufficient, taking into account the need to review the changes and perform assessment of implementation requirement, system enhancements, UAT, actual implementation and training, etc. We propose 18-24 months.

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