

TOPIC 3 - OVERVIEW

1. FUND MANAGER CODE OF CONDUCT (FMCC)	3.3
1.1 Introduction	3.3
1.2 Part I - Organisation and management structure	3.3
1.3 Part II - Fund management activities conducted for clients	3.6
1.4 Part III - Dealings with the fund and fund investors	3.11
1.5 App 1 – Additional requirements for Discretionary Account Managers	3.12
1.6 Part IV – A fund manager’s reporting obligations	3.12
 2. SFC HANDBOOK FOR UNIT TRUSTS AND MUTUAL FUNDS, INVESTMENT-LINKED ASSURANCE SCHEMES AND UNLISTED STRUCTURED INVESTMENT PRODUCTS	 3.13
2.1 General principles	3.13
2.2 Product providers	3.13
2.3 General requirements	3.14
2.4 Disclosure requirements	3.14
 3. COLLECTIVE INVESTMENT SCHEMES (CISs): AUTHORIZATION	 3.14
3.1 Internal Product Approval Process	3.15
3.2 Authorization under the Code on Unit Trusts and Mutual Funds (CUTMF)	3.15
3.3 Advertising requirements	3.18
3.4 Ongoing requirements	3.20
 4. AUTHORIZED COLLECTIVE INVESTMENT SCHEMES: INVESTMENT REQUIREMENTS	 3.25
4.1 Core requirements for authorized CISs	3.25
4.2 Requirements for specialized schemes	3.27

5. COLLECTIVE INVESTMENT SCHEMES: MANAGERS AND TRUSTEES/CUSTODIANS	3.32
5.1 Management companies	3.32
5.2 Trustees/custodians	3.35
6. CODE ON OPEN-ENDED FUND COMPANIES	3.38
7. REAL ESTATE INVESTMENT TRUSTS	3.39
7.1 Authorisation	3.39
7.2 Other parties involved	3.39
7.3 Investment considerations	3.40
7.4 Other considerations	3.41
8. LIQUIDITY RISK MANAGEMENT CIRCULAR	3.42
8.1 Governance	3.42
8.2 Product design and disclosure	3.42
8.3 Ongoing liquidity risk assessment	3.42
8.4 Stress testing	3.42
8.5 Liquidity risk management tools	3.42
9. MUTUAL RECOGNITION OF FUNDS (MRF)	3.43
9.1 Mainland China – Hong Kong MRF Scheme	3.43
9.2 Eligible funds	3.43
9.3 Ongoing requirements	3.44
9.4 Requirements on management firms and custodians	3.44
9.5 Application process	3.45
10. MANDATORY PROVIDENT FUND (MPF) PRODUCTS	3.46
10.1 Pooled Retirement Funds (PRF)	3.46
10.2 MPF Products	3.46
10.3 PRFs under the Code on Pooled Retirement Funds	3.48
10.4 Investment of MPF Products	3.48
10.5 Ongoing requirements	3.49

1. FUND MANAGER CODE OF CONDUCT (FMCC)

1.1 Introduction

- **Applies to Fund Managers** who are licensed/registered with the SFC, and whose business involves the management of:
 - **CISs**, whether or not the CIS is authorised; and/or
 - **Discretionary accounts**, whether in the form of an investment mandate or a pre-defined model portfolio (Discretionary Accounts)

Note: FMCC has slightly different provisions to each of these two categories

CIS: “fund” and “client” refer to the CIS; “fund investors” refers collectively to investors in the CIS

Discretionary Accounts: “fund” and “client” refer to the Discretionary Account; “fund investors” refers to Discretionary Account Clients

- FMCC has four parts and sets the minimum standard of conduct for Fund Managers
- Breaches of FMCC impact a person’s fitness and properness, which may have licensing and discipline implications
- FMCC does not have legal force
- Many of provisions are similar to Code of Conduct, with specific provisions for Fund Managers – where there is any inconsistency between applicable provisions, **the more stringent provision will apply**

1.2 Part I FMCC – Organisation and Management Structure

- Senior management must ensure that:
 - Systems for implementation and compliance with FMCC are in place
 - Performance of Fund Managers managing CISs should be reviewed at least annually
 - When a Fund Manager withdraws from business, all affected persons are promptly notified and client assets are safeguarded
 - Where a Fund manager is wound up, all statutory requirements are complied with
 - Where functions are delegated, Fund Manager monitors to ensure FMCC complied with (obligations and responsibilities cannot be delegated)

1.2.1 Functional Separation

- Fund Manager must have system of functional barriers (i.e. Chinese Walls) to prevent confidential and/or price sensitive information flowing between different financial areas or activities
- There should be physical separation of activities with different people responsible, if possible

1.2.2 Segregation of Duties

- Core functions of a Fund Manager should be physically segregated, carried out by different people and have different reporting lines, if possible, as follows:

Front Office: Making investment decisions Marketing Dealing in CIS Placing orders to deal with brokers	FROM	Back Office: Receiving broker confirmations Settling trades Accounting and reconciliation Valuing client portfolios Reporting to clients
Compliance and Audit	FROM	Each other and all other functions
Investment decision-making	FROM	Dealing

1.2.3 Conflicts of Interest

- Fund managers should establish and implement organisational/administrative arrangements to identify/prevent conflicts of interest, whether actual or potential
- Any conflict should be properly disclosed to clients
- Transactions should always be conducted in the best interests of clients

1.2.4 Risk Management

- A fund manager should identify and quantify the risks to which it is exposed and establish/implement appropriate policies and procedures to adequately manage such risks
- Policies and procedures should be reviewed regularly

1.2.5 Compliance

- Each Fund Manager should have a designated compliance officer reporting directly to senior management
- Compliance activities may be delegated to an external professional entity, but the responsibility and obligations may not be delegated

1.2.6 Staff Dealings

- **Relevant persons** are directors or employees of a Fund Manager:
 - Who make or participate in investment decisions or who acquire information on investments or decisions before buying or selling the investments
 - Whose functions relate to recommendations on buying or selling
 - Any person who they control or influence
- Relevant persons must give clients priority and avoid conflicts of interest
- Relevant persons should:
 - Disclose investment holdings on joining and at least annually
 - Obtain written permission from the compliance officer to make personal account dealings; written permission should be only valid for 5 days or less
 - Not buy or sell an investment on their personal account on the same day as the Fund Manager has a similar order for a client
 - Not buy or sell an investment on their personal account within one trading day before a client transaction or recommendation by the Fund Manager (unless trade executed and conflict no longer exists)
 - Not enter into cross trades with clients
 - Not short sell securities recommended by the Fund Manager
 - Not invest in IPOs available to clients of Fund Manager
 - Hold investments for at least 30 days, unless written permission to dispose of earlier is given
 - Hold all personal accounts with the Fund Manager (or obtain permission to use outside brokers and provide copies of all statements)
 - Not delay settlement
- Fund Managers must keep separate records for transactions of all relevant persons and maintain audit trails

1.2.7 Benefits

- Fund Managers should not accept anything which is likely to cause a conflict of interest with their duties to clients
- There should be written guidelines on acceptance of gifts, rebates and other benefits with monetary limits
- A register should be kept of any gifts received in excess of limits

1.3 Part II FMCC – Fund Management Activities Conducted for Funds

- Part II of the FMCC covers three areas:
 1. Activities conducted for funds
 2. Custody of fund assets
 3. Operations of the Fund
- Some of the provisions only **apply to CIS fund managers and not Discretionary Account Managers** – these will be highlighted as appropriate

1.3.1 Activities Conducted for Funds

Investment Mandate

- Transactions should be in accordance with the investment mandate of the relevant fund
- The mandate will be determined by the fund's **constitutive or other relevant documents** and may include provisions covering investment **strategy, objectives and investment restrictions** in terms of asset class, geographical spread or risk profile

Best Execution

- The fund manager should ensure that orders for funds are executed on the best available terms

Prohibition of Insider Dealing

- Fund Managers should not undertake any client transaction based on confidential price-sensitive information

Order Allocation

- All client orders should be allocated fairly
- Intended allocations should be recorded prior to the transaction
- Executed transactions should be allocated promptly in accordance with prior intentions, unless change will not disadvantage client
- The reasons for any changes in allocation should be documented

Fund Portfolio Turnover

- Fund Managers should not trade excessively in a client portfolio – it should not engage in “churning” – see Topic 4

Underwriting

- Fund Managers should not underwrite on behalf of a fund, unless specifically permitted by the investment mandate
- All commissions and fees received for underwriting should be credited to the fund account

IPOs

- Stock received under an IPO should be fairly and equitably allocated among clients
- Preferential allocations are prohibited
- Reasons for allocations should be documented

Transaction with Connected Persons

- A Fund Manager can only carry out transactions for funds with its connected persons if a transaction is at:
 - Arms length
 - Best execution standards
 - Commission rates no higher than regular rates
- A point to note is that “connected person” is not defined in the FMCC (or the Code of Conduct)
- A Fund Manager can deposit or borrow funds for a client with/from its connected persons as long as the deposit rate is no lower than or the loan rate and fees are no higher than prevailing commercial rates

Cross Trades

- Cross trades between client accounts are allowed if:
 - The trades are in the best interests of both clients
 - The trades are in line with the clients' investment objectives
 - The trades are at arm's length at current market values
 - The activity is disclosed to the clients
 - The reasons are documented prior to executing the trades
- Cross trades between the house account (the account of the Fund Manager) and clients require prior consent of the client, who should be aware of the potential conflict of interest
- Cross trades between staff accounts and clients **should not be permitted**

House Trades

- When the Fund Manager is dealing for the house account they should:
 - Give priority to client orders
 - Only aggregate house orders with client orders where it is in the best interests of clients
 - Not deal before clients have had a reasonable chance to act on recommendations, research reports or analysis
 - Not deal ahead of funds without prior consent of compliance officer
 - *Note: A house account is an account of the Fund Manager, or its connected person, over which it can exert control or influence*

Risk Management

- Each fund will face its own set of particular risks including market risk, liquidity risk, counterparty risk and operational risk
- A fund manager should identify types of risk relevant to a fund it manages and establish/implement appropriate risk management procedures

Leverage

- Fund managers should disclose to fund investors how the fund assets will be leveraged
- The expected maximum amount of leverage should be disclosed as well as the basis of calculating the leverage amount

Securities Lending

- If a fund manager uses fund assets for securities lending, a repurchase agreement (repo) or a reverse repo, it must disclose details of the transactions to fund investors at least annually

Liquidity Management

- Liquidity risk may impact on the ability of an investor to redeem fund holdings
- The primary consideration should be to protect the interests of fund investors
- This provision **does not apply to Discretionary Account Managers**

Compliance

- Instances of non-compliance should be reported to the SFC immediately and remedied promptly

Termination

- Fund termination should take the best interests of fund investors into account
- All relevant information should be disclosed to fund investors
- This provision **does not apply to Discretionary Account Managers**

1.3.2 Custody of Fund Assets

- **Incorporated funds** should have a custodian to protect fund assets, while a **trust structure** should employ a trustee

Safeguarding Client Assets

- Client assets held for safe custody should be properly safeguarded
- A qualified custodian should be appointed or a segregated trust account used (if allowed under the license)
- The custodian should be:
 - A registered trust company
 - An AFI or a subsidiary of a licensed bank
 - An overseas bank or trust company with satisfactory supervision
 - Any other qualified institution with prior written consent of client
- The Fund Manager should ensure the custodian remains suitable on an ongoing basis

1.3.3 Operations of the Fund

Record Keeping

- Requirements include:
 - Compliance with Keeping of Record rules
 - Maintaining an audit trail of all client account transactions
 - Ensuring records are kept safe and can be retrieved when required

Audited Accounts

- A fund manager's accounts should be audited by an independent auditor at least annually (does not apply to Discretionary Account Managers)
- An annual audited report should be made available to fund investors upon request

Portfolio Valuations by Fund Managers

- All client assets should be regularly valued as per the constitutive documents of the CIS
- The basis of the valuation should be disclosed to clients

- **Basis for valuation** of client assets:
 - **Listed shares:** a consistent basis for listed shares (opening, mid, closing or average price) using an independent source
 - **Unlisted shares and unquoted securities:** cost adjusted with reference to:
 - Comparable third-party transactions
 - Appraisals by qualified accountants, appraisers or credit rating agencies for other investments
 - Other relevant general information
 - **Units or shares in CIS** should be valued at latest quoted prices
 - Value of **listed securities which are not actively traded or suspended** from trading should be monitored with procedures to:
 - Actively seek independent price confirmations from brokers/market makers
 - Where appropriate, write down or write off such securities in the fund account
 - Decide whether to transfer such securities to the fund manager's own account and at what price
 - **NAV calculations** should be performed as per the constitutive documents (does not apply to Discretionary Account Managers)
 - Internal records should be reconciled to third party documentation at least monthly
 - All interests in securities should be disclosed
- In some circumstances, a fund manager may segregate illiquid or difficult-to-value assets into so-called “**side pockets**”
- Where an asset is moved into a **side pocket**, clear disclosure must be made to fund investors of asset being moved, valuation at time of move and ongoing asset valuation
- Provisions regarding **side pockets** do not apply to Discretionary Account Managers

1.4 Part III FMCC – Dealing with the Fund and Fund Investors

Information about the Fund Manager

- Fund investors should be provided with information about the Fund Manager, including:
 - Business address
 - Conditions and restrictions on conduct of business
 - Identity and status of person's acting for it
 - Financial information

Fees and Expenses

- Clients should receive details of the basis and amount of fees
- Fees, charges and mark-ups should be fair and reasonable and in good faith
- If Fund Manager is acting as an agent, mark-ups are forbidden; if acting as principal, they should be disclosed

Rebates and Soft Commissions

- A Fund Manager must comply with paras 13.1 and 13.4 of the Code of Conduct
- With an authorized CIS, a Fund Manager must comply with para 10.12 of the CUTMF

Dealing with Complaints

- Complaints should be followed up in a timely and appropriate manner
- Follow-up should be by a person other than the individual involved in the complaint
- There should be investigation and prompt response
- The client should be advised what steps are available to him
- A complaints register should be maintained and regularly reviewed by senior management

Marketing and Representations

- Representations made and information supplied to a fund or fund investors should be accurate and not misleading
- Marketing material, including advertisements, should be authorized by the SFC (where required) and any performance claims should be verified
- These provisions do not apply to Discretionary Account Managers

1.5 Additional Requirements – Discretionary Account Managers

- Before a Discretionary Account Manager can provide any services for remuneration, it will need to enter into a **Discretionary Client Agreement**, in a language understood by the client
- The agreement must comply with the minimum content requirements set out in the **Code of Conduct** and specifically cover the following matters:
 - Appointment of licensed/registered person as Discretionary Account Manager
 - Client's investment policy and objectives
 - Any performance benchmarks
 - For a pre-defined model portfolio, the proportion of asset classes, markets and corresponding risk profile
 - A description of all fees payable by the client to the Discretionary Account Manager or any third person
 - If applicable, client's consent to the Discretionary Account Manager receiving soft commission/cash rebates
 - If Discretionary Account Manager is to provide custody arrangements, details of the custody arrangements
 - Details of periodic reporting to the client
- **Foregoing requirements do not apply** to clients who are Institutional Professional Investors or certain Corporate Professional Investors
- Unless otherwise agreed, a Discretionary Account Manager is required to provide a client with:
 - A **performance review** in writing or in a meeting at least twice a year
 - **Valuation reports**, as agreed, at least monthly

1.6 Part IV FMCC – A Fund Manager's Reporting Obligations

- Fund managers must cooperate with any SFC enquiries, providing information as required
- Information that the SFC might require include fund leverage, asset composition, securities lending and repo activity

2. SFC HANDBOOK FOR UNIT TRUSTS AND MUTUAL FUNDS, INVESTMENT-LINKED ASSURANCE SCHEMES AND UNLISTED STRUCTURED INVESTMENT PRODUCTS

- The Handbook:
 - Establishes codes/guidelines for the **authorisation of investment products**
 - Primary relevance to asset management is that it contains the Code on Unit Trusts and Mutual Funds (**CUTMF**), which is the product code relevant to Collective Investment Schemes (CIS)
 - Section I sets out the **high-level principles** that the SFC applies to all products

2.1 General Principles

- There are seven general principles (GP) with which all product providers must comply
 - GP1**
Product providers shall act honestly, fairly and professionally
 - GP2**
Disclosures must be complete, accurate and, where ongoing disclosure is required, disseminated in a timely and efficient manner
 - GP3**
Assets specifically required by the applicable product code to be held for the benefit of investors must be properly protected
 - GP4**
Product providers, counterparties and service providers shall avoid conflicts of interest that may undermine the interests of the investors of the relevant product
 - GP5**
Applicable legal and regulatory requirements must be complied with, including cooperation with regulators
 - GP6**
Product providers shall discharge their functions with due skill, care and diligence
 - GP7**
Advertisements for a product shall be clear, fair and present a balanced picture with adequate and prominent risk disclosures

2.2 Product Providers

- For a CIS, the product provider is the CIS management company and the CIS itself and, where the CIS is a mutual fund corporation, its board of directors
- Product providers are required to comply with the Handbook and respond to any SFC enquiries
- Product providers must avoid any actual or potential conflicts of interest. Where a conflict cannot be avoided, investor interests must be protected

2.3 General Requirements

- A product name should not be misleading
- Expressions such as “guaranteed”, “principal protected” and “capital protected” should accurately reflect the nature of the product
- When selecting distributors, counterparties and service providers, reasonable care and diligence should be exercised
- Offering documents must be in English and Chinese unless waived by the SFC

2.4 Disclosure Requirements

- The handbook lists appropriate disclosures to be made in the offering document
- A **product key facts statement** (Product KFS) should be part of the offering document, unless stated otherwise in the applicable Code
- A **Product KFS** is a clear, concise and effective summary of the key information to allow investors to understand the features and risks of the investment product
- Each **Product KFS** should be **no more than four pages** and should contain a **warning statement** on the first page that investors should not decide to invest based only on the Product KFS
- CIS offering documents must meet the CUTMF disclosure requirements, to allow investors to make an informed decision
- Advertisements must comply with applicable advertising guidelines

3. COLLECTIVE INVESTMENT SCHEMES (CISs): AUTHORIZATION

- A CIS can only be offered or marketed in Hong Kong if it is:
 - A company which is listed on SEHK; or
 - Authorized by the SFC (most common)
- A CIS that is **both authorised by the SFC and listed on the SEHK** is known as an exchange traded fund (**ETF**)
- REITs and MPF schemes are special forms of CIS with their own codes, however they are not covered by the SFO’s definition of “securities”
- The SFC’s authorisation requirements for CISs are contained in the CUTMF and are covered in the next four sections:
 1. Internal product approval process
 2. Authorisation procedures under the CUTMF
 3. Advertising requirements
 4. Ongoing requirements under the CUTMF

3.1 Internal Product Approval Process

- Prior to SFC authorisation, a product provider must follow a number of steps as set out in the SFC's Internal Guidance
- The Internal Guidance is structured around the following 14 general principles:
 - **Accountability:** An internal product approval committee (IPAC) is established to ensure that investor interests are properly considered
 - **Infrastructure:** The IPAC, consisting of senior management, ensures each new product undergoes proper due diligence and approval processes
 - **Target market identification:** The product is designed according to the target market profile, including whether the product and its risks would be understood by the target market
 - **Product design:** The design is fair (subject to back-testing, if applicable) and meets the needs of the target market
 - **Risk monitoring and stress testing:** Best efforts are used to assess all relevant risks
 - **Termination/de-authorisation:** Any termination or de-authorisation can be fairly carried out
 - **Modification of contract terms/constitutive documents:** To be based on reasonable justifications
 - **Fees:** Fees are fair and proportionate to the investment objectives and risk/return profile
 - **Distributor selection:** control is exercised including whether distributors have necessary product knowledge
 - **Investor education:** Is considered in terms of products
 - **Disclosure:** Complies with applicable laws and regulations
 - **Legal and compliance:** Plays a role during product life-cycle and contractual terms are clear
 - **Conflicts of interest:** are avoided or managed and necessary Chinese walls are established and maintained
 - **Post-sale obligations:** procedures established to monitor and review investor requests and complaints

3.2 Authorization Procedures under the Code on Unit Trusts and Mutual Funds (CUTMF)

- Authorization provides investor protection by ensuring that:
 - CIS is suitable for public investment; and
 - Persons involved in CIS are reputable and capable
- A completed application form and an information checklist supported by specified information should be submitted to the Investment Products Division of SFC
- Recognized Jurisdiction Schemes (RJS), where funds are domiciled in jurisdictions which have similar rules governing funds to SFC, have a streamlined vetting process
- The SFC must also approve any offering document for the CIS

- A revamped authorisation process, effective from May 2016, recognises two streams for new fund applications:
 - **Standard Applications:** processed on a fast-track basis of one to two months. They must meet the following criteria:
 - Is a sub-fund under an existing SFC-authorized umbrella fund
 - Is not seeking authorisation as an approved pooled investment fund under the SFC Code on MPF Products
 - Managed by an existing approved management company
 - The trustee/custodian acts as trustee/custodian of other existing SFC-authorized funds
 - Application documentation is complete and in good order and quality; and
 - Application has no material issues and/or policy implications, as considered by the SFC
 - **Non-Standard Applications:** processed under an enhanced process lasting two to three months. Applies to new funds that are a leveraged or inverse product; a futures based unlisted index fund or ETF; or a fund that invests all non-cash assets in a single CIS (ie a feeder fund)

3.2.1 Information Requirements for Application

- A letter about appointment of approved persons to receive notices from SFC
- Appointment of trustee (unit trust) or custodian (mutual fund)
- Appointment of a management company (independent of trustee/custodian)
- Appointment of auditors for a management company and mutual fund corporation
- Offering document of CIS, including Product KFS
- Constitutive document of CIS
- Hong Kong Representative Agreement and Undertaking for a non-Hong Kong-based scheme with a non-Hong Kong-based management company
- For an RJS, evidence of its authorized status in the recognized jurisdiction

3.2.2 Information in Offering Document

- The offering document of a CIS is the **“document, or documents issued together, containing information on a scheme to invite offers by the public to buy units/shares in the scheme”**
- Offering documents of a CIS must be SFC approved
- Document must be in both English and Chinese (unless SFC waives requirement)
- Full disclosure to help an investor make an informed decision, including:
 - Investment objectives and restrictions
 - Collateral policy and criteria
 - Valuation of property and pricing
 - Liquidity risk management
 - Types and denomination of units/shares
 - Frequency of valuations
 - Frequency of dealing days
 - Application and redemption procedures
 - Details of distribution, fees, charges and tax, if any
 - Details of financial reports to be provided
 - Financial year-end
 - Most recent audited accounts and report
 - Any semi-annual report published after latest annual report
 - Warnings on need for independent advice
 - Instructions on where to find general information or access to other documents
 - Evidence to support any performance data or estimated yield
 - Product KFS
 - Custody arrangements

3.2.3 Information in Constitutive Documents

- Principal documents governing formation of scheme, including:
 - Prospectus
 - Investment management agreement
 - Trustee/custodian agreement
 - Trust deed for unit trust
 - Articles of association for a mutual fund corporation
 - Material contracts

- Information to be included in constitutive documents:
 - Names of operating participants and governing law
 - Trust or custodian arrangements
 - Obligations of management company and its retirement
 - Investment and borrowing restrictions
 - Valuation of property and pricing methods
 - Suspension and deferral of dealing procedures
 - Fees and charges paid out of CIS property
 - Details of any possible transactions with operating participants or connected persons
 - Distribution policy and dates
 - Means of modifying constitutive documents

3.3 Advertising Requirements

- Covered by **Advertising Guidelines Applicable to Collective Investment Schemes Authorized under the Product Codes (CIS Advertising Guidelines)**
- General requirements given in the SFO
- All forms of advertising are covered by CIS guidelines including:
 - Distribution materials (print media advertising, brochures, fact sheets, newsletters, direct marketing, fax on demand etc)
 - Display-only materials (posters, exhibition panels, outdoor displays etc)
 - Broadcasts (radio, TV, cinema etc)
 - Interactive systems (Internet, interactive voice message systems etc)
- Issuer of advert must keep supporting documents for all material information for **3 years** from publication date (CUTMF requirement)
- Requirements apply to both authorized and unauthorized CISs

Language

- Any opinion expressed in advertisement must be reasonable
- Advertisement cannot suggest that an investor will not lose money or will only make profits, unless scheme has a guarantee feature
- Reference to both returns and risks must be made
- Descriptions in the advertisement must be consistent with the offering document
- Reference should not be made to other CISs in a derogatory way

Performance Information

- Performance data should be calculated, selected, published and sourced on a consistent basis using reasonable measures and reliable sources
- Performance data should relate to first/last dealing days or first/last day or month
- Basis of computation of data should be clearly stated
- No forecasts should be made
- A substantiated prospective yield is generally acceptable if CIS investing in products with regular and stable distributions (fixed income securities, money market instruments, real estate investment trusts)
- Any prospective yield must explain the basis of calculation
- Any prospective yield must also include a warning that a positive distribution yield does not imply a positive return
- There must be a 6-month track record before performance information is produced
- If performance information is used, it must contain the returns of the last 5 years (or period since launch) on a 12-month basis (or periods relevant since launch)
- Regular publications may contain figures for latest periods as long as clearly marked for information and are in the same format as other figures
- Performance data should be up to date and no more than 6 months old
- Performance data for print media, broadcasts and interactive systems should not be more than 3 months old
- Actual data should be used
- Hypothetical figures may be used for purposes of explaining complicated mechanisms
- Comparisons should be fair, accurate and relevant and on a like-for-like basis
- Past records relating to an unauthorized CIS may be used to advertise a newly launched authorized CIS with less than 6 months track record, similar investment objectives, policies and strategies and the same management team

Warning Statements

- Warning statements point out general and particular risks of investing in CISs
- Statements should be clear and not disguised, including statements that:
 - Investment involves risk
 - Offering document should be read to understand risk factors
 - Past performance is not indicative of future results
 - Advertisement has not been reviewed by SFC unless authorized
 - Authorized by SFC does not mean recommended
 - Specific warnings should be included to indicate higher risk investments

Radio, Television and Cinema

- Warning statements should be read out at end of broadcast
- Warning statements should remain on screen for sufficient time to read full text
- Advertisement should be professional

Internet

- Prior approval of the SFC is needed if the web pages are targeted at Hong Kong investors
- A hard copy of the web page and the script should be given to the SFC
- Banner ads do not require approval, unless they contain a link to a website which requires SFC authorization

3.4 Ongoing Requirements

- The SFC has published standardised forms to be submitted for various compliance obligations, including proposed mergers, restructurings and changes in investment objectives

3.4.1 Changes to Scheme Documentation

- Prior approval of the SFC is required for proposed changes to:
 - Constitutive documents
 - Key operators (trustee/custodian, management company, Hong Kong representative), their regulatory status or controlling shareholder
 - Investment objectives, policies, restrictions, fee structure, dealing and pricing arrangements
 - Introduction of new fees and charges
 - Increase in fees and charges payable out of CIS property
 - Material changes in dealing arrangements, pricing arrangements or distribution policy
 - Other changes that may materially prejudice holders' rights or interests
- SFC will determine if holders need to be notified and notice period
- SFC needs to authorize revised offering document
- Notices must be in same language as when the scheme was offered to investors
- Management company should communicate changes which do not require SFC approval to holders – normally with one month's prior notice

3.4.2 Valuation and Pricing

- **Offer/redemption price** = Net asset value (NAV) / number of shares or units outstanding less any fees or charges
- Different types of CIS assets may require **different valuation policies and procedures**, which should:
 - Be established by the management company, in consultation with trustee/custodian
 - Seek to detect, prevent and correct pricing errors
 - Be consistently applied
 - Be periodically reviewed by the management company to ensure that they remain appropriate
 - Be reviewed and tested annually by a competent, independent person (eg independent auditor)
- **Frequency of valuing scheme's assets** must be disclosed in the offering document and cannot be less frequent than dealing days
- If the management company has to make a **fair value adjustment**, it must act in good faith, exercise due skill, care and diligence and consult with trustee/custodian
- Unquoted shares must be valued regularly by a professional person approved by trustee/custodian
- Offer and redemption prices or NAVs must be made public, free of charge, on every dealing day in an appropriate manner, such as newspapers, telephone hotlines and websites
- Pricing errors should be corrected as soon as possible:
 - SFC must be informed if error is 0.5% or more of NAV
 - Investors should be compensated if total loss to individual investors is more than HK\$100
 - Management company must bear any loss it suffers

3.4.3 Dealing

- Regular dealing must be available at least one day per month
- Offer price quoted must be the maximum purchase price
- Redemption price must be the net price receivable
- Redemption money must be received within one month of application

Suspension of dealing

- Fund constitutive documents should set out the circumstances under which dealing can be suspended
- Dealings can be suspended by the management company, subject to consultation with the trustee/custodian and should be in the best interests of the holders
- Where dealings are suspended for a prolonged period, the management company must conduct regular reviews
- SFC must be notified immediately of suspension of dealing
- Notification of suspension must be published immediately and at least once during the month of suspension in an appropriate manner, such as newspapers, telephone hotlines and websites

Deferral of dealing

- Dealing may be deferred when redemption requests on any one dealing day exceed 10% of total number of units/shares in issue (excess deferred until next dealing day)
- SFC can vary the 10% threshold on a case-by-case basis

3.4.4 Financial Statements and Reports

- Annual financial statements and reports of CIS must be provided to SFC and to the holders
- CIS annual financial statements and reports must be issued within 4 months of financial year-end
- CIS interim financial statements and reports must be distributed within 2 months of period to which they relate

3.4.5 Fees

- Basis of calculation of fees must be disclosed, with percentages being expressed on a per annum basis
- Aggregate level of fees for investment management/advisory services should be disclosed
- Percentage-based fees payable to management company or connected persons may be disallowed if inconsistent with fiduciary responsibilities
- Performance fees may only be levied annually
- Performance fees must be based on absolute performance, not in relation to a benchmark
- Certain expenses, which reasonably should be paid by the management company or its agents, cannot be paid out of CIS assets

3.4.6 Transactions with Connected Persons

- The trustee/custodian must give prior consent to any transactions between the CIS and the management company, investment adviser, directors of the CIS or their connected persons
- The CIS's annual report must contain disclosure of such transactions
- Any cash deposited with a trustee/custodian, management company, investment adviser or a connected person must earn interest at commercial rates
- The trustee/custodian must give prior approval to any underwriting or sub-underwriting contracts with the management company
- Any underwriting or sub-underwriting fees under such contracts will be part of the CIS assets

Brokers/dealers

- Management company or its connected persons should not retain cash or other rebates from brokers or dealers in return for directing business to them
- However, goods and services ("Soft dollar rebates") may be retained if:
 - They are of benefit to the holders of the CIS
 - Transactions were at best execution standards
 - Brokerage rates are not in excess of normal full service rates
 - There was adequate prior disclosure in the offering document
 - CIS annual report discloses manager's soft dollar practices and goods and services received

Acceptable Soft Dollar Rebates	Unacceptable Soft Dollar Rebates
Research and advisory services	Travel, accommodation and entertainment
Economic and political analysis	General administrative good and services
Portfolio analysis including valuation and performance measures	General office equipment or premises
Market analysis, data and quotation services	Membership fees, employee salaries or other direct money payments
Computer hardware and software incidental to above services	
Clearing and custodian services and investment related publications	

- The management company must comply with the following obligations when transacting with brokers/dealers connected with manager, investment adviser or directors of CIS or their connected persons:
 - Transactions should be on arms length terms
 - Brokers/dealers must be carefully selected and suitably qualified
 - Best execution standards are followed
 - Fees or commissions must not be greater than the prevailing market rates
 - CIS's annual report must disclose nature of such transactions, including commissions paid

3.4.7 Withdrawal of Authorization

- Authorization may be withdrawn upon request or by SFC
- Management company must give 3 months notice to holders of intention not to maintain authorization of CIS
- Notice must be approved by SFC and state:
 - Reasons for withdrawal
 - Consequences of withdrawal
 - Proposed changes in operation of CIS and effects
 - Alternatives available to investors
 - Estimate of any relevant expenses and who will bear them
- SFC may withdraw authorization if:
 - Information in application was, at time submitted, false or misleading in any material particular
 - Any of conditions imposed with authorization are not being complied with
 - Desirable to withdraw the authorization to protect the interests of the investing public

4. AUTHORIZED COLLECTIVE INVESTMENT SCHEMES: INVESTMENT REQUIREMENTS

- Investments held by a CIS should be **sufficiently liquid**. That is, convertible into cash at a reasonable cost within a short period of time so that **a CIS can meet redemption requests and payment obligations**

4.1 Core Requirements for Authorized CISs (Chapter 7)

Spread of Investments

- CIS **may not** hold >10% of its total NAV in securities of one issuer or >20% in one group of companies
- The aggregate amount of cash deposited with a single entity, or entities within the same group, must not > 20% of the CIS total NAV
- CIS **may not** hold >10% of its total NAV in ordinary shares of any single issuer
- CIS **may not** hold >15% of its total NAV in shares that are neither listed, quoted nor dealt in on a market (stock exchange, OTC etc)
- Investments of CIS and wholly-owned investment subsidiaries should be added together

However, note exception for Government and Other Public Securities below

Government and Other Public Securities

- CIS **may** hold up to 30% of its total NAV in Government or other public securities of same issue
- If CIS only holds these types of securities, then CIS must hold at least **six** different issues

Investment in Other CISs

- CIS **may not** hold >10% of its total NAV in underlying schemes that are not RJSs and not SFC authorised
- A CIS may invest in a RJS or an SFC authorised scheme, subject to a cap of not more than 30% of its total NAV
- A CIS may not invest in any underlying scheme which invests primarily in investments restricted by CUTMF
- If CIS and investee CIS are managed by same or a connected company, then all initial charges of the underlying scheme must be waived
- The management company of a CIS may not obtain a rebate on any fees or charges levied by an underlying scheme or its management company

- A CIS that invests 90% or more of its total NAV in another scheme will be **authorised as a feeder fund** – the underlying scheme (referred to as the “**master fund**”) must be SFC authorised and the following applies:
 - The feeder fund’s offering document must state that the CIS and the underlying scheme will be **treated as a single entity** in applying investment restrictions
 - The feeder fund’s annual report must include the master fund’s investment portfolio at the financial year-end
 - Aggregate fees and charges of the feeder fund and the master fund must be disclosed in offering document
 - Any borrowing must only be for meeting redemptions or operation costs
 - If CIS and underlying scheme are managed by the same company, then there should be no increase in initial, annual and other charges

Financial Derivative Instruments (FDIs)

- FDIs cover a wide range of exchange traded and OTC derivatives
- Different rules apply depending on whether FDI investment is for **hedging** or for **investment** purposes
- A CIS may acquire **FDIs for hedging purposes** as long as three criteria are met:
 - Purpose is not to generate an investment return
 - Sole purpose is to mitigate investment risks
 - In normal market conditions, FDI price movements must negatively correlated with investments being hedged
- The following restrictions apply when FDIs are acquired for **investment purposes**:
 - Net derivative exposure arising from these FDIs must not be more than 50% of CIS total NAV
 - FDIs should be listed/quoted on a stock exchange or dealt in OTC markets
 - FDI underlying assets, together with other CIS investments cannot, in aggregate, exceed any restrictions that apply to other CIS investments

Other Limitations

- A CIS is prohibited from:
 - Investing in physical commodities (SFC may override on a case-by-basis)
 - Investing in any interest in real estate (shares in real estate companies/REITs permitted)
 - Any transaction involving unlimited liability
 - Any naked or uncovered short selling
- Any security to be short sold must be **actively traded** on a market where short selling is permitted
- Liability of CIS for short selling **may not** exceed >10% of its total NAV
- Liability of holders must be limited to their investments in the CIS

- CIS **must not** acquire securities in an entity where:
 - Any individual directors/officers of management company of the CIS owns >0.5% of total nominal amount of all the issued shares in that class
 - Directors/officers combined of management company own >5% of securities
- CIS **must not** own securities with uncalled amounts not covered by freely available cash in CIS assets
- CIS **may not** borrow >10% of NAV (no limit on back-to-back borrowing)
- A CIS must maintain at least 100% collateralisation when engaging in securities margin financing
- CIS must invest 70% of non-cash assets in relevant investment category if name identifies particular objective, geographic location or market
- Any breach should be rectified within a reasonable time

4.2 Requirements for Specialized Schemes (Chapter 8 CUTMF)

- Chapter 8 of the CUTMF provides requirements, beyond the core requirements, for **the following specialised schemes**:
 - Money market funds
 - Unlisted index funds and index tracking exchange traded funds
 - Hedge funds
 - Structured funds
 - Funds that invest extensively in financial derivative instruments
 - Listed open-ended funds
 - Closed-end funds

4.2.1 Money Market Funds

- CISs that invest in **short-term and high-quality money market investments**, seeking to offer returns in line with money market rates
- Subject to the following investment restrictions:
 - Investments must be of high quality
 - **Weighted average maturity** of portfolio must not exceed **60 days**
 - **Weighted average life** of the portfolio must not exceed **120 days**
 - No instrument acquired may have a remaining maturity of more than **397 days** (2 years for Government/public securities)
- Instruments and deposits issued by a single issuer may not >10% NAV, except for:
 - 25% for a substantial financial institution as long as not >10% of issuer's share capital and reserves
 - 30% for Government and other public securities
 - No restriction if deposit <US\$1 million

- Aggregate value of investments in the same group may not exceed 20% of its total NAV, however the restriction will not apply:
 - To a deposit of less than US\$1m where the CIS cannot diversify as a result of its size
 - Where the entity is a substantial financial institution and the total amount is not more than 10% of share capital and reserves
- Borrowings must not be >10% of NAV and must only be on a temporary basis for redemption requests and operational expenses
- **Requirements relating to a money market's underlying assets:**
 - May not hold >10% of total NAV in money market funds authorised by the SFC
 - May not hold >15% of total NAV in asset-backed securities
 - Sale/repurchase and reverse repurchase transactions must be in accordance with CUTMF
 - Not <7.5% of total NAV must be held in daily liquid assets
 - Not <15% of total NAV must be held in weekly liquid assets
 - FDIs may only be used for hedging purposes

4.2.2 Unlisted Index Funds

- CISs that track a financial index or benchmark in order to match performance of the index/benchmark
- Underlying index needs to be acceptable, with:
 - Index reflecting underlying market sector
 - Broadly based
 - Investible, where applicable
 - Underlying assets should be liquid
 - Transparent and publically available
 - Objectively calculated and rules-based
 - Provider should have relevant experience
- Core investments of Chapter 7 apply
- Any replacement of index must be approved by SFC
- Financial statements of fund should disclose constituent securities accounting for >10% of weighting of index and comparison of performance of CIS and index

4.2.3 Passive ETFs (Index Tracking Exchange Traded Funds)

- Passive ETFs must be **listed and traded on the SEHK**. Obligations imposed with listed status are:
 - At least one market maker for the securities of the passive ETF
 - Any price sensitive information relating to the passive ETF must be disclosed by the management company as soon as possible to the SFC and ETF holders
 - Provision of certain trading information on the ETF's website
- The **ETF's website should contain** the offering document (including the Product KFS), the most recent interim and annual reports and all public announcements issued in Hong Kong
- Index fund limitations also apply to passive ETFs. The following **additional information**, in the following circumstances, must appear on ETF's website:
 - Where net derivative exposure exceeds 50% of total NAV
 - Where securities financing transactions exceed 50% of total NAV

4.2.4 Hedge Funds

- CIS with flexible investment policy, holds long and/or short positions, invests in derivatives, may use leverage and active trading techniques
- A fund of hedged funds (FofHF) invests all its non-cash assets in other hedge funds

Management Company

- Must satisfy requirements of Chapter 5 CUTMF
- Should have requisite competence, expertise, appropriate risk management and internal control systems
- Should be adequately and suitably staffed to manage risks and operational issues
- Should have at least 2 key personnel with at least 5 years general experience in hedge funds (at least 2 years in same hedge fund strategy or managing an FofHF)
- Should have at least US\$100 million in assets under management
- Ensure that risk management process can deal with normal and exceptional circumstances
- Ensure that any overseas operations have similar inspection and regulatory regime
- FofHF must undertake proper due diligence in selecting underlying funds

Prime Broker

- Must be a substantial financial institution with prudent supervision
- Management company must carry out due diligence on prime broker to ensure suitable and competent
- If assets charged to prime broker for financing then:
 - Assets must remain in segregated custody account in name of trustee/custodian
 - Risks must be disclosed in offer document
 - Charged assets must not exceed amount due to broker

Requirements for the Product

- Minimum initial subscription thresholds:
 - Single Hedge Fund: US\$50,000
 - FofHF: US\$10,000
 - Hedge Fund with at least 100% capital guarantee: No limit
- Limited liability products only
- Assets ring-fenced from liabilities of other sub-funds
- Clear documentation of investment and borrowing restrictions
- Diversification rules for FofHF
- At least one dealing day per month
- Fair valuation by a qualified and independent valuation agent
- Performance fees allowed (as long as full and clear disclosure on calculation methodology, compliance with “high-on-high” calculation basis and annual payment)
- Warning statements must be included in offer documents
- Disclosures must be in “plain language”

4.2.5 Structured Funds

- Structured funds are CISs that invest primarily in financial derivative instruments
- Normally passively managed to track performance of an index and/or make structured pay-outs when certain conditions are met
- The management company of the structured fund and the issuer of FDIs must be independent of each other
- Core requirements regarding collateral are varied to require full collateralisation and no net exposure to any single counterparty of OTC FDIs
- Additional disclosures are required in the offering document covering: scheme structure and attendant risks; potential conflicts of interest; cost of entering swaps and the entity responsible for FDI valuation

4.2.6 Funds that Invest in Financial Derivative Instruments

- CUTMF applies to actively managed CISs which principally invest in FDIs or acquire FDIs extensively for investment purposes
- FDIs can be acquired up to a maximum of 100% of the CIS's NAV

Disclosure

- A CIS must disclose additional risks associated with FDIs
- A summary of risk management policy and methods employed by the CIS must be available for inspection in Hong Kong

4.2.7 Listed Open-Ended Funds

- Listed and traded on the SEHK, other than passive ETFs and closed-ended funds
- Provisions applicable to passive ETFs are also applicable to active ETFs

4.2.8 Closed-Ended Funds

- Typically subject to redemption restrictions
- The shares/units must be listed and traded on the SEHK with an adequate spread of shareholders
- Mechanisms must be in place that address any prolonged significant discount of the secondary trading price in the fund's units/shares to its NAV
- The maximum time between a valid redemption request and payment of the redemption is 90 days
- Where the CIS proposes any redemption, takeover, merger, amalgamation or restructuring, the management company and trustee/custodian must consult with the SFC as soon as possible

5. COLLECTIVE INVESTMENT SCHEMES: MANAGERS AND TRUSTEES/CUSTODIANS

5.1 Management Companies (Chapter 5)

- Every authorized CIS must appoint a management company acceptable to SFC
- **One exception** is a **self-managed scheme**, where the CIS is managed by its own board of directors. Directors of a self-managed scheme are not allowed to deal with the scheme as principals. Self-managed schemes are not that common
- A management company must:
 - Be principally engaged in fund management
 - Minimum issued and paid up share capital and capital reserves of HK\$10 million or equivalent
 - Amounts due to a holding company can be included within the capital as long as amounts are subordinated to all other liabilities and are not repaid without prior SFC consent
 - Have no material lending
 - Have positive net assets at all times

Management and Internal Controls

- SFC expects management companies to have adequate staff and internal controls
- Directors must be of good repute with necessary experience
- Key personnel must have at least 5 years relevant experience (same type of investments managed)
- Key personnel must be full-time staff with track records of management of unit trusts and funds
- There must be sufficient resources without undue reliance on any single individual
- Adequate internal controls, written procedures, regulatory supervision by senior management, proper protection of investors and addressing conflicts of interest
- Supervision and monitoring of personnel in investment management function
- Management company may delegate its functions but remains primarily responsible

Licensing

- Management company operating in Hong Kong will need to be licensed or registered as an asset manager (Type 9 regulated activity)
- Management company also acting as a distributor will need to be licensed for dealing in securities (Type 1 regulated activity)
- Where the management company is based outside of Hong Kong it does not need to be licensed by the SFC
- However, overseas-based management companies need to have a similar regulatory regime
- Acceptable overseas jurisdictions include Australia, France, Germany, Ireland, Luxembourg, Malaysia, Taiwan, UK and USA
- Overseas-based management companies need to appoint a representative in Hong Kong (see below)
- Directors of a self-managed scheme do not need to be licensed by SFC

Obligations

- To manage the CIS in accordance with the constitutive documents and for the exclusive interests of the holders
- To fulfil the duties imposed by general law
- To maintain the books and records of the CIS, or cause them to be maintained
- To prepare the accounts and reports of the CIS (2 reports per year with interim issued within 2 months and final within 4 months to SFC and all holders)
- To ensure constitutive documents are available to public in Hong Kong
- To ensure that trustee/custodian is properly qualified and discharging its obligations
- To ensure that any representatives/agents appointed in connection with the CIS have sufficient knowledge and experience
- Establish effective risk management and control systems
- Ensure that the scheme is designed fairly and operated according to product design

Retirement of Management Company

- Provisions for removal must be set out at time of appointment
- Removal by written notice from trustees or directors if:
 - Management company goes into liquidation, becomes bankrupt or has a receiver appointed
 - A change is desirable in the interests of the holders
 - For a unit trust, if >50% in value of units outstanding request removal
- Trustee/directors of mutual fund corporation must notify SFC of decision to remove management company
- Management company must retire as provided for in the constitutive documents or if SFC withdraws its approval
- Appointment of new management company must be as soon as possible, subject to SFC approval

Non-Hong Kong-based CISs (Chapter 9)

- CISs are **normally established outside Hong Kong**. Where management company is also based outside Hong Kong, the CIS must appoint a representative in Hong Kong
- Such representatives must be either licensed/registered under the SFO or a Hong Kong registered trust company and **authorised to undertake the following matters**:
 - Receives application and money for units/shares from persons in Hong Kong, issues receipts for application money, issues contract notes, receives redemption notices, transfer instructions and conversion notes
 - Accepts notices and correspondence from unit holders to CIS, trustee/custodian or management company
 - Notifies SFC if any redemption process is suspended or ceases
 - Delivers accounts and records of sales and redemptions at request
 - Provides holders with information on CIS, including financial reports
 - Makes available copies of constitutive documents in Hong Kong for inspection
 - Represents CIS and management company
- However, representatives do not take responsibility for acts or omissions of management company or directors of a mutual fund corporation
- Representative must have a proper letter of appointment to represent CIS and management company with copies provided to the SFC and any changes notified
- Representative must provide SFC with a written undertaking that it will perform its duties
- Non-Hong Kong-based CIS must have a representative at all times

Appointment of Auditors (Chapter 5)

- Management company or directors of a mutual fund corporation must appoint an auditor for CIS at outset or on vacancy
- Auditor must be independent of the management company, trustee/custodian and, for mutual fund corporation, the directors

5.2 Trustees/Custodians (Chapter 4)

- Trustee is expected to fulfil duties imposed under general law of trusts and as set out in trust deed
- Custodians' responsibilities are set out in constitutive documents and custodian agreement
- Trustees/custodians are not directly regulated by SFC
- However, trustees/custodian must be acceptable to SFC for CIS to be authorized
- SFC specifies certain acceptability and responsibility requirements for trustees/custodians

Acceptability

- A trustee/custodian must be:
 - A licensed bank; or
 - A trust company which is a subsidiary of a licensed bank; or
 - A registered trust company; or
 - A banking institution or trust company incorporated outside of Hong Kong acceptable to the SFC
 - Independently audited
 - Have a minimum issued and paid up and non-distributable capital reserve of HK\$10 million or its equivalent
 - Alternatively, is a wholly-owned subsidiary of a substantial financial institution (NAV of HK\$2 billion) provided holding company will subscribe for required additional capital and undertakes it will not let its subsidiary default and will not dispose of the subsidiary

Independence

- The trustee/custodian and management company must be independent of each other
- If the trustee/custodian and the management company have the same holding company then they will be taken as independent if:
 - They are both subsidiaries of a substantial financial institution
 - Neither is a subsidiary of the other
 - They do not have a common director, and
 - Both sign an undertaking to act independently

Obligations

- Take custody of or control over property of CIS
- Hold property of CIS in trust for unit holders or beneficiaries of mutual fund corporation
- Register cash and registerable assets in its name
- CIS property must be segregated from property of others, including management company and trustee/custodian
- CIS property must also be segregated from other clients of trustee/custodian, except where an omnibus account is operated to international standards
- Assume liability for acts and omission of its nominees or agents if they effect the assets of the CIS
- Ensure that sale, issue, repurchase, redemption and cancellation of units/shares are in accordance with CIS provisions and valuation basis
- Carry out the investment instructions of management company (unless they conflict with constitutive documents or CUTMF)
- Ensure that investment and borrowing restrictions complied with
- Issue a report to holders on whether the management company has managed CIS in accordance with constitutive documents
- Ensure units/certificates are not issued until the amount of subscription money has been paid
- Ensure that CIS cash flows are properly monitored
- Exercise care in selection and appointment of nominees, agents and delegates who should be suitably qualified
- Have procedures to report to SFC any material or potential breaches in discharging obligations

Supervision and Internal Controls

- Trustee/custodian must:
 - Be subject to ongoing regulatory supervision (which includes regular inspections and reviews), or
 - Appoint an independent reporting accountant (“Auditor”) to periodically review its internal controls and systems (with SFC setting terms of reference and receiving report)

Internal Control Review

- Management of the trustees/custodian are required to issue a report to describe the control objectives and the internal control policies and procedures
- The engagement letter with auditor should include terms of reference set by SFC and also those covered in Appendix G of CUTMF
- The internal control review should:
 - Assess whether the internal controls and systems of the trustee/custodian are adequate and sufficient
 - Cover all material procedures and controls
 - Review whether different classes of investors are treated fairly
 - Carried out in accordance with international standards
 - Cover a minimum period of 12 months (in line with financial year)
 - Be conducted at least annually
- The auditors' report should describe the work done and the conclusions reached

Retirement

- The trustee/custodian must make a new appointment, approved by SFC, before it can retire
- Retirement and new appointment must be simultaneous

6. CODE ON OPEN-ENDED FUND COMPANIES

- OFCs allow investment funds in Hong Kong to be established as **incorporated companies with limited liability and variable capital** as an alternative to the unit trust structure
- The OFC Code applies to both public and private OFCs and their key operators
- A **public OFC** is authorised by the SFC and a **private OFC** is not a public OFC
- Code requirements applicable to all open-ended fund companies cover:
 - General principles
 - Registration and naming
 - Directors
 - Investment manager
 - Custody of OFC assets
 - Administration of the OFC
 - Audit and annual accounts
 - Termination and cancellation of registration
- There are additional **Code requirements for private OFCs** covering:

Investment Scope

- Private OFCs are designed to operate as investment vehicles and so should not operate as corporate entities for general commercial business or trade
- At least 90% of an OFC's gross asset value must be invested in normal asset management classes of investment (listed equities, debt, FX and cash)

Changes to the scheme

- Any change to the instrument of incorporation must have shareholder approval

Fund operations

- The instrument of incorporation should clearly set out details of: pricing, dealing, issue and redemption of shares, valuation, distribution policy, use of leverage, fees and charges

Disclosure

- An OFC must file its offering document with the SFC as soon as practicable
- Any changes to the offering document must be filed within 7 days of issuing the revised document

7. REAL ESTATE INVESTMENT TRUSTS

- As per the SFO, REITs must be authorised by the SFC
- Specific SFC requirements are provided in the SFC Code on REITs

7.1 Authorisation

- To be authorised by the SFC, a REIT must have the following characteristics:
 - A CIS constituted as a trust, not a company
 - Invest in real estate that generates recurrent rental income
 - Active trading in real estate is restricted
 - The majority of income must be derived from real estate rental income
 - A significant proportion of income must be distributed as dividends
 - A maximum borrowing limit must be defined
 - Connected party transactions are subject to holders' approval
- Real estate covers land or buildings (freehold or leasehold), car parks and incidental assets (eg fixtures and fittings)
- A Hong Kong resident must be nominated and approved by the SFC to be served with notices and decisions
- An SFC authorised REIT must be listed on the SEHK within an acceptable period

7.2 Other Parties Involved

7.2.1 Trustee

- A REIT trustee must be acceptable to the SFC, requiring it to be:
 - A bank licensed under the Banking Ordinance;
 - A trust company which is a subsidiary of such a bank; or
 - A bank or trust company incorporated outside Hong Kong, acceptable to the SFC
- A trustee must:
 - Be independently audited;
 - Meet specific capital requirements; and
 - Be independent of the management company
- A trustee's duties are to:
 - Act in a fiduciary capacity to hold the REIT's assets in trust for the benefit of the holders;
 - Oversee investment and other activities of the management company; and
 - Ensure all activities comply with the scheme's constitutive documents, applicable regulations and the scheme's investment objectives

7.2.2 Management Company

- Every REIT must appoint a management company **licensed** under the SFO that is **acceptable** to the SFC
- SFC will consider management companies licensed by securities regulators of **acceptable overseas regimes** (*Australia, Germany, Ireland, Luxembourg and the UK*)
- Must have **adequate experience** and operational and financial resources
- Must have **two responsible officers** with at least five years experience in investment management, at least one of whom must be available at all times to supervise
- Primary duty is to manage the scheme, **making investment decisions** in line with the scheme's constitutive documents

7.2.3 Retirement

- Both a trustee and a management company can retire under specified circumstances
- When a management company retires, a new management company shall be appointed **as soon as possible** by the trustee
- One trustee cannot retire until another is appointed

7.2.4 Other Parties

- **Listing Agent:** prepares trust for a stock exchange listing, carrying out same duties as the sponsor of an IPO
- **Financial Adviser:** Helps with particular transactions
- **Auditor:** Must be independent of trustee and management company
- **Principal Valuer:** Responsible for valuing all real estate held under the scheme

7.3 Investment Considerations

- A scheme shall invest primarily in real estate, which should be income generating
- Schemes are **prohibited** from:
 - Investing in vacant land or property development
 - Lending money
 - Using scheme property as security
- Schemes are permitted to invest in real estate outside Hong Kong
- Transactions must be at arms length; connected party transactions are allowed if consistent with scheme investment objectives
- At least 90% of annual net income must be distributed as dividends

7.4 Other Considerations

- Offering documents and constitutive documents must comply with the Code on REITs
- A register of holders must be maintained in Hong Kong
- Audited annual and semi-annual reports should cover matters set out in the Code on REITs
- New issue of units must be offered to existing holders on a pro-rata basis
- Advertisements and other invitations must not be false, biased, misleading or deceptive
- REITs are subject to the SEHK Listing Rules and the SFC Code on Takeovers and Mergers

8. LIQUIDITY RISK MANAGEMENT CIRCULAR

- Effective 1 January 2017, management companies of SFC-authorized funds are expected to follow a set of principles covering liquidity risk management of funds
- The principles cover five key areas, as follows.

8.1 Governance

- Liquidity risk management policies and procedures should be proper, up-to-date and overseen by effective, independent personnel

8.2 Product Design and Disclosure

- Management companies need to understand the profile of the fund's investors and their historical and expected redemption patterns
- Management companies need to disclose in funds' offering documents:
 - Significance and potential impact of liquidity risks on funds and their investors
 - Summary of liquidity risk management process
 - Liquidity risk management tools

8.3 Ongoing Liquidity Risk Assessment

- Management companies should:
 - Regularly assess liquidity profile of fund's liabilities and assets
 - Classify assets into different liquidity categories, setting internal targets/indicators on how much should be invested in each category

8.4 Stress Testing

- Management companies should regularly stress test for different market conditions and adequacy of fund's action plan and risk management tools
- Stress test results should be reviewed by liquidity risk management committee/senior management

8.5 Liquidity Risk Management Tools

- Management companies should ensure that they have the necessary liquidity risk management tools in place

9. MUTUAL RECOGNITION OF FUNDS (MRF)

- CISs that have been authorised in an MRF jurisdiction can be authorised by the SFC under a streamlined process allowing the scheme to be offered to the Hong Kong public
- Unlike an RJS scheme, an MRF scheme is two-way
- Mutual recognition allows funds authorised or registered for sale to the public in one jurisdiction (“Home Jurisdiction”) to be made available to the public in the other jurisdiction (“Host Jurisdiction”)
- SFC has entered into six MRF schemes to date:
 - May 2015: China
 - December 2016: Switzerland
 - July 2017: France
 - October 2018: United Kingdom
 - Followed by: Luxembourg and the Netherlands

9.1 Mainland China – Hong Kong MRF Scheme

- The first MRF scheme to be put in place was with Mainland China
- In May 2015, a memorandum was signed between the SFC and the China Securities Regulatory Commission (CSRC)
- This study material covers funds authorised or registered in Mainland China, and authorised by the SFC for offering in Hong Kong
- Accordingly, this material refers to China as the Home Jurisdiction and Hong Kong as the Host Jurisdiction

9.2 Eligible Funds

- Only specified funds may apply under the MRF scheme. Currently they are:
 - General equity funds
 - Bond funds
 - Mixed funds
 - Unlisted index funds
 - Physical index-tracking ETFs
- Recognised Mainland Funds must be registered with the CSRC for sale in Mainland China and must:
 - Have been established for more than one year
 - Have a minimum fund size of RMB200 million
 - Not invest primarily in the Hong Kong market
 - Have no more than 50% of its total assets held by Hong Kong investors

9.3 Ongoing Requirements

- A Recognised Mainland Fund authorised in Hong Kong must observe the following obligations:

In Home Jurisdiction (Mainland China)

- Remain supervised and regulated by the regulator
- Remain compliant with its constitutive documents

In Host Jurisdiction (Hong Kong)

- Comply with regulations relating to sale and distribution of the fund
- Comply with additional rules in the Host Jurisdiction
- Make constitutive documents available for inspection
- Have a bilingual offering document and a Product KFS – if original documents are in simplified Chinese, traditional Chinese will be required for the Hong Kong documents
- If fund ceases to meet Host Jurisdiction requirements, it must notify Host regulator, cease marketing and stop accepting subscriptions

In Both Jurisdictions

- Ensure that holders of the fund receive fair and equal treatment
- Disclosure information made available in one market must be made available to the other market at the same time (both to investors and regulators)
- Notifications made to the Home jurisdiction regulator must, at the same time, be made to the Host regulator
- Ensure that Hong Kong courts are not excluded from accepting an action concerning the fund
- Changes made to the fund in accordance with Home regulations must be filed with the the Host regulator
- Any breach of laws/regulations must be notified to both regulators at the same time

9.4 Requirements on Management Firms and Custodians

- Mainland management firms and custodians of Recognised Mainland Funds must comply with applicable Mainland laws
- A Mainland management firm must be licensed by the CSRC
- A Mainland custodian must be qualified to act as custodian of publicly offered investment funds
- SFC requires management firms not to have been the subject of any CSRC regulatory actions in the three years prior to application
- SFC prohibits Mainland management firms from delegating management functions to anyone operating outside the Mainland

9.5 Application Process

- SFC has published an information checklist for Mainland Funds wishing to be authorised for Hong Kong distribution. Applicants should consult with the **Investment Products Division** with any queries
- Prior to any application, the Mainland management company must have engaged in the **internal product approval process** set out in the SFC's Internal Guidance. A written confirmation of compliance is needed
- The Mainland management firm will need to complete and submit an information checklist. Significant items of information required to be submitted are:
 - General information about the Fund
 - Details and licensed status of the fund manager and custodian, including any regulatory actions taken against them
 - Information on the Hong Kong representative
 - Hong Kong offering document
 - Product KFS
 - Latest audited report of the Recognised Mainland Fund
 - A completed checklist indicating whether the Recognised Mainland Fund complies with regulatory requirements, particularly the CUTMF
- Recognised Mainland Fund must appoint a Hong Kong representative who will perform duties as outlined in CUTMF and nominate a Hong Kong approved person, ordinarily resident in Hong Kong, to receive SFC notices
- Any applicant providing information to the SFC that is false or misleading will be committing an offence under the SFO

10. MANDATORY PROVIDENT FUND (MPF) PRODUCTS

- MPF products that are subject to authorisation requirements include:
 - Pooled retirement funds (PRFs)
 - MPF schemes
 - Pooled investment funds which may be for retail investors in general or MPF contributors only
- A six-month application lapse policy applies to new MPF and PRF products seeking SFC authorisation (effective May 2016) – in line with other SFC-authorized investment products
- The concept of a **Default Investment Strategy (DIS)** was introduced to MPF Schemes from 1 April 2017
- New constituent funds and pooled investment funds are required to be set up as building blocks for DIS, subject to approval from MPFA and SFC

10.1 Pooled Retirement Funds (PRFs)

- PRFs were non-mandatory schemes set up for retirement purposes prior to implementation of the MPF system and are subject to Occupational Retirement Schemes Ordinance (ORSO)
- Applicant company must be:
 - Authorized insurer; or
 - A company supervised by a regulatory authority acceptable to SFC (in Hong Kong or overseas)
 - Have a management company and trustee acceptable to the SFC
- An overseas incorporated applicant without a place of business in Hong Kong must appoint a representative in Hong Kong
- The principal brochure should contain information to enable prospective investor to make an informed judgment and will be similar to offering document under CUTMF
- The constitutive documents will be a policy document for an insurance arrangement PRF and a trust deed for a trust PRF
- Advertising requirements are covered in the **CIS Advertising Guidelines**

10.2 MPF Products

- MPF schemes have two or more constituent funds, giving scheme members a choice of investments
- Constituent funds may have direct investments or invest in pooled investment funds
- MPF schemes must be registered with the MPFA
- All constituent funds and pooled investment funds must be approved by the MPFA
- SFC is responsible for authorising MPF schemes, constituent funds and pooled investment funds with an emphasis on vetting/authorising information disclosure and marketing materials

- SFC will authorise pooled investment funds that are only made available to MPF schemes under the SFC Code on MPF Products
- SFC will authorise pooled investment funds that are available to both MPF service providers and retail investors under the CUTMF
- Each MPF scheme is required to provide a Default Investment Strategy (DIS), which is a highly standardised and fee-controlled MPF investment strategy with the objective of building up long-term retirement savings. Scheme members who do not choose their MPF investments, will have their benefits invested according to their scheme's DIS. Scheme members can also choose to opt for the Scheme DIS

10.2.1 SFC Code on MPF Products

- During the vetting process, the SFC will consider **offering document disclosure requirements** and qualifications/experience of the investment manager
- SFC also monitors/authorises **advertisements for MPF products**
- Applications for MPF product authorisation is dealt with by the **Investment Products Division**

Application form and supporting information

- Separate application form for each scheme or fund
- MPFA and SFC receive the same **package of information**, including:
 - Profile of investment manager (if not previously approved by SFC)
 - Offering documents
 - Constitutive documents
 - Copies of any material contracts (investment management contract)
 - Proposed sales and advertising material
 - Trustee's written approval for any delegation of investment functions
 - Trustee's written approval for exchange of information between MPFA and SFC
- Core disclosure requirements in the **offering document** (as per SFC Code on MPF Products Chapter 5)
 - Constitution of scheme and fund
 - Operators and principals
 - Constituent funds
 - Investment policy and restrictions (no forecasts allowed)
 - Valuation of constituent funds and pooled investment funds
 - Contributions and withdrawals
 - Fees and charges
 - Warning notifications
 - Governing law
 - Impact of taxation

- Provision of accounts and reports
- There are additional disclosure requirements for **specialized products**:
 - Capital preservation, money market and cash management funds; and
 - Guaranteed funds

10.2.2 Registration and Approval by the MPFA under the Code on MPF Investment Funds

- MPFA looks at operational and investment aspects
- General focus is on compliance with MPF legislation
- MPFA protects MPF scheme assets and liabilities by:
 - Requiring proper trust arrangements
 - Requiring MPF trustees to take out adequate insurance cover
 - Covering losses attributable to misconduct through compensation fund arrangements

10.3 PRFs Under the Code on Pooled Retirement Funds

- The core investment requirements for CISs under CUTMF apply to PRFs
- No money from a PRF portfolio may be invested in securities of or lent to an applicant company, the management company, the guarantor, the trustee or any connected person except:
 - where any are a substantial financial institution or an insurance company; or
 - the securities are authorized CISs

10.4 Investment of MPF Products

10.4.1 Requirements under SFC Code on MPF Products

- SFC sets investment requirements for approved pooled investment funds that are authorized unit trusts or authorized mutual funds under CUTMF; not MPF products
- The only requirements for constituent funds and pooled investments are:
 - If constituent fund indicates a particular objective, geographical region or market, the fund should invest at least 70% of its total NAV to reflect the fund description
 - Fund name should not imply investments in money market or cash management funds is same as placing cash on deposit with AFI

10.4.2 Requirements under Code on MPF Investment Funds

- Each constituent fund and approved pooled investment fund must have a statement of investment policy covering:
 - Investment objectives
 - Kinds of securities and other assets in which investments will be made
 - Balance between various kinds of securities and markets

- Risk of investment strategy and expected returns of portfolio
- Policy on holding financial futures and options contracts
- If fund will conduct securities lending
- Constituent funds:
 - May only invest in permissible investments as per MPF Schemes (General) Regulations
 - Borrowing may not >10% NAV
 - Borrowing for settlement is only allowed for unexpected temporary need

10.5 Ongoing Requirements

- There are ongoing MPF Scheme regulatory requirements from both the SFC and the MPFA

10.5.1 SFC Code on MPF Products

- Offering documents should:
 - be up to date
 - be consistent with constitutive documents
 - contain performance data/estimated yield which can be substantiated
 - not contain forecasts except when an investment return is guaranteed

10.5.2 MPFA Requirements

- Constituent funds must have different investment policies
- All constituent funds must be available to all scheme members
- There must be at least **one dealing day per month**
- All constituent funds must be **unitized** (except if not investment linked and provide guarantees)
- Each MPF fund must have a **capital preservation fund**
- Prices of funds (other than employer-sponsored funds) must be published in a Chinese and an English newspaper
- **Capital preservation funds** are low-risk investments with expected returns in line with bank savings deposit rates. They must
 - be totally invested in HK\$ short term bank deposits or debt securities guaranteed by Government
 - have an average investment period not exceeding 90 days
- **Approved pooled investment funds** must meet following requirements:
 - Basis of all charges and details of guaranteed returns must be disclosed
 - Investment manager charges must be shown as % of fund assets
 - No extra initial charges where fund invests in fund it manages
 - Investments allowed in SFC authorized unit trusts or mutual funds