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Submitted electronically to
utc-consultation@sfc.hk

Ashley Alder
Chief Executive Officer
Securities and Futures Commission
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Hong Kong

Re: Consultation Paper on Proposed Amendments to the Code on Unit Trusts and Mutual Funds (Consultation Paper)

Dear Mr. Alder,

ICI Global¹ commends the Hong Kong Securities and Futures Commission (SFC) for undertaking a holistic review of the Code on Unit Trusts and Mutual Funds (UT Code) to ensure that regulations in Hong Kong are aligned with global standards and those of international fund markets. Hong Kong is a dynamic, global asset management centre with a diverse array of funds available to retail investors. Many of our member firms already sponsor public funds authorized by the SFC (domiciled in Hong Kong or outside of Hong Kong, *e.g.*, UCITS); many others are considering whether and/or how to enter the Hong Kong public fund market.

We strongly support further strengthening of Hong Kong's regulatory framework for collective investment funds offered to the retail public, which will bolster Hong Kong's reputation as a desirable destination for asset managers seeking to offer funds to retail investors. We fully support SFC's efforts to provide an up-to-date regulatory framework for public funds that is in line with international standards and that of key overseas markets. This work will benefit investors, fund

¹ [ICI Global](#) carries out the international work of the [Investment Company Institute](#), the leading association representing regulated funds globally. ICI's membership includes regulated funds publicly offered to investors in jurisdictions worldwide, with total assets of US\$28.8 trillion. ICI seeks to encourage adherence to high ethical standards, promote public understanding, and otherwise advance the interests of regulated investment funds, their managers, and investors. ICI Global has offices in London, Hong Kong, and Washington, DC.

managers, and the Hong Kong financial services industry as a whole by, among other things, increasing trust and confidence in the regulatory framework. Specifically, we are pleased that the SFC adopted the suggestion from our response to the SFC's 2017 soft consultation to indicate clearly the provisions that would be applicable to UCITS² by proposing to include an appendix specifying the relevant provisions.

Although we support most aspects of the proposed changes to the UT Code, we are concerned that in a few areas the SFC may be taking steps that appear to be inconsistent with Hong Kong's position as a global fund centre/market. Our suggested revisions to the proposed UT Code changes are described briefly below and in more detail in the subsequent sections.

- Proposed Derivatives Classifications and Restrictions. We urge the SFC to eliminate the proposed classifications and limits based on the calculation of notional exposure because this type of approach would impose arbitrary limits that do not reflect economic exposure or risk. If the SFC were to proceed with the proposed approach, however, we urge the following to reduce its negative effects: disconnect the automatic designation of funds that use derivatives more frequently as “derivatives products” under the Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct) (with significant additional distribution and disclosure requirements); eliminate the minimum subscription amounts required based on notional exposures; and expand and clarify the “for hedging purposes” exclusion.
- Investment Experience and Expertise. We request that the SFC permit fund managers to effect an investment manager change without prior SFC approval so long as certain conditions are met.
- Diversification Requirements. We request that the proposed diversification provision limiting the value of a fund's cash deposits with the same entity to 20 percent include additional exemptions for unusual circumstances to make the exemptions useful and practically workable.
- Investment in Other Schemes. We request that the Note on investments in other schemes clearly state that a determination of how an exchange traded fund (ETF) is treated (whether considered a listed security or a collective investment scheme) is to be made at an individual fund level.
- Counterparties. We request that the SFC delete the requirement for a counterparty to a securities financing transaction to be a “substantial financial institution” as defined in the UT Code and instead allow the fund manager to have discretion to determine the appropriateness of a fund's counterparty.

² See Letter from Qiumei Yang, CEO, ICI Global Asia Pacific, dated June 9, 2017, available at https://www.iciglobal.org/pdf/17_ici_softcode_ltr.pdf/ (ICI Global Soft Consultation Response).

- Securities Financing Transactions Indemnification. We request the removal of the requirement for securities lending agents to indemnify a fund against counterparty default.
- Collateral Requirements. We request that the SFC confirm that the fund manager may determine that, for certain assets, it would be appropriate not to take any haircut based on the fund manager's assessment of the market risks of those assets.
- Money Market Funds. We request that the SFC clarify and expand the guidelines regarding reverse repurchase agreement collateral to include specifically government securities. Additionally, we request that the liquid asset definitions be expanded to include government securities.
- Valuation and Pricing. We request that the SFC confirm that the requirement to notify the fund's trustee/custodian of any pricing error applies only to a material error that would impact the price as published to the public.
- Implementation Timeline. We request that the SFC provide a 24-month transition period rather than the 12-month period as currently proposed.

Proposed Derivatives Classifications and Restrictions

Response to Question 6: Do you have any comments on the proposal to introduce an overall limit on derivatives investments for a plain vanilla public fund? Do you consider the proposed 50 percent limit appropriate? Please explain your views.

The SFC proposes to modify its current derivatives classification system and requirements for Hong Kong-domiciled funds and extend them to other funds, including UCITS. The SFC is proposing the changes with the goal of improving the transparency and overall regulation of funds' use of derivatives.³ Similar to its current classification system for Hong Kong-domiciled funds, the SFC proposes to impose differing requirements on three categories of funds: plain vanilla funds; derivatives-based funds; and retail hedge funds. First, the SFC would broaden the definition of a "plain vanilla" fund from those funds that limit their derivatives use to futures, options, and warrants (each with separate limits)⁴ to those funds that invest up to 50 percent of their NAV in

³ In the UT Code the term "scheme" is used to refer to the collective investment schemes that are regulated under the UT Code; in the executive summary the SFC generally uses the term "fund." We use the term "fund" throughout this letter to refer to "schemes" under the UT Code, as applicable.

⁴ Currently, a plain vanilla fund may enter into futures contracts for non-hedging purposes provided the net total aggregate value of the contract prices, together with the aggregate value of holdings of physical commodities and commodities-based investments, do not exceed 20 percent of the fund's net asset value (NAV). A plain vanilla fund may not invest in warrants and options for non-hedging purposes in amounts greater than 15 percent of its NAV. In

any type of derivatives under a proposed commitment approach.⁵ Second, the SFC would identify “derivatives-based funds” as those funds that can invest up to 100 percent of their NAV in derivatives under a proposed commitment approach. Third, the SFC would consider “retail hedge funds” to be funds that may invest in derivatives without any limit, subject to enhanced requirements, including a minimum initial subscription of at least \$50,000 US. All funds would provide disclosure about the purpose of, and anticipated maximum range of, their derivatives use based on the proposed commitment approach.⁶

The SFC would impose additional requirements on derivatives-based funds and retail hedge funds. Specifically, the SFC would treat derivatives-based funds and retail hedge funds as “derivative products” subject to enhanced distribution requirements under 5.1A and 5.3 of the Code of Conduct. Those provisions would impose additional know-your-client assessments on persons licensed by or registered with the SFC when selling those products. Moreover, the SFC would require both derivatives-based funds and retail hedge funds to provide additional plain language disclosure about the risks associated with derivatives and the risk management policy and methods employed to measure and manage derivatives risks.

ICI Global supports the SFC’s goals of improving transparency and the overall oversight of funds using derivatives. We applaud the SFC’s intention to remove the restriction that certain funds (*i.e.*, plain vanilla funds) only invest in futures, options, and warrants. Eliminating this restriction would enable all funds to increase efficiency and cost savings by expanding the choices available to them to manage their portfolio consistent with their investment strategies.

We are deeply concerned, however, with the SFC’s proposal to classify funds and impose significant restrictions on funds’ derivatives use. As we previously have noted to regulators in other major jurisdictions, use of any gross notional exposure-based test may overstate the true economic risk of

addition, a plain vanilla fund may not write call options on portfolio investments in amounts greater than 25 percent of its NAV. *See* footnote 12 of the Consultation Paper.

⁵ Under the proposed commitment approach, derivatives positions acquired for investment (*i.e.*, non-hedging purposes) are converted into the equivalent prevailing market values in their underlying assets. In other words, derivatives positions for hedging purposes would be excluded from the test. *See* footnote 13 of the Consultation Paper. The SFC generally would consider derivatives to be acquired for “hedging purposes” if they meet all the following criteria: (a) they are not aimed at generating any investment return; (b) they are solely intended for the purpose of limiting, offsetting, or eliminating the probability of loss or risks arising from the investments being hedged; (c) although they may not necessarily reference the same underlying asset, they should relate to the same asset class with high correlation in terms of risk and return, and involve taking opposite positions, in respect of the investments being hedged; and (d) they exhibit price movements with high negative correlation with the investments being hedged under normal market conditions. *See* proposed Chapter 7.25 of the UT Code.

⁶ Funds could provide these disclosures in ranges, such as: up to 50 percent; more than 50 percent and up to 100 percent; or more than 100 percent and up to [x] percent of the fund’s NAV. *See* paragraph 47 of the Consultation Paper,

the fund's exposure to derivatives.⁷ In addition, many funds may be unable to reduce appropriately their gross notional exposures because the "for hedging purposes" exclusion under the proposed approach may be difficult to implement in practice. Before discussing our concerns with the SFC's proposal, we describe how fund managers commonly use derivatives to manage a fund's portfolio.

Benefits of Derivatives

As the SFC notes, financial innovation and changing investment needs have led to funds' increased use of derivatives.⁸ Derivatives have become important and practical portfolio management tools as funds look to increase efficiency, enhance liquidity, and reduce costs for their investors. Funds utilize derivatives to achieve these results in several ways, including:

- Hedging risk. Derivatives enable funds to manage a variety of risks, including interest rate risk, credit risk and currency risk. Using derivatives, for example, a portfolio manager may seek to hedge the currency risk of a Japanese -denominated security by purchasing a currency forward that neutralizes the impact on the fund when the value of the yen falls against the HK dollar. This serves to eliminate or minimize currency risk – *i.e.*, currency fluctuations between the HK dollar and the yen – on the fund's performance, providing investors only the return of the Japanese security.
- Managing interest rate risk and duration. Many funds use interest rate derivatives to adjust interest rate exposure, offset risks posed by interest rate volatility, and increase or decrease the duration of their portfolios. Funds use derivatives to more precisely target specific risks and reduce a portfolio's volatility at lower costs than using physical securities. For example, a portfolio manager holding a portfolio of bonds may believe that interest rates will rise. To reduce volatility caused by the change, the portfolio manager may enter into interest rate swaps in which the fund receives a floating rate of interest based on daily interest rates and pays a fixed rate of interest. Entering into these swaps could offset the expected effect that the increase in interest rates would have on the price of bonds in the fund's portfolio.
- Enhancing liquidity compared to other, more traditional securities. Derivatives can enhance substantially the liquidity profile of a fund. They allow a fund to reduce market exposure efficiently. For example, a corporate bond fund often can sell US treasury futures or index-based credit default swap (CDS) more quickly and efficiently with one or a few transactions and with minimal impact on the bond market than it could if selling corporate bonds individually.

⁷ See, e.g., Letter from David W. Blass, General Counsel, Investment Company Institute, to Brent J. Fields, Secretary, Securities and Exchange Commission, dated March 28, 2016, available at <https://www.sec.gov/comments/s7-24-15/s72415-114.pdf>.

⁸ See paragraph 40 of the Consultation Paper.

- Gaining or reducing exposure, including when access by other instruments is difficult, costly, or practically impossible. A fund can access certain asset classes, including some emerging market assets and currencies or commodities, more efficiently and at a lower cost through derivatives than through other means and without materially changing the risk profile of the fund. Indeed, a fund might otherwise have no other access to these assets. A fund, for example, would have difficulty obtaining direct exposure to A-shares in China. A fund or other foreign investor typically must obtain a license to be a qualified foreign institutional investor, a process that may be costly and lengthy. Faced with this hurdle, a fund could obtain indirect exposure to the A-shares market by entering into a total return swap or other form of derivatives contract.⁹
- Managing or equitizing cash. A fund that receives varying amounts of cash daily may invest that cash in derivatives almost immediately to gain exposure to a stock or bond market quickly while maintaining liquidity. Use of derivatives in this manner puts cash to work faster, in line with investment objectives, and often reduces impact costs by allowing the fund to increase gradually its direct positions in stocks and bonds. Portfolio managers of actively-managed equity funds with inflows, for example, could buy S&P 500 futures on a temporary basis to gain immediate exposure to the equity market. This portfolio management tool allows a fund manager to time stock purchases and accumulate shares while minimizing any adverse price impact caused from purchasing large blocks of shares. This strategy also minimizes any negative effect on a fund's performance caused by holding excess cash in lieu of equities.
- Reducing costs or managing portfolios efficiently. A fund could use one derivative or a small number of derivatives to obtain exposure to the return of a broad-based stock or bond index without having to purchase each of the stocks or bonds in the index individually. The derivative contract likely costs substantially less than directly acquiring and holding the index constituents to achieve the return of the broad-based stock or bond index. Portfolio managers use index-based CDS as another means to gain exposure to a portfolio of bonds. Index-based CDS have deep liquidity and generally cost less to trade than a basket of cash bonds.

Issues with the Proposed Approach to Derivatives

We believe that the SFC's proposed classification system could unnecessarily hamstring a fund's ability to use derivatives in ways that are beneficial to investors. First, the proposed approach imposes limits that are not necessarily related to economic exposure or risk. As a result, some funds will be mischaracterized and treated as being riskier than they truly are, exposing them to additional regulatory requirements and severe practical repercussions. Second, the proposal's exclusion for hedging instruments is too narrow and would force many funds to count certain risk-reducing

⁹ Chinese A-shares are Renminbi-denominated common stock listed and traded on the Shanghai or Shenzhen exchanges in China. They account for nearly 98 percent of total tradable shares in the People's Republic of China stock exchanges.

derivatives toward the proposed limits. As a result, to avoid breaching the limits, funds will avoid or limit their use of these instruments, including duration-adjusting derivatives, that otherwise could alleviate portfolio risk. Bond funds, which often use derivatives to adjust their portfolio duration and exposures, may suffer disproportionately from the impact of these proposed regulations. Overall, the proposed classification system could substantially reduce the use of an invaluable portfolio management tool that has served investors across the globe so successfully. For these reasons, we urge the SFC to reconsider the proposed classifications and restrictions.¹⁰

Gross Notional Exposure is not an Accurate Measure of Economic Exposure or Risk

We firmly believe that limits that rely on gross notional exposure are problematic because the exposure calculation does not provide an accurate measure of economic exposure or risk.¹¹ Simply adding up the notional exposures of derivatives, even under a commitment method that excludes derivatives used for “hedging,” gives an inaccurate picture of the amount of leverage and economic risk within a fund portfolio.¹² Rather, notional exposures could overstate a fund’s obligations and the economic risks associated with derivatives transactions. In fact, notional exposure has little relationship to the return volatility of a fund (often used in finance as an indicator of risk). Consequently, the proposed test would restrict a fund’s use of derivatives beyond the extent necessary to accomplish the SFC’s goals and to the detriment of fund investors.

¹⁰ As the SFC notes, under the EU regulatory regime, UCITS funds can choose to be subject to a limit on derivatives investments similar to the proposed commitment approach or a value-at-risk (VaR) approach where no limit on derivatives is imposed. See paragraph 39 of the Consultation Paper. We understand that a large majority of UCITS that use derivatives rely on the VaR approach. US-registered funds currently are not subject to a limit based on gross notional exposure as long as they set aside assets to cover the amount of their obligations under the derivatives contract and/or implement offsetting positions.

¹¹ See, e.g., *supra* note 7.

¹² Other government bodies share this view. For example, in 2017, the US Treasury Department, when reviewing a proposed rule from the US Securities and Exchange Commission (SEC) that would have imposed limits on a fund’s use of derivatives based on notional exposures, stated:

... high gross notional exposure of a fund’s portfolio is not necessarily correlated with leverage or risk levels. A recent study conducted by economists at the SEC’s Division of Economic and Risk Analysis noted that similar notional amounts of derivatives across different underlying asset classes generally do not represent similar units of risk. High gross notional amounts could lead to a fund being more risky, less risky, or equally risky compared with a fund that has no derivatives exposure. Using the gross notional amount as a measure for derivatives exposure risks does not take into account the beneficial effects of using derivatives in portfolio management. Absent a clearly defined connection between gross notional amounts of derivatives and leverage, and evidence that derivatives used for leverage create unacceptable levels of risk, the SEC’s proposed rule is problematic. (footnotes omitted)

See US Treasury Department, A Financial System that Creates Economic Opportunities – Asset Management and Insurance (Oct. 2017) at p. 37, available at https://www.treasury.gov/press-center/press-releases/Documents/A-Financial-System-That-Creates-Economic-Opportunities-Asset_Management-Insurance.pdf.

The following two-step example illustrates how a relatively low-risk bond fund might be considered to be a “retail hedge fund” under the proposal. As noted above, portfolio managers utilize a variety of derivatives to mitigate risks, such as those arising from changes in exchange rates, interest rates, and credit quality. For instance, portfolio managers may utilize foreign exchange (FX) futures, forwards, options, and other FX derivatives contracts to hedge a fund’s exposure to currency risk.

Consider a bond fund (Fund A) that offers exposure to GBP10 million in government bonds issued by the British government (Gilts). The fund is registered to be sold to investors in Hong Kong and is denominated in HKD. As shown in Figure 1, the fund manager has opted to mitigate losses to Fund A arising from an appreciation in the HKD by initiating an FX forward contract with a notional exposure of GBP10 million that gives the fund a short position in HKD.

Under the proposed approach, Fund A has no notional exposure and would fall into the category of a “plain vanilla” fund as described in the SFC proposal. The fund manager makes this determination because the currency forward is considered “for hedging purposes” under the proposed approach and the GBP10 million notional exposure of the forward contract is not included in the fund’s calculation of the value of its notional exposure relative to its total net assets.

Figure 1: Fund A Uses Currency Hedge and Has Zero Percent Notional Value to NAV

Total assets = HKD107.9 million

Current portfolio duration target = 10 years

Asset type	Value	Denomination	GBP/HKD	HKD Value
Gilts	10 million	GBP	10.79	107.9 million
FX forward (short HKD/long GBP) ¹	0	GBP10 million Notional	10.79 delivery price	0
Total net assets				107.9 million

Notional value to total net assets = 0 percent

1. The value of the currency forward at initiation is zero because the delivery price for GBP/HKD is set close to its current spot. This is a 3-month currency forward that will be rolled until the Gilt bonds mature or are sold out of the portfolio.

Fixed-income derivatives, such as interest rate swaps, short-term interest rate futures, and CDS, are important tools that many bond fund managers use to manage risks, gain exposure, or reduce exposure. Also, they generally are more liquid and less costly to trade than cash bonds. Yet, the

proposed rules would seem to limit bond funds' use of these instruments and make bond portfolios more difficult and costly to manage – to the detriment of their investors.

To demonstrate, let's build on the previous example. Say, one month later, the fund manager wants to lower the duration of Fund A's portfolio temporarily from 10 years to 9.7 years because of its view on interest rates.¹³ Bond fund managers often will use derivatives to achieve precise duration targets or implement small changes in duration targets—both of which could be unattainable or very costly to obtain in a portfolio of physical securities. In this case, the manager uses 3-month Eurodollar futures to accomplish this because Eurodollar futures are short-term, very liquid, and have an extremely low volatility (10-year annualized daily volatility of 0.3 percent).¹⁴

With GBP10 million in bonds and a portfolio duration of 10 years, the fund manager can achieve a target portfolio duration of 9.7 years by selling an equivalent of GBP12 million in Eurodollar futures (Figure 2). Funds generally would not exclude the Eurodollar futures positions from the limits under the proposed hedging exclusion, so the fund would have notional exposure of nearly 120 percent of total net assets—above the 100 percent net asset threshold—and would be classified as a “retail hedge fund” under the SFC proposal.¹⁵

¹³ Many bond funds will engage in “duration management” whereby the fund's manager seeks to adjust the average duration of the bond portfolio to coincide with the manager's view on interest rate and market conditions. If a fund manager expects interest rates to rise, the manager can use these derivatives to shorten the fund's average duration, moving it closer to zero to minimize the negative effect of the rise on the fund's value. If the manager expects interest rates to fall, it can use these derivatives to lengthen the fund's average duration to profit from the change.

¹⁴ For purposes of this example, we used Eurodollar futures. Duration management is not limited to Eurodollar futures and is generally carried out using a variety of derivatives instruments, such as swaps, futures, or bond forwards.

¹⁵ After the Eurodollars futures transaction, Fund A likely would enter into additional FX currency forwards to hedge currency fluctuations between the USD, GBP and HKD. We assume these added currency forwards would be hedging under the commitment method, and do not include them in this example.

Figure 2: Fund A Lowers Duration, But Exceeds 100 Percent Net Asset Threshold

Current portfolio duration target = 10 years

New portfolio duration target¹ = 9.7 years

Asset type	Duration (years)	Weight ¹	GBP Value
Gilts (long)	10	1	10 million
Eurodollar futures (short)	0.25	-1.2	12 million

Notional value to total net assets² = (HKD126 million/HKD108.1 million) = 117 percent

1. The duration of the portfolio (D_p) is the weighted average of the duration of the positions in the portfolio (D_1 and D_2). The formula is $D_p = w_1D_1 + w_2D_2$. The new target portfolio duration (D_p) is 9.7, the weight on the bonds (w_1) in the portfolio equals 1 (GBP10 million/GBP10 million), the duration of the bonds (D_1) is 10, and the duration (D_2) of the Eurodollar futures is 0.25. Solving ($9.7 = 10 + .25 w_2$), we obtain $w_2 = -1.2$. As a result, the manager sells short an equivalent of GBP12 million ($1.2 \times \text{GBP}10 \text{ million}$) in Eurodollar futures.

2. Assume current GBP/HKD exchange rate = \$10.50. The notional value of the Eurodollar contract in HKD = 12 million*10.50 = HKD126 million. Total net assets of the fund in HKD = value of Gilts in HKD [10 million*10.50 = HKD105 million] + value of currency forward in HKD [10 million*($10.79e^{(0.0122-0.0036)*1/6} - 10.50$) = HKD3.1 million] = HKD108.1 million. For purposes of this example, the current exchange rate is 10.50, the delivery price of the forward contract is 10.79, the Hong Kong annual short-term interest rate is 1.22 percent, the UK annual short-term interest rate is 0.36 percent, and there is 2 months (1/6 of a year) remaining on the FX forward contract.

To avoid this outcome, another fund (Fund B) that holds the same bonds and FX forwards as Fund A could reduce its duration by selling some of its 10-year bonds and buying bonds with shorter maturities, but this strategy almost certainly would drive up transaction costs for investors. In addition, because the fund would be forced to transact in physical securities, it may not be able to hit precisely the duration target of 9.7 years. Another complication that could arise is that the fund may find it difficult to source bonds with the maturities and credit profiles necessary to meet the manager's investment objective and strategies.

Fund A engaging in FX forwards and Eurodollar futures would have the same economic risk as Fund B, which reduces its duration by selling and buying physical bonds. It also would have lower economic risk than a third fund (Fund C) with the same portfolio holdings but that does not adjust its duration (*i.e.*, that does not invest in the Eurodollar futures). In fact, by using Eurodollar futures, Fund A would have lowered its interest rate sensitivity and provided protection in an anticipated rising interest rate environment. Nevertheless, Fund A would seem to be classified as a

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“retail hedge fund” subject to the higher distribution requirements in Section 5.1A and 5.3 of the Code of Conduct and the minimum subscription requirements, while the other two funds (Funds B and C) would be classified as “plain vanilla” funds.

Moreover, for other types of derivatives, the notional exposure may not reflect the economic risk of the instrument because of the low volatility of its underlying reference asset. For example, a futures contract on an underlying asset with low volatility (*e.g.*, a two-year US Treasury futures contract) historically has had significantly less return risk than a futures contract on an underlying asset with higher volatility (*e.g.*, the S&P 500 e-mini futures contract). Finally, for certain derivative instruments, notional exposure simply serves as a reference rather than a measurement of the obligation of the derivative. A fund that enters into interest rate swaps, for example, is obligated to make only interest rate payments based on the notional exposure of the contract, not payments equal to the entire notional exposure of the contract.

Categorizing/Labelling Funds using Gross Notional Exposure will have Negative Consequences for Funds and their Investors

We believe imposing a label on funds (with significant implications) based on an imperfect measure, such as gross notional exposure, would not protect investors but rob funds of an important portfolio management tool to the detriment of investors. As shown in the above example, a fund can have nearly identical investment exposure investing through derivatives as another fund that invests in corresponding physical instruments, but the fund investing in derivatives would be subject to additional restrictions while the other fund would not. In some cases, funds that are less economically risky might be placed in a category that implies higher risk (*i.e.*, derivatives-based funds and retail hedge funds) than other comparable funds and subject to heightened regulatory requirements. These somewhat random categorizations will label funds as being “higher risk” with severe consequences on their ability to be sold to retail investors. As a result, funds either will have to: (1) restrict their beneficial derivative use or (2) avoid offering funds in Hong Kong – both consequences that will be to the detriment of Hong Kong investors.

Labelling funds under this faulty system could be not only misleading to investors but could also unfairly impact a fund’s viability as a retail product. We understand that licensed distributors may avoid funds that are labelled “derivative products” and “retail hedge funds” because of heightened requirements and concerns about suitability. For instance, an equity fund that physically tracks the S&P 500 index and does not engage in derivatives transactions would be labelled a plain vanilla fund under the proposal. On the other hand, an investment grade bond fund that uses derivatives in excess of the 50 percent threshold (but below the 100 percent threshold) would be labeled as a derivatives-based fund. Because of these *ad hoc* categorizations, investors could perceive the bond fund to be riskier than the plain vanilla S&P 500 fund, yet the bond fund would have a lower historical return volatility than the S&P 500 fund.

Likewise, the imposition of the \$50,000 US minimum subscription requirement on funds that are “retail hedge funds” could create issues for funds that currently offer their shares in other retail

markets.¹⁶ For example, UCITS that are distributed in Europe are offered without minimum subscription thresholds or at significantly lower minimum subscription thresholds than those the SFC proposes and are not based arbitrarily on a UCITS' derivatives usage.¹⁷ In some cases, fund managers may decide that the minimum subscription threshold may decrease the amount of potential investors that will invest in the fund and choose to refrain from offering their products in Hong Kong, reducing investment choice again to the detriment of Hong Kong investors. In addition, imposing this higher threshold uniquely for Hong Kong offerings creates monitoring and compliance obligations for fund managers.

We are concerned that the proposed categorization of funds may result in two unfortunate consequences. One alternative may be that funds will be forced to restrict their use of derivatives to avoid these additional distribution and minimum subscription requirements to the detriment of their investors. In particular, funds that are classified as either plain vanilla or derivatives-based will restrict their derivatives usage to avoid falling into a different classification category that is subject to additional regulatory requirements. The other alternative may be that for funds, such as UCITS, these new restrictions may prevent their sale in Hong Kong because the new requirements would force many of those funds to calculate notional exposure using the commitment approach and to establish costly and operationally difficult systems to do so on an at least daily basis even if they do not use the commitment approach in their home jurisdiction. Rather than proceeding with these costly requirements, funds may simply choose to avoid offering their shares in Hong Kong. This result would be particularly regrettable given that these monitoring systems under the proposed approach will not provide any additional insight on risk management.¹⁸

We therefore strongly urge the SFC to eliminate the proposed classifications and limits based on the gross notional calculation. Fund investors invest in funds to reap the benefits of diversification and professional management expertise provided through the use of efficient portfolio management tools. Removing or substantially limiting the derivatives option from asset managers hobbles their ability to deliver these benefits to investors.

¹⁶ We understand that Hong-Kong domiciled funds that are deemed retail hedge funds because of their derivatives usage already are subject to these requirements.

¹⁷ For example, the Central Bank of Ireland does not impose minimum subscription requirements with respect to a UCITS's use of derivatives.

¹⁸ In addition, we note that funds would be required to monitor their derivatives transactions to ensure that the derivatives are adequately covered on an ongoing basis. See proposed Chapters 7.29 and 7.30 of the UT Code. These regulatory requirements and ongoing counterparty margin requirements would address certain of the SFC's purposes for proposing a notional limit and the classifications scheme (e.g., they place a *de facto* limit on the amount of leverage a fund can enter into as a fund should not segregate more than its net assets).

Certain Critical Changes Must be Adopted if the Classifications based on Notional Exposures are not Eliminated

Notwithstanding our significant concern of categorizing funds through the use of a gross notional measurement, if the SFC decides to move forward with its proposed classifications, we urge the SFC, at the very minimum, to make the following changes: (1) not designate derivatives-based funds and retail hedge funds that invest in derivatives products as *per se* “derivatives products” under 5.1A and 5.3 of the Code of Conduct that are subject to the higher distribution requirements; (2) eliminate the \$50,000 US subscription minimum tied to the notional exposure for UCITS; and (3) clarify and expand what would be considered hedging under the commitment approach.¹⁹

Avoid Classifying Funds as Derivative Products

If the SFC were to proceed with the proposed approach, it should disconnect the automatic tie between funds that use derivatives more frequently and “derivatives products” under the Code of Conduct. Mechanically subjecting funds that have higher cumulative notional exposures to heightened distribution requirements conflates the perceived riskiness of a fund that uses derivatives with the overall economic riskiness of the fund. Labelling a fund as a “derivatives product” and therefore a riskier investment would deem all use of derivatives as *per se* increasing risk when we have illustrated above that the use of derivatives could reduce risk (even if they are not within the hedging exclusion in the proposal). Instead, the Commission should reserve heightened distribution and suitability requirements for products that introduce more economic risk to investors. Detaching the heightened distribution requirements from such a test would appropriately recognize that licensed portfolio managers, upon whom retail investors depend to operate their investment funds, could use various derivatives instruments to reduce risk within their portfolio and achieve their investment objectives.

Eliminate the Minimum Subscription Amount based on Notional Exposure

Similarly, if the SFC moves forward with the proposed approach, it should eliminate the minimum subscription amount requirement based on notional exposure. Once again, notional exposure is not a good indicator of economic risk that warrant heightened distribution requirements, including

¹⁹ The Consultation Paper also does not make clear whether a fund that seeks to limit its exposure to derivatives but temporarily or inadvertently crosses the 50 percent or 100 percent thresholds would be required to adhere immediately to the requirements of the new category. We recommend that the SFC provide in any final rule that a fund that temporarily exceeds one of these thresholds not be required to comply immediately with the requirements of the new category. A fund could temporarily exceed the 50 percent threshold solely due to market developments and the fluctuations of a fund’s net assets. Such a temporary event does not warrant a fund having to expend its resources to establish additional policies and procedures to comply with the additional requirements if the fund falls under the threshold within a reasonable cure period, such as 30 days.

subscription minimums. Eliminating the subscription minimum would put the Hong Kong distribution system in line with those of other jurisdictions and remove a hurdle that will discourage UCITS issuers from offering their products in Hong Kong.

Expand and Clarify the “For Hedging Purposes” Exclusion

If the SFC decides to move forward with the proposed approach, it also should clarify what it means by derivatives used “for hedging purposes.” Although the proposed approach would allow funds to exclude certain hedging instruments from the limits, one major problem remains - the requirements for what constitutes a derivative acquired “for hedging purposes” are too narrow and lack clarity, creating a challenge for funds in determining whether activities are used for hedging or investment.²⁰ As a result, we understand that numerous funds would not consider many instruments used for hedging to be “for hedging purposes” under the proposed approach and instead would apply their full notional exposures toward the portfolio limits.²¹ We therefore have the following recommendations for changes to the definition of “hedging purposes.”

First, the requirements that the excluded instruments be “*solely* intended for the purpose of limiting, offsetting, or eliminating the probability of loss or risks arising from the investments being hedged” and “not aimed at generating any investment return” are too restrictive and could discourage funds from engaging in beneficial hedging activities. Many derivatives that might be used for hedging under certain circumstances also could generate investment return. In many cases, it is difficult for a manager to forecast whether a derivatives position would generate investment return and therefore would satisfy the requirement that the instrument not be “aimed” at any generating investment return. For example, if a manager believes the Federal Reserve will increase interest rates in April but the rest of the market thinks it will increase rates in June, the manager may adjust the portfolio’s duration to its April view. If the manager is correct, it will have hedged the portfolio and made money for the fund (as the market priced the instruments based on the June view). Forcing funds to classify the same types of derivatives differently under various scenarios would create practical challenges for fund compliance departments.

Accordingly, we recommend that the SFC modify the “solely” requirement by replacing the word “solely” with “primarily.” In addition, the SFC should eliminate the requirement that derivatives used “for hedging purposes” not be aimed at generating any investment return. These changes

²⁰ See *supra* note 5 (defining “for hedging purposes” under proposed Chapter 7.25 of the UT Code). See also *Use of Derivatives by Registered Investment Companies and Business Development Companies*, 80 Fed. Reg. 80884 (Dec. 28, 2015) at n. 236 available at: <https://www.gpo.gov/fdsys/pkg/FR-2015-12-28/pdf/2015-31704.pdf> (providing the US SEC’s similar concerns with the commitment approach).

²¹ We understand that the limitation on what would be considered “hedging” is one of the major reasons that many UCITS do not rely on the commitment approach. See *supra* note 10.

would provide funds with the flexibility to utilize the “for hedging purposes” exclusion to properly exclude risk-reducing derivatives from the limits.

Second, the requirement that the excluded instruments “exhibit price movements with high negative correlation with the investments being hedged under normal market conditions” creates interpretive questions regarding the meaning of “normal market conditions.” Markets are dynamic and change over time. A manager may enter into a hedged position that has exhibited high negative correlation over a specified period but, as soon as it is entered, the correlation could change. For certain instruments, it may be unclear whether a high negative correlation is normal. Changing the requirement from “normal” market conditions to “prevailing” market conditions would enable a manager to make comfortably the correlation determinations based on information it has available at the time the position is entered. It also would alleviate any uncertainty as to what could occur in the future.

We therefore recommend that, if the SFC continues with its proposed approach, the SFC should modify its proposal to: (1) require that excluded instruments be “*primarily* intended for the purpose of limiting, offsetting, or eliminating the probability of loss or risks arising from the investments being hedged” (emphasis added); (2) remove the requirement that excluded instruments not be aimed at generating any investment return; and (3) require that excluded instruments “exhibit price movements with high negative correlation with investments being hedged under *prevailing* market conditions” (emphasis added). Without more clarity on, and expansion of, the definition of “for hedging purposes,” we are concerned that the proposal would discourage funds, particularly bond funds, from utilizing many legitimate hedging derivatives.

Investment Expertise and Experience

Response to Question 2: Do you have any comments on the proposals to provide flexibility for well-established fund management groups to leverage group investment expertise and experience?

The SFC’s proposed revisions to Chapter 5.5 would give management companies with a multinational presence more flexibility to leverage group resources and expertise from different offices. We support this proposal, which would permit firms to meet the key personnel requirement on public funds investment management experience by showing that the management company belongs to a well-established fund management group and by being able to demonstrate that, on a group-wide basis, it possesses the requisite experience and resources as well as an appropriate oversight system to administer public funds. This amendment recognizes that a fund and its investors may be best served by allowing a fund management firm to combine its experience in managing public funds together with the substantial investment experience of investment personnel who do not have the requisite length of public fund experience.

For similar reasons, we request that the SFC consider granting global fund managers further flexibility to provide investment management services to SFC-authorized funds in the most

efficient manner by allowing funds to effect an investment manager change without prior SFC approval so long as (1) the new manager is an affiliate within the same group that is already subject to the Acceptable Inspection Regime and (2) the new manager has already been approved to manage other SFC-authorized funds.²²

Diversification Requirements (Chapter 7.1B)

The SFC has proposed revisions to the requirements on the spread of investments (diversification) for Hong Kong-domiciled funds. These revisions include the addition of a new Chapter 7.1B that would limit the value of a fund's cash deposits with the same entity or entities within the same group to 20 percent of the fund's total NAV, except with respect to cash held before the launch of a fund and cash proceeds from liquidation of an investment prior to the merger or termination of a fund. The SFC's proposal appropriately takes into account industry feedback that requested an exemption from this provision during the launch or termination of a fund, which are non-typical or unusual times for a fund that present unique challenges.

We request that the SFC consider a few more exemptions to this provision for additional non-typical or unusual circumstances that may arise to make the exceptions to the 20 percent restriction practically workable and useful. First, as drafted, the Note contains an exemption from the 20 percent requirement for cash held before the launch of the fund; it does not, however, contain any exemption for cash held immediately after the launch of a fund. It therefore appears that if the cash held by a fund upon launch is not immediately invested, the fund would need multiple bank accounts (potentially up to six) to hold such cash until it is invested. Requiring a fund to open multiple accounts for this limited and unusual circumstance seems unnecessary. We therefore request that the Note be revised to read as follows, "cash held before the launch of a fund and for a reasonable time thereafter."

Second, we request that the SFC include an additional exclusion permitting "cash held by the fund's custodian temporarily for operational cash management purposes (and not based on investment strategy), including to manage substantial subscriptions or redemptions." Situations may arise, for example, in which a fund that utilizes one custodian is experiencing significant subscriptions (in excess of 20 percent of the fund's current NAV), and investing all of the cash immediately may not be in the interest of the fund (*e.g.*, to avoid market impact costs). This additional exclusion would give fund managers the flexibility to manage such situations as appropriate in keeping with the investment strategy and objectives of the fund.

The risk of harm to investors stemming from the fund's custodian holding such cash for a limited time is minimal, if any. Trustees and custodians are already subject to substantial authorization requirements under the UT Code that specify the entities that are permitted to be appointed for such functions, as well as the general obligations of the trustee and custodian. The SFC proposes to

²² This comment was included in the ICI Global Soft Consultation Response.

codify additional requirements and further strengthen the regulatory framework regarding trustees and custodians, further reducing any concerns.

Investment in Other Funds

The SFC has proposed a new Note to the Chapters on investment in other funds (Chapters 7.11, 7.11A and 7.11B) specifying that qualifying ETFs may either be considered and treated as (1) listed securities or (2) collective investment funds for purposes of the diversification requirements, so long as the relevant investment limits are “consistently applied and clearly disclosed in the offering document of a fund.” For the avoidance of doubt, we request that the SFC confirm and clarify that this determination would be made at an individual fund level, and that funds operating under the same umbrella or that have the same investment manager may make different determinations, so long as the provisions are consistently applied at the level of the individual fund.

Chapters 7.11 and 7.11A describe a fund’s investment limits in different funds, depending on whether they are funds that are authorized by the SFC, eligible funds, or neither. The SFC has proposed revisions to certain language in these provisions (*e.g.*, changing “recognized jurisdiction funds” to “eligible funds”), but does not appear to have the intent of changing their substance. In this regard, we request the SFC to revise Chapter 7.11 to read “The value of a fund’s investment in units or shares in other collective investment funds (namely, “underlying funds”) which are neither authorized by the Commission nor eligible funds [see Note to 7.11A] may not in aggregate exceed 10 percent of its total net asset value.”

Counterparties

Response to Question 8: Do you agree with the proposed framework for Securities Financing Transactions? Please explain your views.

As part of the proposed framework for securities financing transactions (SFT), the SFC proposes to require that, for Hong Kong-domiciled funds, the counterparty to an SFT must be a “substantial financial institution,” defined as “an authorized institution as defined in section 2(1) of the Banking Ordinance (Chapter 155 of Laws of Hong Kong) or a financial institution which is on an ongoing basis subject to prudential regulation and supervision, with a minimum NAV of HK\$2 billion or its equivalent in foreign currency.”²³ We request that the SFC delete this requirement as it may unduly restrict a fund’s ability to engage in SFT with a diverse range of counterparties, ultimately contributing to a consolidation of risk and increasing costs, which would be borne by investors. Determining whether a fund should enter into an SFT is appropriately within the scope of responsibility of the fund’s investment manager – and its credit/risk committee – as part of its overall due diligence process.

²³ This requirement is contained in the Note to Chapter 7.32. The proposal also requires that the counterparty to an over-the-counter derivative instrument or its guarantor be a substantial financial institution. *See* Chapter 7.28(b).

Moreover, this proposed requirement with respect to SFT counterparties would be inconsistent with the requirements in other major jurisdictions, such as those applicable to UCITS and investment companies registered under the US Investment Company Act of 1940 (US 40 Act Funds). Rather than being constrained with respect to the parties with whom it can enter into a transaction, a UCITS, for example, is required to specify in its prospectus the criteria it uses to select a counterparty, including the credit rating assessment, as well as the legal status and country of origin of the counterparty. A US 40 Act Fund may lend securities if lending is permitted by its organizing documents and disclosed to investors in the fund's prospectus or statement of additional information. The fund's lending program also is subject to approval and oversight by its board of directors, including its independent directors.

Additionally, although a Note to the counterparty requirements (contained in Chapter 7.28(b)) provides that the SFC may consider accepting other entities falling outside the definition of a substantial financial institution on a case-by-case basis, the requirement to obtain such affirmative approval from the SFC, particularly in time-sensitive situations, would be burdensome and unnecessary, as described above.

Securities Financing Transactions Indemnification

Response to Question 9: Do you consider indemnification by securities lending agents is a necessary and appropriate safeguard? Please explain your views.

Proposed Chapter 7.35(b) would require securities lending agents to indemnify a fund to protect against counterparty default. We urge the SFC to delete this proposed requirement. Although indemnification is generally offered by most agent lenders, securing indemnification may become increasingly difficult as securities lending agents seek to reduce their indemnification offering due to capital constraints under Basel and related global regulations. Mandating that Hong Kong-domiciled funds require indemnification from agent lenders will likely increase the cost of securities lending transactions for these funds, putting them at a relative disadvantage to other funds or market participants. The regulatory regimes for US 40 Act Funds and UCITS, for example, do not require securities lending agents to indemnify the fund.²⁴ In our view, fund/asset managers and risk/credit personnel are the appropriate subject matter experts who appropriately should be responsible for assessing whether indemnification by the securities lending agent is critical in the fund's overall determination of entering into a securities lending program. Furthermore, we believe that the counterparty risk analysis combined with collateral requirements provide sufficient protection and that indemnification by securities lending agents is not a necessary safeguard.

²⁴ As is proposed in Chapter 7.35, US 40 Act Funds and UCITS must retain the ability to terminate a loan and recall the loaned securities at any time.

Collateral Requirements

Response to Question 11: Do you think that the proposed collateral requirements are sufficient to safeguard investor interests? What additional criteria should be considered?

Proposed Chapter 7.36(d) would require Hong Kong-domiciled funds to apply a prudent haircut policy and describes how a haircut should be determined in an accompanying Note. We request that the SFC confirm that fund managers can determine not to subject certain assets to a haircut, based on an assessment of the market risks of those assets. For example, in the case of certain government securities, an investment manager may reasonably determine that based on an analysis of the market risk, such collateral should not be subject to any haircut amount. This interpretation is appropriate, considering that the SFC's proposed revised framework requires 100 percent collateralization, that collateral be liquid and of a high credit quality, and otherwise imposes substantial requirements limiting counterparty exposure.²⁵

Money Market Funds

Response to Question 15: Do you agree with the proposed requirements for money market funds? Please explain your views.

We recommend that certain of the proposed requirements for money market funds be revised to be more consistent with those in other major jurisdictions and in line with IOSCO standards, as described in this section. The SFC's proposed revisions to Chapter 8.2(k) would add guidelines governing the use of repurchase and reverse repurchase transactions. Specifically, the proposed guidelines would limit the collateral received in such transactions to short-term deposits or high-quality market instruments. It is not clear from the proposed revisions, however, whether permitted collateral would include government or other public securities. Under the EU Money Market Fund Regulation (MMFR), for example, reverse repurchase agreement collateral generally may include securities issued by government entities that are not otherwise eligible for direct investment by the money market fund (*e.g.*, government securities with maturities greater than 397 days). Moreover, there are no maturity limitations on government securities used to collateralize repurchase agreements under Rule 2a-7 under the US Investment Company Act of 1940. We therefore strongly urge the SFC to clarify and expand the guidelines regarding reverse repurchase agreement collateral to include specifically government securities.

The SFC's proposed revisions to Chapter 8.2(n) include daily and weekly liquidity requirements. Specifically, the proposal defines daily liquid assets and weekly liquid assets as assets (or amount receivable and due unconditionally on pending sales) that can be readily converted to cash within one or five working days, respectively. Importantly, unlike the money market fund rules in the

²⁵ This approach would be consistent with the provisions applicable to UCITS, which do not require that a haircut always be taken. Rather, a UCITS must document its haircut policy and justify and document each decision to apply a specific haircut. Similarly, although US 40 Act Funds are limited to receiving cash, government securities, and bank letters of credit as collateral, they are not required to take a haircut on the collateral held.

European Union or the United States, the definitions do not include government securities within these definitions. Under the EU MMFR, 17.5 percent of a short-term money market fund's weekly liquidity can consist of government debt that matures in less than 190 days. In the United States, the definition of daily liquid assets includes direct obligations of the US government (*i.e.*, Treasuries) and the definition of weekly liquid assets includes both Treasuries and US government agency discount notes with remaining maturities of 60 days or less. The US SEC decided to include government securities in the liquid assets definitions after determining that the market for these securities tends to be sufficiently liquid under stressful market conditions.²⁶ As a way to provide greater flexibility to money market funds to meet the challenges of different market conditions, we urge the SFC to expand the liquid asset definitions to include government securities, as appropriate.

Valuation and Pricing

Response to Question 22: Do you agree with the proposed amendments to the provisions in the UT Code relating to operational requirements and financial reporting? Please explain your views.

In Chapter 10.2, the SFC proposes to require the fund's manager to notify the trustee/custodian of any error in the pricing of units/shares in a timely manner. We request that the SFC confirm and clarify that this requirement would apply only to a material error that would impact the price as published to the public (*e.g.*, >0.01 of the fund's NAV).

Implementation Timeline

Response to Question 29: Do you agree with the proposed implementation timeline for the proposed amended UT Code? If not, please set out your reasons and what you think is an appropriate transition period.

We respectfully request that the SFC provide a 24-month transition period rather than the 12-month period as currently proposed. Many of the changes proposed, including those regarding the use of derivatives, will require significant revisions to current policies and procedures, as well as significant systems and operational changes. Undertaking compliance with the proposed changes would likely require substantial personnel and financial resources. To ensure appropriate resources are secured for successful implementation of new obligations, firms typically must plan their budget and allocate resources well in advance. A 12-month transition period could pose serious compliance challenges for firms. A 24-month transition period will allow firms to thoughtfully plan for implementation with the substantially revised UT Code.

²⁶ See Money Market Fund Reform, SEC Release No. IC-29132 (February 23, 2010) at 65-66, available at <https://www.sec.gov/rules/final/2010/ic-29132.pdf>.

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18 March 2018
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We greatly appreciate your consideration of these issues. If you have any questions, please contact Qiumei Yang, CEO, ICI Global Asia Pacific, at +852 2168 0881 or qiumei.yang@iciglobal.org or Jennifer Choi, Chief Counsel, ICI Global, at +1 (202) 326-5876 or jennifer.choi@iciglobal.org.

Sincerely,

/s/ Dan Waters

Dan Waters
Managing Director
ICI Global