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22 August 2018

*Submitted electronically to*  
[utc-consultation@sfc.hk](mailto:utc-consultation@sfc.hk)

Ashley Alder  
Chief Executive Officer  
Securities and Futures Commission  
35/F Cheung Kong Center  
2 Queen's Road Central  
Hong Kong

Re: UT Code Review Proposing Refinements to Proposed Amendments to the Code on Unit Trusts and Mutual Funds

Dear Mr. Alder,

I am writing on behalf of ICI Global<sup>1</sup> and our members to express our appreciation for the Securities and Futures Commission's ("SFC") proposal to refine its proposed amendments related to a fund's use of derivatives in the Code on Unit Trusts and Mutual Funds ("UT Code").<sup>2</sup> Although we continue to disagree with classifying funds as "derivatives products" subject to heightened distribution requirements based on an adjusted gross notional exposure measurement (*i.e.*, the commitment approach),<sup>3</sup> we welcome the proposed changes expanding the types of derivatives excluded from that measurement. In addition, we generally support exempting certain derivatives from the determination that a fund is a "derivatives-based fund." The excluded transactions and exempted circumstances reflect common techniques that funds engage in daily to

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<sup>1</sup> [ICI Global](http://www.iciglobal.org) carries out the international work of the [Investment Company Institute](http://www.investmentcompanyinstitute.com), 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\$29.6 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.

<sup>2</sup> See Securities and Futures Commission, Slides on UT Code Review – Funds' derivatives investments – proposed refinements (for discussion), dated 25 July 2018.

<sup>3</sup> See, *e.g.*, Letter from Dan Waters, Managing Director, ICI Global, to Ashley Alder, Chief Executive Officer, Securities and Futures Commission, dated 6 June 2018; Letter from Dan Waters, Managing Director, ICI Global, to Ashley Alder, Chief Executive Officer, Securities and Futures Commission, dated 18 March 2018, *available at* <https://www.iciglobal.org/pdf/31143a.pdf>. As we noted in our prior letters, the proposed regulations are more stringent than other major fund jurisdictions (*e.g.*, many UCITS may rely on either a value-at-risk approach or a commitment approach to constrain leverage or derivatives use).

reduce risk or manage their portfolios more efficiently and should be excluded from any measurement that might be used to limit derivatives use.

To make the proposed refinements more workable for and reflective of the actual practice of the global asset managers, we provide recommendations below. These recommendations summarize our thoughts on the proposed refinements and feedback that ICI Global members have provided during the abbreviated comment period.

### **I. Except “Exempted Circumstances” When Classifying *All* Funds**

The proposed refinements would permit an SFC-authorized fund to except the portion of derivatives exposure (calculated under the UCITS or SFC commitment approach) that exceeds 50 percent of the fund’s net asset value (“NAV”) up to 100 percent of the fund’s NAV from the determination of whether the fund is a “derivatives-based fund” when that portion is solely attributable to one or more of five “exempted circumstances.”<sup>4</sup> The exception, however, would not apply for a fund whose derivatives exposure exceeds 100 percent of the fund’s NAV.

We recommend that the SFC expand the use of the “exempted circumstances” exception to cover those instances in which a fund’s derivatives exposure exceeds 100 percent of its NAV. Exempted circumstances reflect common investment techniques that funds use to reduce risk or more efficiently manage their portfolios. The SFC appropriately determined that these techniques should be placed in a separate category and should not count toward the determination of whether a fund is a derivatives-based fund.

Treating the same types of derivative instruments differently for these purposes seems incongruous when they are utilized in the same manner. For example, take two funds – one (“Fund A”) that has derivatives exposure of 100 percent whose exposure above 50 percent is attributed to hedging and another (“Fund B”) that has derivatives exposure of 105 percent whose exposure above 50 percent also is attributable to hedging. If the SFC views hedging as risk reducing and beneficial to the fund and hence should be excepted, then both Fund A and Fund B should be able to except the hedging derivatives. There appears to be no policy reason to treat Fund A differently simply because it has 100 percent derivatives exposure or less. Funds use derivatives under the exempted circumstances for risk-reducing or other beneficial purposes whether they have between 50 to 100 percent derivatives exposure or above 100 percent derivatives exposure.<sup>5</sup> For these reasons, funds that have

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<sup>4</sup> “Exempted circumstances” include derivatives for: (i) hedging purposes; (ii) cash flow management or downside risk mitigation; (iii) market access or exposure replication (without incremental leverage at the fund portfolio level); (iv) interest rate strategies qualifying for duration netting rules; and (v) investment in convertible bonds (without stripping out the embedded derivatives) (these would be subject to the condition that the option to convert (to equities) is exercisable by the holder (*i.e.*, the fund)).

<sup>5</sup> The disparate treatment in the example can be further highlighted if Fund A and Fund B held the same assets, but Fund A is an SFC-domiciled fund subject to the SFC’s proposed commitment approach and Fund B is a UCITS that is subject to the commitment approach of its home rules. Because there are different rules for calculating commitment leverage (*e.g.*, under the Hong Kong UT Code or under the Committee of European Securities Regulators’ (“CESR”)

greater than 100 percent derivatives exposure also should be permitted to except the exempted circumstances when determining their classification.

## **II. Revise the “Exempted Circumstances” Exception to Require that Exposure in Excess of 50 Percent be Attributable to the Exempted Circumstances**

As noted above, the proposed refinements would permit an SFC-authorized fund to except the portion of derivatives exposure that exceeds 50 percent of the fund’s NAV (up to 100 percent of the fund’s NAV) from the determination of whether a fund is a “derivatives-based fund” when that portion is *solely* attributable to the exempted circumstances.

We recommend that the SFC permit a fund to except that portion of the derivatives exposure above 50 percent of the fund’s NAV (including those above 100 percent of the fund’s NAV) when the portion is attributable, not *solely* attributable, to the exempted circumstances. Eliminating the modifier “solely” would allow a fund to rely on the “exempted circumstances” exception to engage in derivative transactions when there is more than one purpose for entering the transaction. As long as a derivative transaction is attributable to an exempted circumstance, then it should be excepted. We further recommend that the SFC clarify that, for purposes of classifying whether derivative transactions are attributable to exempted circumstances, it is sufficient that an asset manager assess each derivative transaction at its inception and reassess that determination periodically (*e.g.*, monthly).

## **III. Permit Hong Kong-Domiciled Funds to Net Offsetting Positions in Limited Circumstances**

Funds generally can eliminate exposure gained through a derivative instrument (*e.g.*, foreign exchange (“FX”) derivatives, futures contracts, swaps) on an underlying asset only by taking an opposite, offsetting position in another derivative instrument on the same underlying asset. Accordingly, we recommend that the SFC permit the netting of offsetting positions in derivatives that are based on the same underlying asset when calculating derivatives exposure under the commitment approach, even if the maturity dates of the instruments are different. This change would permit a fund to eliminate its economic exposure without artificially grossing up its measured derivatives exposure. For example, when a fund enters an offsetting position, it may have for a limited time, two times the notional exposure it might otherwise have, even though, for all practical purposes, the economic exposure has been cancelled out.

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approach for UCITS), two funds with the exact same investment strategy and assets potentially could have different commitment leverage levels and fall under different classifications under the SFC’s proposed amendments. Under that circumstance, prohibiting funds with over 100 percent derivatives exposure from using the exempted circumstances could lead to disparate outcomes even though both funds held the same assets, as Fund A could reduce its exposure to 50 percent or less, while Fund B would remain at 105 percent.

Permitting a fund to net the offsetting positions would reflect the true economic realities of a fund's position. In addition, the approach is consistent with the UCITS commitment approach, which allows the netting of offsetting positions between two "financial derivative instruments" ("FDIs") on the same underlying asset, even if the maturity dates of the instruments are different.<sup>6</sup> It also is consistent with the example the SFC provides on "rollover" derivatives hedging in which a fund enters into a new FX forward contract in view of the expiration of an existing FX contract.<sup>7</sup> Instead of maintaining the derivatives exposure as in the example, however, the fund would be eliminating or "offsetting" it.

#### **IV. Add Fixed-Income and Other Scenarios to the "Exempted Circumstances" Examples in the Appendix**

Appendix B of the proposed refinements provides examples of derivatives that the SFC would deem as meeting the "exempted circumstances" requirements. We understand that the examples are not intended to cover the entire universe of exempted circumstances but find them to be illustrative and helpful for funds in determining whether a derivative transaction qualifies under an "exempted circumstance."

The examples, however, seem to be equity focused. We therefore recommend that the SFC add common fixed-income and other investments as examples. We recommend that the examples generally cover, among other things: (a) foreign currency proxy hedging; (b) interest rate swaps ("IRS"); (c) interest rate futures; (d) credit default swaps; and (e) total return swaps. In addition, we recommend that the examples generally cover other transactions that are not outright derivatives but are covered under the proposed commitment approach, including: (f) reverse repurchase agreements; and (g) To-be-announced transactions ("TBA Transactions"). These additions would help funds determine whether certain types of derivative transactions qualify as "exempted circumstances." Each scenario is discussed briefly below:

- (a) Foreign Currency Proxy Hedging (Exempted Circumstance: Hedging or Downside Risk Mitigation):** As the proposed refinements indicate, funds may use foreign currency derivatives denominated in the same currency as an investment being hedged to reduce currency risk of the associated investment. In some cases, however, funds may not be able to place foreign currency derivatives in the currency of an investment (local currency) for several reasons, including: (i) for non-standard currency pairs – in which the foreign market may not be liquid enough and transacting in local currencies may result in substantial additional costs for the fund, and ultimately its investors; (ii) the local currency may be extremely volatile and the over-the-counter FX market may have dried

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<sup>6</sup> See paragraph 2.1.3 of CESR's Guidelines on Risk Measurement and the Calculation of Global Exposure and Counterparty Risk for UCITS, dated 28 July 2010, where "netting arrangements" are defined as "combinations of trades on financial derivative instruments and/or security positions which refer to the same underlying asset, irrespective – in the case of financial derivative instruments – of the contracts' due date . . ."

<sup>7</sup> See proposed refinements at page 11.

up. This situation could arise under stressed market conditions and force a fund to remain unhedged if it cannot use proxy hedging to cover its exposure. For example, because the Hungarian forint and the Euro are highly correlated and the Hong Kong Dollar/Euro forward contract is likely much more liquid, a fund might choose a Hong Kong Dollar/Euro forward contract to hedge an exposure to the Hungarian forint acquired through an investment in Hungarian stocks; (iii) for a global portfolio with multiple currency exposures, it often is more cost-effective and efficient to use a foreign currency proxy hedging rather than hedge each local currency individually. A hard currency, such as the US dollar or Euro, may display a high correlation with multiple local currencies and taking a short position in the US dollar or Euro would result in risk mitigation across multiple local currencies simultaneously, decreasing the cost of hedging for the fund, and ultimately, its investors, as a single FX contract would be entered into, instead of several smaller ones, while mitigating downside risk.

- (b) Interest Rate Swaps (Exempted Circumstance: Hedging, Downside Risk Mitigation, and Market Access or Exposure Replication):** Many funds use IRS to adjust interest rate and yield curve exposures. Long swap positions (*i.e.*, those IRS positions that “receive fixed” payments) increase duration of the portfolio, similar to a long position in a physical bond, while short positions (*i.e.*, those IRS positions that “pay fixed” payments) decrease exposure, similar to selling a physical bond. For instance, to reduce interest rate exposure of a fixed-coupon bond and hedge against the negative price risks caused by potential increases of interest rates, a portfolio manager could enter into an IRS by “paying fixed” payments and “receiving floating” payments. Furthermore, IRS can be used for efficiently gaining market access. Specifically, it allows a fund to access global interest rate markets in a cost-efficient manner. For example, if a fund wishes to gain exposure to the Japanese yield curve to express a view on decreasing medium-term interest rates, it may choose to enter into a Japanese IRS in which it “receives fixed” payments and “pays floating” payments based on the benchmark Japanese interest rate.
- (c) Interest Rate Futures (Exempted Circumstance: Hedging, Downside Risk Mitigation, and Market Access or Exposure Replication):** Interest rate futures can be based on underlying instruments such as Eurodollars, Treasury bills, and Treasury bonds. The underlying interest rates they are exposed to can range from short-term money market rates to Treasury yields that exceed 10 years, depending on which part of the interest rate curve the fund intends to gain exposure to (or hedge). Similar to IRS, interest rate futures are commonly used for hedging interest rate risks and enabling investors to access global interest rate markets. The 10-Year Japanese Government Bond Futures traded on the Osaka Exchange, for instance, allows global investors to gain or hedge exposure to the yield on the 10-Year Japanese government bond.

- (d) **Credit Default Swaps (Exempted Circumstance: Downside Risk Mitigation and Market Access):** Funds may use purchased credit default swaps to provide downside risk protection for bonds in their portfolio. As the proposed refinements indicate, funds may use single-name credit default swaps to hedge the credit risk of an issuer whose bond(s) the fund holds. In some cases, however, funds may take a similar approach using index-based credit default swaps. For example, funds may use the Investment Grade Credit Default Swap Index (“CDX”) to hedge the credit risk of the 125 most liquid investment grade corporate issuers (where the underlying issuers of the CDX and the bond holdings may be different). These derivatives should qualify as “downside risk mitigation,” as the purchased CDX (*i.e.*, those positions that “buy protection”) legitimately can be used to mitigate downside credit risk. In addition, single-name credit default swaps and index-based credit default swaps are commonly used as an efficient means of gaining exposure to certain markets due to better liquidity, deeper markets, and lower transactions costs relative to physical bonds. For instance, if a portfolio manager would like to increase credit beta exposure efficiently, selling credit default swap protection (taking a long position) could be a more cost-effective way to do so, particularly when the physical bond market lacks liquidity (hence larger bid/ask spreads) due to inactive market participants, or in certain tenors where physical bonds may be in more limited supply. Furthermore, because CDX allows funds to gain exposure to a basket of 125 equally weighted investment grade companies in one transaction, it is a more efficient means of providing diversification than acquiring all the target physical bonds one by one.
- (e) **Total Return Swaps (Exempted Circumstance: Market Access or Exposure Replication):** Funds may use total return swaps to replicate the exposure (or total return) to a reference asset in exchange for paying a financing cost. The reference asset may be an equity, bond, or commodity index or a single bond or stock, among other possible exposures.

Certain investments are not necessarily derivative instruments, but their notional exposures might count toward the commitment approach calculation. Although reverse repurchase agreements and TBA Transactions may not be derivative instruments, if their notional exposures count under the applicable commitment method, they should be treated as exempted circumstances in the scenarios below.

- (f) **Reverse Repurchase Agreements (Exempted Circumstance: Cash Flow Management):** Although not outright derivatives, reverse repurchase transactions (“reverse repos”) are a type of short-term funding transaction in which an “asset owner” obtains short-term funding by exchanging assets (*e.g.*, agency mortgage-backed securities, US Treasuries) with the “cash holder” and receiving a cash amount equal to the market value of the assets less a negotiated “haircut.” The “asset owner” simultaneously agrees to repurchase those assets at

a later date for a price equal to initial purchase price plus interest over the repurchase period. Funds may use reverse repos to obtain a short-term, cash-equivalent investment return as a reverse repo generates a return similar to lending cash on a secured, short-term basis at the reverse repo rate. In practice, reverse repos are used to provide liquidity in lieu of proceeds or cash that has yet to be deposited into the account and settled.

- (g) **TBA Transactions (Exempted Circumstance: Market Access or Exposure Replication):** While we do not necessarily consider TBA Transactions to be derivatives, the UCITS commitment approach treats them in the same manner as derivatives. Funds intending to gain exposure to the US mortgage market may invest in TBA Transactions. Despite being a forward-settling instrument with derivative-like characteristics, TBA Transactions are the most common method of accessing mortgage-backed securities issued by US government-sponsored enterprises. Provided no additional incremental leverage is generated, TBA Transactions should be excluded from net commitment leverage calculations.

Moreover, we recommend that the SFC expand the examples it provides for market access or exposure replication (specifically in the category “cash backing as equivalence to cash position of other financial assets”) to include derivatives that fixed-income funds commonly use to gain market access or achieve exposure replication. These derivatives are backed by cash or cash equivalent securities positions<sup>8</sup> against the derivatives exposure that reduce economic leverage in the same manner as seen in the other cash-backed examples and likewise should be excepted.<sup>9</sup> In particular, we recommend that the SFC include examples of, among other things: (a) interest rate swaps (IRS) and index-based credit default swaps; (b) options; and (c) money market fund and Eurodollar futures. Each example is further described below.

- (a) **Interest Rate Swaps and Index-Based Credit Default Swaps (Exempted Circumstances: Market Access or Exposure Replication):** A fund should be able to treat these instruments as exempted circumstances when the fund holds cash or cash equivalents equal to the full notional amount of the IRS or index-based credit default swap (hence, limiting economic leverage).
- (b) **Options (Exempted Circumstances: Market Access or Exposure Replication):** A fund should be able to treat options as exempted circumstances when it holds cash or cash equivalents equal to the full delta-adjusted notional value of the option (hence, limiting economic leverage).

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<sup>8</sup> In this regard, we recommend that the SFC include “cash equivalent”-backed positions as well as cash-backed positions.

<sup>9</sup> The SFC could require that, to treat these derivatives as exempted circumstances, funds demonstrate that they have a robust risk management process to manage the exposure from these derivatives.

- (c) **Money Market Fund and Eurodollar Futures (Exempted Circumstances: Market Access or Exposure Replication):** A fund should be able to treat these instruments as exempted circumstances when it holds cash or cash equivalent positions equal to the total market value of the money market future or Eurodollar future.<sup>10</sup>

#### V. Permit Funds Using Interest Rate Derivatives to Scale Notional Exposures

The proposed refinements would allow interest rate strategies qualifying for duration netting rules to be treated as “exempted circumstances.” The SFC provides additional guidance regarding the duration netting rules in Appendix B setting forth a very detailed explanation on how to apply the netting rules. These exempted circumstances indicate that the SFC understands and is willing to treat interest rate derivatives differently than other types of derivatives, excepting them from being counted toward the classification requirements.

Consistent with this approach, we recommend that the SFC permit funds that use interest rate derivatives either to rely on the proposed duration netting rules or alternatively to scale those notional amounts to a standard fixed-income instrument (*e.g.*, a 10-year bond equivalent). We understand that the SFC may have based its duration netting rules on a model that UCITS use under a commitment approach. The UCITS model, however, is not widely used because it is too complicated. Instead, many UCITS opt to rely on a value-at-risk approach, rather than the UCITS commitment approach, to constrain their derivatives use.

To facilitate the calculation of leverage exposure under the commitment approach in such circumstances, we recommend that the SFC permit a less complicated duration-adjustment approach to interest rate derivatives. For example, if a portfolio manager were trying to construct a portfolio to achieve a target duration of 2 years, he or she could use a wide range of instruments to do so. While the resulting portfolios would by design have the same interest rate sensitivity (or duration), the notional amounts of the derivatives exposure could be very different depending on the instrument used. This is because the value of a short duration contract is less sensitive to interest rate changes than the value of a long duration contract. For example, the value of a Eurodollar futures contract with a notional of value of \$1,000,000 will change by \$25 for a 1 basis point change in the interest rate, but the value of a 3-year Treasury note futures contract with a notional of value \$1,000,000 and a duration of 2 years will change by \$200. Therefore, for a portfolio to have the same risk irrespective of whether the manager invests in Eurodollar futures contracts or Treasury note futures contracts, the notional amounts in the two contracts would have to be very different: The notional amount of the Eurodollar futures contracts would be 8 times (2 years/0.25 years) the notional amount of the Treasury note futures contracts. Although many funds will choose to use the Eurodollar futures because those instruments are short-term, very liquid, and have an extremely low volatility, the difference in notional values under the SFC’s proposed commitment approach might preclude them from doing so.

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<sup>10</sup> See, *e.g.*, proposed refinements at page 15 (citing other examples of futures contracts that are similarly cash backed).



The duration-adjustment approach, however, could scale the notional amounts for these and other interest rate derivatives based on a specified bond equivalent. If the approach used a 10-year bond equivalent, for example, an interest rate derivative instrument with a reference asset having a 10-year duration would count 100 percent of its gross notional exposure toward the measurement and derivatives with shorter durations would be scaled to those amounts. An approach like this would not include the netting benefits of the duration netting rules, but it would be simpler to use than the proposed duration netting rules and would reflect the reduced risk for shorter-term interest rate derivatives.

## **VI. Confirm that the “Expected Maximum Leverage” Disclosure Does Not Impose a Hardwired Limit on a Fund’s Investment in Derivatives**

As set forth in the consultation paper and reiterated in the proposed refinements, the SFC would require funds to disclose in the product key facts statement the purpose of, and expected maximum leverage arising from, derivatives investments based on the commitment approach. The SFC provides sample disclosure that reads “The fund’s expected maximum leverage arising from investments in derivatives is [up to 50 %] / [more than 50% and up to 100%] / [more than 100% / and up to [x]%] of the fund’s NAV.” The proposed disclosure requirement is similar to disclosure that the SFC already requires UCITS that use financial derivative instruments (FDIs) to make.<sup>11</sup> We recommend that, in connection with the proposed disclosure requirements, the SFC clarify that the term “expected maximum leverage” means the maximum level of leverage that a fund’s portfolio manager reasonably expects the fund to use under normal market conditions and that the amount disclosed is not viewed as a hardwired limit on the fund. At times, market events could change suddenly causing the amount of leverage reasonably projected under normal market conditions to exceed expectations. We believe clarity around the requirement would ensure that funds have sufficient protection for their reasonably projected expectations and would encourage funds to provide meaningful projections that are a fair and reasonable impression of how the fund typically is managed. Clarity also would allow all portfolio managers to understand and adhere to a single standard.

Separately, we recommend that the SFC confirm that no additional disclosure would be required for funds that rely on the “exempted circumstances” exception when classifying their funds. To avoid investor confusion, the SFC should require funds only to disclose the expected maximum leverage after factoring in the exempted circumstances.

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<sup>11</sup> Pursuant to the SFC’s Guide, UCITS that use FDIs must disclose either the expected or maximum leverage as a result of the use of FDIs and a brief explanation as to the basis of such calculation. The SFC suggests disclosure that states “The maximum level of leverage of the fund calculated using the commitment approach is [x]% of the NAV;” or “The expected level of leverage of the fund is [x]% of the NAV calculated using the sum of notional approach (and in the range of [x% to x%] calculated using the commitment approach.”

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Securities and Futures Commission  
22 August 2018  
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We truly appreciate the opportunity to express our concerns to you. If you have any questions regarding ICI's recommendation or would like any additional information, please contact Qiumei Yang, CEO, ICI Global Asia Pacific, at +852 2168 0881 or [qiumei.yang@iciglobal.org](mailto:qiumei.yang@iciglobal.org) or Jennifer Choi, Chief Counsel, ICI Global, at +1 (202) 326-5876 or [jennifer.choi@iciglobal.org](mailto:jennifer.choi@iciglobal.org).

Sincerely,

/s/ Dan Waters

Dan Waters  
Managing Director  
ICI Global

cc: Christina Choi, Executive Director (Investment Products), SFC