

9 June 2010

Code on Unit Trusts and Mutual Funds (UT Code)

In addition to the new requirement to observe the Overarching Principles (see “Marketing Investment Products in Hong Kong - the New Regime”), which contain the obligation to deliver a key facts statement to all investors in SFC authorised funds, the UT Code has been revised in the following five areas.

1. STRUCTURED FUNDS WHICH INVEST SUBSTANTIALLY ALL OF THEIR ASSETS IN MARKET ACCESS PRODUCTS

- As a result of the increasing use of financial derivative instruments, a new category of funds, called structured funds, has been created.
- Structured funds seek to achieve their investment objective through investing in market access products, swaps, repos or similar arrangements.
- The authorisation criteria address the independence of counterparties and those undertaking mark to market valuations, the risk of over exposure to a single counterparty, eligible collateral and contingency plans for counterparty credit events.

2. NON UCITS FUNDS WHICH INVEST SOME OF THEIR ASSETS IN MARKET ACCESS PRODUCTS

- This amendment is designed to level the playing field for non-UCITs schemes e.g. domiciled in the Cayman Islands or Hong Kong wishing to use financial derivative instruments (FDI) for

investment purposes, subject to a 100% of the net asset value exposure limit, thereby allowing comparable investment flexibility for efficient portfolio management to UCITs III schemes with expanded powers.

- The manager will be required to demonstrate that it has appropriate risk management and controls in place to monitor the use of FDI.
- As for the calculation of the fund's exposure of pursuant to the FDI, the commitment approach, instead of determining the value-at-risk (VaR), shall be applied in order to provide consistency and comparability in risk measurement and to facilitate investors understanding.

3. HYBRID FUNDS WHICH INVEST IN OTHER FUNDS, AS WELL AS SECURITIES

- Previously, funds that invested more than 10%, but less than 100%, of their net asset value in other collective investment schemes were not contemplated, nor permitted.
- Notwithstanding the concentration risk, ‘hybrid structures’ are now allowed whereby a fund which invests more than 10% of net asset value in other collective investment schemes may concurrently also invest in other financial instruments such as bonds, equities or money market instruments.
- Hybrid funds may invest: up to 10% of net asset value in non-recognised jurisdiction schemes, up to 30% of net asset value in any one of SFC authorised funds or recognised jurisdiction

schemes, and more than 30% of net asset value in an SFC authorised fund (but not a recognised jurisdiction scheme) if the underlying scheme is specifically named in the prospectus and its key investment information is disclosed therein.

4. CHINESE LANGUAGE VERSIONS OF REPORTS TO REMAIN OPTIONAL

- Chinese language versions of annual and interim reports will not, after further consideration by the SFC, be mandatory.
- Managers of SFC authorised funds are required to inform investors that reports will only be made available in English if that is to be the case.

5. MISCELLANEOUS ASPECTS WHERE GREATER FLEXIBILITY IS ALLOWED

- *CPTs* - The 50% transaction limit on connected party transactions in any one financial year has been replaced with a disclosure obligation - the nature of such transactions, and the total commissions and other quantifiable benefits received by 'connected' brokers, in the year under review, must be disclosed in the annual report.
- *Hong Kong Representative* - A Hong Kong representative must now be an entity licensed or registered under the SFO, whether or not it is undertaking a distribution function, or a trust company registered under the Trustee Ordinance which is an affiliate of a Hong Kong authorised financial institution.
- *Performance Fees* - funds that are currently charging performance fees shall be permitted to reference a benchmark as an alternative to a high water mark subject to (i) amending the fund's constitutive documents; (ii) giving holders three months' prior notice; and (iii) clearly disclosing the calculation basis and the relevant benchmark in the fund's offering documentation.
- *Fund Redemptions* - the maximum interval between the receipt of a redemption request and the payment of redemption proceeds may now

exceed one month if realisation of a substantial portion of the fund's investments is subject to legal, regulatory or currency approvals.

- *Multi Manager Schemes* - managers with less than five years' experience and a demonstrable record of managing public funds are now allowed where the manager exercises and discloses proper due diligence procedures in selecting and monitoring sub managers.
- *Electronic Communications* - the use of websites to enable investors to readily access annual and interim reports is now allowed; the distribution of hard copies of key fact statements, prospectuses, shareholder letters and net asset values, is described as best practice.

Code on Investment-Linked Assurance Schemes (ILAS Code)

In addition to the new requirement to observe the Overarching Principles, which contain the obligation to deliver a key facts statement to all investors in SFC authorised Investment-Linked Assurance Schemes, the ILAS Code has been revised in the following three areas.

1. ENHANCED DISCLOSURE REQUIREMENTS

- For ILAS or investment options with 'with-profits' features, ILAS insurers have the discretion to declare the relevant applicable investment return by reference to the performance of the underlying assets.
- ILAS insurers also have the discretion to apply a market value reduction to the encashment/surrender value of the ILAS policy. The amount of the reduction could be up to 100% of the policy value.
- ILAS insurers are also required to disclose the extent to which the value of the investment can be reduced by market value adjustments and how the prevailing rate of market value reduction is disclosed to scheme participants.

- Where the return of an investment option is determined with reference to one or more SFC-authorized funds, ILAS insurers are required to disclose how to access the offering documents of such fund(s).

2. CODIFICATION OF CERTAIN EXISTING PRACTICES

- The computation of surrender values should not take account of any non-guaranteed returns, such as discretionary bonuses, dividend payments, reimbursements of charges.
- One month's prior notice shall be given of changes to a scheme that requires SFC approval. However, a shorter period of notice may be permitted if the change is not significant or if it is not practicable for the applicant due to circumstances beyond its control.

3. DELETION OF OBSOLETE PROVISIONS

- ILAS insurers no longer need to appoint a Hong Kong representative.
- To the extent ILAS insurers wish to delegate investment authority to external managers, they would be able to do so within the requirements of the current regime without the need for the broker managed provisions which have been deleted.

- The provisions relating to investment-linked savings plans (ISPs) are no longer relevant as an ILAS must be issued by an insurance company authorized under the Insurance Company Ordinance to carry on the relevant class of insurance business in Hong Kong.

Implementation/Timing

- The new regime comes into force on 25 June 2010 (the "Effective Date") on which the amendments are gazetted in the Government Gazette.
- Applications for authorisation submitted after the Effective Date will be subject to the new regimes.
- However, existing SFC authorized schemes will have a grace period of one year after the Effective Date to comply with the new regimes.

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