

August 15, 2017

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

By post and by email

Re: Consultation Paper on the Securities and Futures (Open-ended Fund Companies) Rules and the Code on Open-Ended Fund Companies

Dear Sir / Madam,

CFA Institute appreciates the opportunity to provide comments on the highly-anticipated consultation on Opened-Ended Fund Companies (OFCs) issued by the Securities and Futures Commission (SFC).

CFA Institute is a global non-profit organisation best known for the Chartered Financial Analyst program and designation, which is designed to enhance the technical and ethical understanding of investment professionals. We are a champion for ethical behaviour in the investment management profession and a respected source of knowledge in the global financial community. The end goal that we strive for is an environment where investors' interests come first, markets function at their best and the investment profession grows in a sustainable manner. Globally we have nearly 150,000 such professionals as members, who operate across the broad spectrum of global financial markets.

In Asia-Pacific, Hong Kong is special to us not only because it is our single largest society with over 7,000 members, it is also our regional headquarters — in fact, we will be celebrating our 20 years' anniversary in the city this year — and we are keen to contribute to its continued success as an international financial centre. In the last two decades, significant progress has been made in the growth and development of asset management industry globally, and the OFC structure has been instrumental to that growth and development. The latest proposal is therefore an important step in positioning Hong Kong as the key asset management hub in the Greater China region, not least for funds into and out of China. We are, in-principle, supportive. Notwithstanding this, we would like to take this opportunity to share with you our thoughts and observations:

- 1. Enhancing Hong Kong's capacity for asset management activities:** In its original consultation in March 2014, the Financial Services and the Treasury Bureau (FSTB) of Hong Kong cited this as a key rationale for introducing the OFC structure in Hong Kong. The OFC structure will help further develop Hong Kong's fund manufacturing capabilities and enhance Hong Kong's funds platform and infrastructure.

We acknowledge that the OFC structure is important to Hong Kong and will allow it to catch up with other global asset management hubs. However, we should also be aware that Hong Kong's unique proposition is in its proximity to, and special relationship with, China. In that regard, we suggest that the SFC work with overseas regulators, in particular those in China, to ensure that Hong Kong-registered OFCs will be recognised as being appropriately regulated

for licensing purposes. This step is essential if Hong Kong is to establish itself as a gateway and the focal point of activity to capture inbound and outbound fund flows from China.

- 2. Independent director:** We believe the presence of independent directors to be an important governance feature. In the 2016 consultation conclusions published by FSTB¹, it was concluded that the board of directors of an OFC would comprise a minimum of two directors, at least one of whom would be independent of both the investment manager and the custodian. However, in Chapter 5 of the draft OFC Code, the requirement is only for this independent director to be independent of the custodian—there is no mention of independence from the investment manager. We suggest this be tightened to reflect the original intention of the FSTB consultation conclusion and to ensure that independent directors are independent of both investment managers and custodians.

International best practice is that there must be genuinely independent directors on the board — the Financial Conduct Authority in the UK has recently changed the rules which now require 25% directors to be independent — in fact, a good case can be made for a majority, if not all, directors to be fully independent.

- 3. Fees:** The proposed fee schedule included in Appendix C, while comprehensive, is perhaps too complex. There are over 60 fee categories in total which is cumbersome and confusing. Our suggestion would be to trim this down significantly.

In any event, given that Hong Kong is catching up from behind vis-à-vis other asset management hubs, the SFC may wish to consider waiving OFC-related fees for say, three years, as an additional incentive to motivate asset managers to establish their operations in Hong Kong.

- 4. Fees disclosure:** The current consultation is silent on the disclosure of fees and expenses by public OFCs. Under the Hong Kong Code on Unit Trusts and Mutual Funds, fees and expenses paid by an investor or by the fund must be disclosed. In practice, disclosure of fees and expenses vary widely across different managers and funds making direct comparison by investors difficult. We propose that the SFC take this opportunity to mandate disclosure of total expense ratio as a single number to support the investment decision making process. In addition, SFC may wish to consider mandating the disclosure of other information such as entry/exit charges, portfolio turnover or portfolio transaction costs. Transparency over costs is essential to facilitate the purchase of suitable products by investors.
- 5. Tax regime:** While the principle that there will be one-stop registration for Hong Kong tax purposes is positive, tax issues for both public and private OFCs need to be addressed further. As taxation is not within the SFC's remit, the Inland Revenue Department, together with the HKSAR Government, need to make sure that the process for obtaining tax exemption is transparent, simple and automatic once SFC registration and authorisation is obtained. Further, the application of existing double tax treaties needs to be confirmed. Additional clarity on the tax regime for private OFCs would be welcomed.
- 6. Delegation:** It is a requirement that the investment management function be conducted through an appointed SFC licensed manager. There is no provision specifically addressing the delegation to non-SFC licensed managers/advisers (for example in overseas jurisdictions) or the use of an internal manager (for example, in the case of Link REIT) both of which appear to be permitted currently. Where such delegation arrangements are made, it is important that the

¹ http://www.fstb.gov.hk/fsb/ppr/consult/doc/ofc_conclu_e.pdf, para. 60

delegated manager is licensed in an acceptable jurisdiction, subject to appropriate internal control and oversight arrangements, and that investors' interests are protected.

7. **Private OFCs:** In the 2016 consultation conclusions published by FSTB, it was concluded that for private OFCs, a maximum of 10% of total gross value of the fund may be allocated to non-traditional financial assets. We believe that placing such a limit on private OFCs is too rigid as there may be circumstances where investors would want access to high risk asset classes and can accept higher risk concentrations.
8. **Legal capacity of OFCs:** Rendering any transaction entered into outside an OFC's operation as a collective investment scheme invalid has the potential to be cumbersome and problematic, creating uncertainty and pointlessly adding to costs. It is for very good reasons that company law in many jurisdictions did away with the old *ultra vires* laws.

Conclusion

CFA Institute welcomes the initiative to broaden and deepen the development of the asset management industry in Hong Kong. We understand the difficulty in striking a balance between protecting investors and providing regulatory oversight while encouraging market development and product innovation. We are optimistic that, with certain improvements, the current proposals will go a long way in achieving these objectives.

Yours faithfully,

/s/ Paul Smith, CFA

President and CEO
CFA Institute