

NEW REGULATORY REGIME FOR TRUSTEES AND CUSTODIANS OF HONG KONG PUBLIC FUNDS

Trustees and custodians of public funds (i.e. funds authorised by the Securities and Futures Commission (SFC) for retail distribution) in Hong Kong are currently not required to be licensed by the SFC and are not subject to any direct on-going regulatory supervision. As part of Hong Kong's asset management strategy to enhance the safe custody regime for public funds, the SFC proposes to regulate intermediaries acting as a trustee or custodian of public funds by introducing a Type 13 regulated activity (RA13)¹.

INTRODUCTION

The current regulatory regime in Hong Kong that applies to trustees and custodians of public funds² is described by the SFC as "patchy". Whilst the SFC Product Codes³ set out, amongst other things, the eligibility provisions and ongoing obligations of a trustee or custodian of public funds, the SFC is unable to directly supervise such intermediaries because the provision of their services for the public funds is not a regulated activity per se.

Certain trustees and custodians of public funds are regulated by different regulators. For example, trustees of MPF schemes are approved by the Mandatory Provident Fund Schemes Authority (MPFA) and are subject to its regulation and supervision. However the MPFA's regulatory power is limited to supervising trustees of pure MPF products but not trustees for other non-MPF public funds, even if the trustee may provide its services to both types of funds. A trustee company servicing a public fund may be registered under the Trustee Ordinance as a registered trustee company (RTC) but as the SFC has no oversight of the trust laws, it is unable to supervise RTCs directly.

The regulatory expectations of the key operators of Hong Kong public funds are set out in the UT Code⁴. Currently the SFC only has direct powers to supervise or take disciplinary action against fund managers of public funds in breach of the UT Code. Due to the lack of a specific and direct regulatory handle, the SFC faces practical difficulties when supervising trustees and custodians even when they play key roles in safeguarding fund assets and providing independent

Key issues

- RA13 applies "top-level" trustees and custodians, i.e. the entity at the top of the custodial chain
- Corporations licensed for RA13 are subject to the Manager-In-Charge regime
- Trustees and custodians should have a level of responsibility as they play a key role in providing independent oversight of the management of Hong Kong public funds
- Potential RA13 depositaries and their related staff members will be given around 12 to 18 months from the Gazetted Date to complete the licensing or registration process prior RA13 regime implementation
- The SFC plans to adopt a "grandfathering" approach to bring existing staff of public funds depositaries within the RA13 regime

¹ Consultation Paper on the Proposed Regulatory Regime for Depositaries of SFC-authorized Collective Investment Schemes (Consultation) published by the SFC in September 2019.

² These are collective investment schemes (CIS) authorised for retail distribution by the SFC under section 104 of the Securities and Futures Ordinance (SFO).

³ These are the Code on Unit Trusts and Mutual Funds (UT Code), the Code on Real Estate Investment Trusts (REIT Code), the Code on Pooled Retirement Funds (PRF Code) and the Code on Open-Ended Fund Companies (OFC Code).

⁴ In particular, the duty of oversight of trustees and custodians are primarily provided in Chapter 4.5 of the UT Code.

oversight of the management of Hong Kong public funds. In view of this, the SFC proposes to introduce RA13 as part of the SFC's asset management strategy to enhance the regulatory standards of trustees and custodians that service public funds.

PROPOSED SCOPE

RA13 will be a new type of regulatory activity under Schedule 5 to the SFO. This covers intermediaries acting as a trustee or custodian (generally referred to as a "depository") of a public fund (relevant CIS).

A "depository" in respect of a relevant CIS is defined as:

- (a) for a unit trust, a person appointed as the trustee pursuant to the trust deed which constitutes or governs such CIS; and
- (b) for a structure other than a unit trust, a person (by whatever name called) appointed to perform the functions of a custodian pursuant to a written agreement entered into between the person and such CIS.

An important point to note is that RA13 will be applied to "top-level" depositories, i.e. the trustees and custodians at the top of the custodial chain and they have the responsibility to safeguard the fund assets and perform independent oversight of fund operations. This means that whilst the depositories may delegate their functions to third parties such as the depository's nominees, agents and delegates (e.g. sub-custodian or the global custodian), such third parties will not fall within the scope of RA13. Further, the proposed regulatory obligations are in addition to the legal obligations that the depository is currently subject to. As an example, a trustee will need to comply with the proposed RA13 licensing requirements, the Product Codes as well as its fiduciary duties as trustee of the relevant CIS under the common law.

Given MPF-approved trustees are already subject to the MPFA's regulation and supervision, a trustee providing services to pure MPF products will not need to be licensed or registered for RA13. The carve-out however does not include approved pooled investment funds (APIFs) which may be offered directly to retail investors as public funds.

LICENSING

Where an individual performs a function in relation to an intermediary's business of "acting as a depository", he or she will be required to be licensed representatives or relevant individuals⁵ accredited to the intermediary. The SFC has taken the view that operational tasks performed by clerical staff are generally not required to be licensed or registered. Other staff as part of the internal corporate functions of an RA13 depository (e.g. human resources, information technology, finance and accounting, legal and compliance) will also be excluded from the licensing requirements.

The Manager-In-Charge regime will apply to corporations licensed for RA13. It is important that the scope of each senior manager's duties of the depository is clear and that each senior manager is fully aware of his or her obligations under the Hong Kong's regulatory regime.

The fit and proper requirement under the current regime will apply to firms or individuals seeking to be licensed or registered for RA13. The SFC will introduce

⁵ Relevant individuals who perform regulated functions in relation to regulated activities for registered institutions are not required to be licensed or registered with the SFC. However, under the Banking Ordinance, their names will have to be entered in the register maintained by the HKMA.

new licensing examinations for staff applying to be responsible officers, executive officers or representatives for RA13 depositaries. However, exemption may apply to existing staff as explained further below.

To cater for the new licensing examinations and recognised industry qualifications for RA13 the Guidelines on Competence and Guidelines on Continuous Professional Training (CPT) will be amended as appropriate.

CONDUCT AND INTERNAL CONTROLS REQUIREMENTS

In addition to the provisions in the existing Product Codes which already apply to trustees and custodians, RA13 depositaries and licensed individuals must comply with the SFO and the SFC's codes and guidelines. These include the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (Code of Conduct) and the Management, Supervision, and Internal Control Guidelines for Persons Licensed by or Registered with the Securities and Futures Commission (Internal Control Guidelines).

As Product Codes are meant to cater for the specific nature of each product type, the SFC intends to retain and rely on the existing trustee and custodian provisions in the respective Products Codes. With respect to internal control measures, the SFC will generally adopt the provisions from the internal control measures applicable to trustees and custodians from the recently updated UT Code. Such provisions will be set out in the new Schedule 11 to the Code of Conduct. The SFC emphasises that it is the responsibility of senior management of an RA13 depositary to exercise professional judgment in designing suitable internal controls and systems and ensure that requirements in Schedule 11 are adequately, effectively and properly implemented.

As part of the proposals, RA13 licensed corporations will also be subject to financial resources and profession indemnity insurance requirements.

IMPLEMENTATION AND TIMELINE

The Product Codes will be amended to reflect the introduction of RA13 with any consequential amendments to subsidiary legislation subject to further public consultation.

Upon the date of the gazettal notice to amend Schedule 5 of the SFO (Gazettal Date), potential RA13 depositaries and their related staff members will be given around 12 to 18 months from the Gazettal Date to complete the licensing or registration process prior RA13 regime implementation. The SFC expects prospective applicants to submit their applications to the SFC, or to the HKMA as the case may be, within two months from the Gazettal Date. The SFC warns against a delay which may result in disruption to the applicant's business operations.

Noting that the existing depositaries of public funds have a long history of operation in Hong Kong and they are managed by experienced staff, the SFC plans to adopt a "grandfathering" approach to bring existing staff of public funds depositaries within the RA13 regime. The competence of staff applying to be responsible officers, executive officers or representatives of RA13 depositaries during the transitional period will be assessed in accordance with the academic qualification, relevant industry experience and management experience tests, without having to pass the local regulatory framework papers. However, they must complete appropriate training not less than five hours on legal and regulatory framework for RA13 within 12 months of securing licensing or registration approval, in addition to fulfilling the normal CPT requirements.

The Consultation period ends on 31 December 2019. Clifford Chance will be submitting a response to the SFC. We welcome your comments and any questions you may have on the Consultation.

CONCLUSION

Protection of fund assets has been the subject of heightened attention as observed in recent enhancements in custody regimes for funds internationally at IOSCO and other major overseas markets. In recent years the SFC has come across a number of cases involving deficiencies in the internal control systems of some trustees and custodians, but due to practical difficulties it has been unable to discipline or take other enforcement action against the trustee or custodian. The introduction of RA13 is seen as a necessary move to strengthen and enhance the regulation of public funds in Hong Kong.

Depositaries of relevant CIS should carefully consider their internal control policies and procedures and ensure they meet the standards for eligibility, governance, organization and operational conduct under the new RA13 licensing regime.

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