



Hong Kong

April 2020

## SFC GUIDANCE FOR AUTHORISED FUNDS AMID THE COVID-19 PANDEMIC

### SFC's Regulatory Response to COVID-19

On 21 April 2020, the Securities and Futures Commission (the **SFC**) published a press release<sup>1</sup> outlining its regulatory response to the considerable impact of the COVID-19 pandemic on the Hong Kong financial markets. The SFC's main areas of focus have been ensuring that Hong Kong's financial markets continue to function efficiently, assuring investor protection, and preserving market integrity, against a background of extreme market volatility and the challenges posed by special work arrangements adopted due to the pandemic.

In relation to funds, the SFC has issued guidance to SFC-licensed fund managers highlighting their obligations to ensure the fair treatment of fund investors particularly when activating liquidity risk management measures, such as swing pricing or suspensions. Fund managers are also reminded of their obligations to review investment funds' liquidity and their redemption profiles. The SFC has also been closely supervising the derivatives markets and short selling data to avoid any systemic risks or disruption in the financial markets.

The SFC has issued two circulars and two sets of FAQs with guidance relating specifically to COVID-19. All information issued by the SFC in relation to COVID-19 is available on a dedicated SFC website at <https://www.sfc.hk/web/EN/information-for-firms-on-covid-19.html>.<sup>2</sup>

1 SFC. SFC regulatory response to COVID-19. 21 April 2020. Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR35>

2 <https://www.sfc.hk/web/EN/information-for-firms-on-covid-19.html>

The following is a summary of the SFC's guidance for fund managers issued during the COVID-19 outbreak.

### 1. SFC Circulars to Authorised Funds

#### 1.1 Circular to management companies and trustees and custodians of SFC-authorized funds<sup>3</sup>

In light of the market disruption caused by the COVID-19 pandemic, the SFC issued a circular to all management companies (**Fund Managers**), trustees and custodians of SFC-authorized funds on 27 March 2020. The circular reminds Fund Managers, trustees and custodians of SFC-authorized funds of their obligation to act in the best interest of the investors and to closely monitor dealing and trading in the funds under their management, and in the case of ETFs, to assess whether continuous trading can be conducted in the best interests of investors and in a fair and orderly manner.

Fund Managers are also reminded of their obligation to keep investors informed, and to immediately notify the SFC, of any untoward circumstances affecting any fund under their management. This would include:

- a) fund managers' use of liquidity risk management tools, such as an intention to increase or apply any swing factor or anti-dilution levy; and

3 SFC. Circular to management companies and trustees and custodians to SFC-authorized funds. 27 March 2020. Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=20EC22>

- b) a decision to defer redemption, suspend creation and/or redemption in the primary or secondary market and the impact on the fund.

Fund managers are also required to consult the relevant trustee or custodian before using liquidity risk management tools. The circular also reminds trustees and custodians of their obligations to safeguard fund assets, and to provide independent oversight of the management of funds.

For a detailed summary of the obligations of Fund Managers, custodians and trustees with regard to SFC-authorized funds highlighted in the circular, please see Charltons' newsletter SFC Publishes Guidance to Fund Industry in view of COVID-19 Outbreak.<sup>4</sup>

## 1.2 Circular to Management Companies and Market Makers of SFC-authorized Exchange Traded Funds<sup>5</sup>

On 17 April 2020, the SFC issued a circular to Fund Managers and market makers of SFC-authorized exchange traded funds (ETFs) reminding them of their risk management obligations amid the COVID-19 outbreak. The circular serves as guidance for management companies and market makers working in: (i) SFC-authorized passive ETFs; (ii) active ETFs; and (iii) listed unit/share class(es) of unlisted SFC-authorized funds. The SFC was concerned about a recent incident in relation to a sole market maker of an ETF which temporarily suspended its market making functions due to the COVID-19 pandemic, raising concerns as to ETF management companies' and market makers' ability to manage this risk.

For a detailed summary of this circular, please see Charltons' newsletter SFC Guidance to ETF Fund Managers and Market Makers after Temporary Halt by ETF Market Maker amid COVID-19 Pandemic.<sup>6</sup>

<sup>4</sup> Charltons. SFC publishes guidance to fund industry in view of COVID-19 outbreak. Available at: <https://www.charltonslaw.com/sfc-publishes-guidance-to-fund-industry-in-view-of-covid-19-outbreak/>

<sup>5</sup> SFC. Circular to management companies and market makers of SFC-authorized exchanged traded funds – ETF market making. 17 April 2020. Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=20EC30>

<sup>6</sup> Charltons. SFC guidance to ETF fund managers and market makers after temporary halt by ETF market maker amid COVID-19 pandemic. Available at: <https://www.charltonslaw.com/sfc-guidance-to-etf-fund-managers-and-market-makers-after-temporary-halt-by-etf-market-maker-amid-covid-19-pandemic/>

## 2. SFC FAQs for SFC-authorized Funds amid COVID-19

### 2.1 SFC FAQs on Post Authorisation Compliance Issues of SFC-authorized Unit Trusts and Mutual Funds – Novel coronavirus (COVID-19)<sup>7</sup>

Question 1: Whether in view of the extreme market volatility and uncertainty in local and international markets relating to the COVID-19 outbreak, Fund Managers can increase the swing factor to be applied on the net asset value (NAV) of their SFC-authorized funds beyond the maximum swing factor disclosed in the funds' offering documents, and whether SFC approval is required for such increase?

#### SFC Response

The SFC notes Fund Managers' responsibility for ensuring: (i) that all fund assets are fairly and accurately valued and that liquidity risk management tools (e.g. swing pricing or anti-dilution levies) are used appropriately; and (ii) the fair treatment of all investors including redeeming investors and those remaining in the funds.

Fund Managers can increase the swing factor beyond the maximum level disclosed in funds' offering documents as a temporary measure without the SFC's prior approval if the following conditions are met:

- i) the decision to increase the swing factor must be duly justified (i.e. with the support of a robust methodology that provides an accurate NAV representing the prevailing market conditions) and be in the best interests of the investors. The decision must go through a robust internal governance process which should be properly documented;
- ii) existing and new investors of the fund and, where applicable, fund distributors, must be informed of the decision to increase the swing factor before the revised swing factor is applied;
- iii) the Fund Manager must be able to demonstrate and justify that the swing factor applied was representative of the prevailing market conditions and was in investors' best interests; and

<sup>7</sup> SFC. Frequently asked questions on post-authorization compliance issues of SFC-authorized unit trusts and mutual funds. Available at: [https://www.sfc.hk/web/EN/files/ER/FAQ\\_on\\_Post\\_Authorization\\_Compliance\\_Issues\\_COVID%2019\\_20200401.pdf](https://www.sfc.hk/web/EN/files/ER/FAQ_on_Post_Authorization_Compliance_Issues_COVID%2019_20200401.pdf)

- iv) the revision and use of a higher swing factor comply with the fund's constitutive documents, and applicable laws and regulations imposed by its home regulator.

If the above conditions are met, Fund Managers can notify investors through the fund's website and/or through the fund's usual communication channels, and apply the increased swing factor immediately.

Fund managers are also required to notify the SFC of their intention to increase or apply the swing factor which exceeds the swing factor disclosed in the fund's offering documents. Fund managers must also file with the SFC the notification given to investors of the increased swing factor. The SFC may ask fund managers to justify on an ex-post basis the level of the swing factor applied and to provide supporting documents in relation to paragraph (iii) above.

The above treatment will also apply to fund managers' use of the anti-dilution levy.

**Question 2:** Can an SFC-authorized fund apply the swing pricing mechanism under the proposed temporary measure in FAQ 1. above, if it has not disclosed in the offering document that swing pricing may be used?

#### SFC Response

The temporary measure outlined in FAQ 1. only applies to funds which have already disclosed the use of swing pricing mechanism and liquidity risk management in their offering documents.

The SFC will deal on a case by case basis with funds wishing to use swing pricing that have not included a swing pricing mechanism in their offering documents. It will require such fund managers to provide the SFC with information regarding:

- i) why they need to implement swing pricing; and
- ii) whether the relevant fund is permitted to adopt the swing pricing mechanism under its constitutive documents and relevant governing laws and regulations, and by its home regulators.

In particular, Fund Managers must ensure that investors' interests will not be prejudiced and that investors are treated

fairly at all times. The SFC should be consulted in cases where there is any doubt. The treatment outlined above will also apply to the use of any anti-dilution levy.

**Question 3:** Will the SFC implement any temporary relief measures as regards post-authorization due to operational difficulties relating to the COVID-19 outbreak?

#### SFC Response

The SFC is implementing the following temporary measures to relieve funds from strict compliance with the post-authorisation matters.

##### (i) Accepting Soft Copy Documents

Fund Managers are allowed to submit documents by soft copy only for all applications and post-authorisation filings, including, *inter alia*, documents submitted in fulfilment of post-authorisation conditions. The official receipt date of an application or a post-filing will be the business day on which the SFC receives the full and complete set of soft copy documents.

##### (ii) Accepting Unsigned Documents

Fund Managers are allowed to submit unsigned copies of application forms, filing forms, confirmations and other relevant documents, provided that they are submitted together with an email confirmation from a person who meets the signatory requirements for the relevant forms. The SFC will accept these forms and documents in connection with the subject application or filing provided that they are in order. The signed originals of relevant forms and documents should be submitted to the SFC in accordance with existing protocols as soon as practicable.

## **2.2 Frequently Asked Questions on Application Procedures for Authorization of Unit Trusts and Mutual Funds under the Revamped Process<sup>8</sup>**

**Question 14:** Will the SFC implement any temporary relief measures as regards new fund applications due to the operational difficulties relating to the COVID-19 outbreak?

#### SFC Response

<sup>8</sup> SFC. Frequently Asked Questions on application procedures for authorization of unit trusts and mutual funds under the revamped process. Available at: [https://www.sfc.hk/web/EN/files/ER/FAQ\\_on\\_Application\\_Procedures\\_for\\_Authorization\\_COVID%2019\\_20200401.pdf](https://www.sfc.hk/web/EN/files/ER/FAQ_on_Application_Procedures_for_Authorization_COVID%2019_20200401.pdf)

The SFC is implementing the following temporary measures to relieve the administrative burden for new fund applications.

(i) Accepting Soft Copy Documents

Applicants are allowed to submit all application documents related to new fund applications by soft copy only. The official receipt date of a fund application will be the business day on which the SFC receives the complete set of soft copy documents before 6 p.m. on that business day. If documents are received after 6 p.m., the official receipt date will be the following business day.

(ii) Accepting Un-signed Documents

Applicants are allowed to submit unsigned copies of application forms, information checklists, confirmations and other relevant documents, provided that they are submitted together with an email confirmation from a person who meets the signatory requirements for the relevant documents. The signed originals are required to be submitted to the SFC in accordance with existing protocols as soon as practicable.

(iii) SFC Accepts New Fund Application(s) with Application Fee(s) to Follow

The SFC will process new fund applications that are in order where payment of the application fee(s) is the only outstanding issue. Applicants are expected to submit the application fee as soon as practicable upon receipt of the SFC's Take-up Letter. If there are any questions, fund managers should contact their designated SFC case team to discuss the payment arrangement.

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