Non-Hong Kong Investment Funds: Relaxation of SFC Authorization Practices

This article looks at recent developments which suggest a relaxation of SFC authorization requirements for collective investment schemes based outside of Hong Kong. First, the SFC has expanded the ability of managers of authorized schemes to delegate their investment management functions to sub-managers in jurisdictions previously considered to be generally unacceptable. Secondly, the SFC appears to have softened its policy of insisting that investment management agreements and custodian agreements preserve the jurisdiction of the Hong Kong courts.

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Hong Kong is an important market for global asset managers. Whilst the Securities and Futures Commission ("**SFC**") is open to authorizing collective investment schemes ("**CIS**") based abroad, experience shows that difficulties can arise in the complying with SFC requirements. This is particularly so where the scheme has already been commercialized outside of Hong Kong.

Jurisdiction of Sub-Investment Manager

One area that has sometimes proven difficult is the SFC's requirement that, with certain exceptions, both the manager of a collective investment scheme and every sub-manager to whom the manager delegates investment discretion be either licensed by the SFC or otherwise subject to regulatory supervision in specified jurisdictions which are regarded as subject to an acceptable inspection regime ("**AIR**").

AIR Jurisdictions

AIR jurisdictions are recognized by the SFC as providing regulatory protection for investors comparable to that in Hong Kong. The Code on Unit Trusts and Mutual Funds ("**the Mutual Fund Code**") lists 8 specific AIR jurisdictions, namely Australia, France, Germany, Ireland, Hong Kong, Luxembourg, the United Kingdom, and the United States.

Approval of these locations as AIR jurisdictions is based upon the fact that the regulatory authority of the AIR jurisdiction carries out

inspections of the scheme managers within its jurisdiction in a manner generally consistent with the requirements of the SFC and the regulatory authority of the AIR jurisdiction has a satisfactory procedure in place (usually in the form of a formal Memorandum of Understanding) for exchanging information about the scheme managers with the SFC.

The Challenges Posed By Globalization

Potential scheme managers or sub-managers located in non-AIR jurisdictions have in the past been approved on a case-by-case basis under the Mutual Fund Code. However, the SFC has been understandably cautious about granting such approvals and the delays in securing such approvals can be significant.

The small number of jurisdictions officially recognized by the Mutual Fund Code, combined with the SFC's conservative approach to *ad hoc* approvals, has proven problematic for some scheme sponsors.

For example, a scheme sponsor may be based in a non-AIR jurisdiction and thus, may be unable to arrange for investment discretion to be exercised by the core manufacturing center for the sponsor group.

Equally, for example, a scheme sponsor may wish to arrange for investment discretion to be exercised by sub-managers in non-AIR jurisdictions which have markets in which the scheme invests.

New Practice

To address these developments, the SFC recently announced its intention to facilitate the delegation of investment management functions to sub-managers based in non-AIR jurisdictions. It has formulated the following criteria for acceptance of a non-AIR sub-manager:

- the delegating manager must itself be licensed by or registered with the SFC for Type 9 regulated activity, or be subject to supervision in an AIR jurisdiction;
- the sub-manager must be licensed or registered for management of investment funds by its home regulator, and have a good regulatory record;
- the sub-manager should be an affiliate of the delegating manager subject to the same system of internal controls and compliance procedures, and it should comply with various prescribed requirements of the Mutual Fund Code;
- the sub-manager should remain under the supervision of the delegating manager, which will be responsible for the sub-manager's activities in respect to the delegated management functions;
- all transaction records relating to the delegated activities should be available for inspection by the SFC, and all enquiries from the SFC should be properly addressed;
- the delegating manager must report any material breach, infringement or non-compliance by the sub-fund manager or itself with the laws and regulations of its home regulator to the SFC;

… the SFC recently announced its intention to facilitate the delegation of investment management functions to sub-managers based in non-AIR jurisdictions.

- the jurisdiction where the sub-manager is based should have a developed fund market (demonstrated by the presence therein of international firms) or its regulator should be a signatory to international cooperation arrangements; and
- the delegating manager must retain primary responsibility for the proper management of the scheme in question.

… foreign collective investment schemes seeking admission to the Hong Kong market may no longer need to undertake the difficult task of amending investment management agreements or custodian agreements to remove non-Hong Kong exclusive jurisdiction clauses.

Illustrative Case

Shortly before the release of the SFC's announcement of the change in practice on non-AIR jurisdictions, we obtained SFC authorization of a Luxembourg-based scheme whose Luxembourg-based manager delegated investment discretion to a Belgian sub-manager. Belgium is not an AIR jurisdiction. In our submission to the SFC we emphasized that:

- the manager is regulated in Luxembourg, an AIR jurisdiction, and is required by the regulatory authority there, the Commission de Surveillance du Secteur Financier ("**CSSF**"), to closely monitor and supervise the Belgian sub-manager;
- the Belgian sub-manager is subject to indirect supervision by the CSSF as the CSSF and the Belgian regulator, the Commission Bancaire, Financière et des Assurances ("**CBFA**"), have a supervision agreement in place pursuant to which the CSSF can request the CBFA to provide information regarding the Belgian sub-manager or to take corrective action;
- the Belgian sub-manager and the Luxembourg manager are both members of the same corporate group and thus subject to the same system of internal controls and compliance procedures; and
- the Belgian sub-manager was willing to provide a voluntary undertaking to submit to the jurisdiction of the SFC by providing information on request to the SFC to demonstrate that it was carrying out its investment management functions satisfactorily.

The process confirmed the SFC's commitment to enhanced flexibility in the delegation of investment management functions.

Exclusive Jurisdiction Clauses

Another area that has sometimes proven difficult is the SFC's historical objection to any clause ("**non-Hong Kong exclusive jurisdiction clause**") in the investment management agreement or custodian agreement providing for exclusive jurisdiction of non-Hong Kong courts.

Constitutive documents of collective investment schemes structured outside of Hong Kong often provide for the courts of the jurisdiction in which the scheme is domiciled or the manager is based to assume exclusive jurisdiction in the event of a dispute. For example, the constitutive documents of a Luxembourg based scheme may provide for the courts of Luxembourg to exercise exclusive jurisdiction.

In the past, the SFC has required non-Hong Kong exclusive juris-

diction clauses to be amended to allow for Hong Kong courts to assume jurisdiction. For existing schemes, such a requirement is often undesirable for the scheme sponsors as amendments to such agreements may require, in addition to consent of scheme holders, approval from regulators in other jurisdictions in which the scheme is marketed.

Authority

Ostensibly, the SFC's objection to non-Hong Kong exclusive jurisdiction clauses arises as a result of the Mutual Fund Code. The Mutual Fund Code provides that the constitutive documents of a CIS may not exclude the jurisdiction of the Hong Kong courts to entertain actions concerning the CIS. In this regard, "constitutive documents" means "the principal documents governing the formation of the scheme, and includes the trust deed in the case of a unit trust and the Articles of Association of a mutual fund corporation and all material agreements".

These provisions are designed to ensure that Hong Kong investors may enforce their rights under an SFC authorized scheme in Hong Kong courts and thus, are not deprived of a forum in which to pursue available remedies.

Non-Hong Kong Jurisdiction Clauses Now Acceptable?

Whilst the SFC has yet to publish formal guidance, in a recent application to the SFC in which the investment management agreement provided for the exclusive jurisdiction of Luxembourg courts, we argued, and the SFC apparently accepted, the following:

- no Hong Kong investors are parties to the investment management agreement, and thus the agreement creates no contractual rights which may be enforced by Hong Kong scheme holders;
- the agreement creates no third-party rights in favour of Hong Kong scheme holders; and
- the agreement does not affect, either positively or negatively, the ability of Hong Kong scheme holders to enforce, in the courts of Hong Kong, any rights (whether in contract or tort) they may otherwise possess.

As a result, the SFC has intimated that it will no longer object to non-Hong Kong exclusive jurisdiction clauses in investment management agreements or custodian agreements. However, based on the Mutual Fund Code, the SFC will continue to object to non-Hong Kong exclusive jurisdiction clauses in articles of association or trust deeds.

If in fact the SFC has changed its practice, foreign collective investment schemes seeking admission to the Hong Kong market may no longer need to undertake the difficult task of amending investment management agreements or custodian agreements to remove non-Hong Kong exclusive jurisdiction clauses. ■

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