

# CAPCO

## **RAISING THE BAR FOR COLLECTIVE INVESTMENT SCHEME TRUSTEES AND CUSTODIANS**

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# INTRODUCTION

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Licensing regimes for Collective Investment Schemes (CIS) have become commonplace globally over the last couple of years, following the financial crisis and growing scrutiny of the standards for the custodians of assets managed under CIS. While Trustees and Custodians of public funds in Hong Kong have obligations to safeguard assets and conduct oversight, currently they are not subject to any licensing regime.

However, through the proposed introduction of Type 13 Regulated Activity (RA13), the Securities and Futures Commission (SFC) seeks to bring Hong Kong in line with other jurisdictions by enforcing a licensing regime that

will fundamentally and permanently impact the way in which Trustees and Custodians conduct business.

The SFC initially issued a Consultation Paper setting out its proposals for the regulation of Trustees and Custodians of Hong Kong public funds back in September 2019. There followed a period of industry consultation, with responses requested by a closing date of 31 December 2019. However, due to ongoing delays linked to the pandemic, at the time of writing the industry is still awaiting for those responses to be published.

# WHY IS THIS HAPPENING?

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The current regulatory framework is fragmented across the CIS landscape. SFC Product Codes stipulate various ongoing requirements from a product eligibility perspective, but there is a lack direct supervision. At the same time, some participants are regulated in their capacity as Trustees of Mandatory Provident Fund (MPF) schemes, falling under the remit of the Mandatory Provident Fund Authority (MPFA) where a Trustee provides only MPF products. Conversely, certain other products are subject to some degree of oversight from both the SFC and MPFA. In summary, there is no 'one size fits all' approach at present.

The SFC faces an abundance of practical difficulties as things stands in directly supervising Trustees or Custodians of public funds, primarily because the provision of such services is not a regulated activity. The introduction of RA13 seeks to address this through a formal oversight regime.

The SFC has been building towards this step for some time and has accordingly looked at the experiences of regulators in Europe and North America, notably around UCITS legislation and the Alternative Investment Fund Managers Directive (AIFMD) framework. Amendments to the SFC Code on Unit Trusts and Mutual Funds (UT Code) came into force in January 2019 (with a 12-month transition period). Since then the Commission has been actively pursuing consultations on other regimes, including those covering real estate investment trusts (REITs), pooled retirement funds (PRFs) and open-ended fund companies (OFCs).

Through such revisions and alignments across the various product codes, the obligations on Trustees and Custodians will be brought in line, regardless of the type of CIS they are safekeeping.

# WHAT IS CHANGING?

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Perhaps understandably, many will point to the proposed changes around staff licensing, the Manager-In-Charge regime, or the increased administrative, financial resource requirements on capital and liquid arrangements and insurance requirements. However, arguably the most significant change relates to the consequential impact to becoming a licensed entity.

**Consequential impact:** Once licensed under RA13, Trustees and Custodians will be subject to SFC supervision and subsequently must comply with a non-exhaustive list of Codes, Guidelines and Circulars. The consequences of this will have transformation professionals protesting about ‘scope creep’ and cause compliance managers no little upset. This is due to there currently being in excess of over 500 existing Circulars for licensed entities alone. One of the more notable changes ushered in by RA13 will be the insertion of a new ‘Schedule 11’ into the Code of Conduct, which not only highlights existing Product Code provisions but also introduces additional provisions along the way.

**Individual licensing:** Any individual performing any regulated function in relation to an intermediary’s business of ‘acting as a

depository’ will be required to be licensed under the SFC. While the plan is to adopt a ‘grandfathering’ approach for existing staff, approved individuals will still be required to complete a course – running no less than five hours – on RA13’s regulatory framework within 12 months of being licensed.

## **Manager-In-Charge (MIC) & Responsible Officers (RO):**

The MIC regime introduced in December 2016 sets out eight core functions that require a designated MIC. The MICs of overall management oversight functions and key business line functions must also be an RO. Under RA13, intermediaries must also appoint at least two ROs, one of whom is an Executive Director of the entity.

**Financial resources:** New requirements require a minimum level of paid-up capital totalling HK\$10 million to be maintained, alongside liquid capital of HK\$3 million, by Trustees and Custodians.

**Insurance coverage:** A non-statutory professional indemnity insurance policy must be put in place to cover claims for liability arising from breaches of duty while carrying out RA13 business.

# WHAT ARE THE IMPACTS?

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The introduction of the licensing requirements will fundamentally and permanently impact the way in which Trustees/Custodians conduct their business. In many cases RA13 will require them to boldly go where they have not gone before, so it will be key for Trustees/Custodians to scrutinize potential areas of change carefully to understand implications for their first- and second-line staff.

**Consequential impacts:** Appendix C in the Consultation paper sets out a list of subsidiary legislations that will fall within the scope of RA13 change however, it does not detail the nature or extent of these impacts. The SFC has confirmed that indicative changes would be highlighted in a subsequent round of consultation, but it can already be observed that some key rules including Client Money, Client Securities and Financial Resources Rules will need to be within the scope of consideration for licensed entities.

At present, many of these Rules are not applicable to the Trustee business. Take Client Money Rules as an example there are going to be complications in comparing Trustee/Custodian operating flows to those stipulated within the Rules, considering the many different structures of bank account operating flows resulting from the diversity of products that Trustees/Custodians offer to clients.

Likewise, Financial Resources Rules require 13 return forms to be submitted to the SFC, many of which ask for vastly different types of financial data, so licenced entities will need to ensure their reporting and disclosure processes are up to this challenge. Of course, these impacts only relate to the initial round of consultation. As noted above, the larger impact will encompass all the Circulars/Guidelines/Rules currently in effect, plus those that will come into force in the future. Licensed entities will be obligated to comply with the full scope and should act sooner rather than later to ensure they are prepared. This includes recent Circulars such as the EDSP Circular, which relates to the use of external electronic data storage providers. Tracking all these moving pieces will be difficult for intermediaries in determining their compliance approach.

**Individual licensing:** Trustees and Custodians would be advised not to view RA13's 'grandfathering' provisions as an easy win. They will still need to develop processes to monitor new joiners and leavers, and may want to determine if licensing teams should be created to ease the administrative burden on team managers and other first-line staff in critical functions when applying for individual licenses. HR will play an important role here, and should support by providing up to date job descriptions and employee contracts to include additional criteria for licensed roles.

**MIC & RO regime:** Entities will have to closely examine existing governance structures, including reviewing current directorships and determining if sitting directors currently meet the fit and proper standards imposed by the SFC. The standards themselves not only set a high bar but encompass multiple areas, such as qualifications and relevant experience. It should be noted that some licensed market players have come under SFC scrutiny where directors and appointed ROs are located outside of Hong Kong and hence potentially not located in sufficient proximity to key business lines and activities. The eight core functions within this regime highlight the need to involve functions such as Compliance and IT within the core governance and organisational structure of the licensed entity, requiring an appointed MIC for each function. This will need to be reflected in the associated corporate documents such as organisational charts and business plans required as part of the licensing application.

**Conduct and internal controls:** It is important to consider this as a separate element arising from the Consequential impacts of Schedule 11, the schedule is an adoption of the conduct and controls implemented in Appendix G of the UT Code enhancement with additional requirements for other products such as PRFs and REITS. The additional requirements across UTs, PRFs and REITS detailed within the current Consultation will need to be reviewed and mapped against the wider impacts of the Product Codes facing separate SFC consultations.



# NEXT STEPS

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Prioritize planning above all else. While firms have begun to assess the incoming RA13 impacts, the perception of a relatively long implementation timeline has lulled many into waiting until further industry feedback is presented. However, when all key areas of change are taken into account, prompt forward planning and preparation will be the deciding factor in timely compliance.

Capco's RA13 programme of work focuses on compliance across all key workstreams, planning sessions to identify suitable solutions, and advising management on adherence to ongoing obligations.

Our programme is divided into three parts:

## 1) Mobilisation

Setting up a dedicated Project Management team to build a structured approach that will ensure the successful delivery of the RA13 programme. Capco's subject matter expertise and regulatory COE (Centre of Excellence) gives firms access to our experienced industry specialists in addition to wider industry networks and best practice. This includes:

- Coordination and reporting of workstreams across business areas and functions.
- Monitoring and analysis of current developments relating to RA13.
- Project management and business analysis support from beginning to end.

## 2) Analysis

The wide-reaching impacts of RA13 require firms to review many aspects of their business practices, and also to review non-traditional aspects of Trustee or Custodian business as well. Capco will share templates that capture the full requirements of the RA13 regime. This includes:

- Creating practical Traceability Matrices that contain comprehensive reviews of requirements, and identify new gaps in policies, procedures and recommended controls.
- Impact assessments and workshops on high impact items.
- Review of the current state documentation (Subsidiary legislation interpretation, Application Forms, SFC Circulars, etc.) and produce a RA13 Inventory that provides a consolidated view of all in-scope changes.
- Creation of a RA13 Licensing Checklist that incorporates a list of requirements to attain licenses at entity / individual level.

### 3) Compliance

Capco can assist you with developing an 'in-house' view that brings all the associated documentation into scope sooner rather than later. This involves:

- Guidance and support for management on the responsibilities expected from the MIC regime and role as RO of licensed entity.
- Collection, checking and submission of the documents required for application (e.g. application forms, questionnaires, and supplements).
- Future proofing solutions and implementation to ensure scalability and sustainability of maintaining an RA13 license and the ongoing obligations expected of a licensed entity.
- Assessment of high-risk decisions and potential impacts of delays in licensing.

### 4) Transition to BAU

Before the completion of the RA13 programme, Capco will ensure a smooth transition of control from the project team to the Trustee/Custodian team. This involves:

- Evaluate the framework implemented and demonstrate the controls for continuous monitoring to management.
- Ensure Trustee teams are well equipped to capture and effectively track the ongoing obligations of being a licensed entity.
- Avoid any disruptions to business with an effective exercise in 'handing the reigns' over to the Trustee teams.



# CONCLUSION

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RA13 is an ambitious, and necessary, proposal. Inevitably, bringing Trustees and Custodians under the supervision of the SFC, and everything that entails, will give rise to some anxiety about how the SFC might engage with industry concerns around the workability of some of the proposed Rules for licensed entities.

Many existing rules also leave the definition of 'clients' open to interpretation, and the SFC may find themselves in an uncomfortable position of trying to define where responsibilities lies between asset managers and their Trustees/Custodians.

Firms intending to seek a license should waste no time in scoping how RA13 will impact their business and be prepared to demonstrate to the SFC they are able to comply. Such early preparations will also put firms in a position to highlight potential bumps in the road to the SFC, and so help influence wider industry compliance efforts. Conversely, firms taking a reactive stance may suffer the consequences of decisions taken without their involvement or input.

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## ABOUT CAPCO

Capco is a global technology and management consultancy dedicated to the financial services industry. Our professionals combine innovative thinking with unrivalled industry knowledge to offer our clients consulting expertise, complex technology and package integration, transformation delivery, and managed services, to move their organizations forward.

Through our collaborative and efficient approach, we help our clients successfully innovate, increase revenue, manage risk and regulatory change, reduce costs, and enhance controls. We specialize primarily in banking, capital markets, wealth and asset management and insurance. We also have an energy consulting practice in the US. We serve our clients from offices in leading financial centers across the Americas, Europe, and Asia Pacific.

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