

# FSTB Consults on Open-Ended Fund Companies

On 20 March 2014 the Financial Services and the Treasury Bureau (FSTB) published a consultation paper on open-ended fund companies (Consultation Paper). The proposals aim to enhance Hong Kong's legal infrastructure for investment fund vehicles by introducing a new open-ended fund company (OFC) structure. The Government hopes that, through the introduction of this additional structure, Hong Kong's asset management industry would be further developed when market participants are offered more choice and better flexibility in establishing and operating funds domiciled in Hong Kong, which are currently limited to unit trust structures.

The consultation period will end on 19 June 2014.

## Overarching principles

The government is proposing that the OFC framework would align to international regulatory practices and standards for collective investment schemes (CIS) including the fundamental International Organization of Securities Commissions principles with respect to, amongst other things, eligibility and disclosure requirements, oversight of fund managers and segregation and protection of clients assets.

OFCs may be set up as a public or private fund. It is proposed that publicly offered OFCs will be Securities and Futures Commission (SFC) authorized under the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (SFC Handbook) and subject to the same regulatory requirements applicable to existing publicly offered funds, while privately offered funds will be given some flexibility to pursue their investment strategies subject to basic governance principles and conduct requirements in line with international regulatory standards.

## Proposed framework for OFCs

The new OFC vehicle will be regulated by the SFC under enabling provisions set out in the primary legislation, with the details set out in new subsidiary legislation enacted under the Securities and Futures Ordinance (SFO). Certain winding up provisions will be referenced to the existing winding up procedures under the Companies (Winding Up and Miscellaneous Provisions) Ordinance. A separate OFC Code will be issued under the SFO, and will apply to all SFC-registered OFCs whether publicly or privately offered. The OFC Code will be subject to further consultation.

## Legal structure

Currently an open-ended investment fund may not be set up in corporate form due to various restrictions on capital reduction under the Companies Ordinance (CO). It is proposed that the OFC will be an open-ended CIS structured in corporate form with limited liability and variable share capital.

As the OFC is proposed to be a pure legal vehicle for investment, it will not be required to be licensed as a licensed corporation under the SFO. The day-to-day management and investment functions of the OFC must be delegated to an investment manager licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity, and appointed by the OFC board. It appears that the specific licensing requirement for the investment manager will leave little flexibility to those “third country” managers located outside Hong Kong.

The board will only comprise natural persons and subject to the same statutory and fiduciary duties owed to a conventional company. It is proposed that the assets of the OFC must be segregated from that of the investment manager and entrusted to a separate, independent custodian for safekeeping.

## Incorporation and registration arrangements

All OFCs would be required to be “registered” with the SFC under the new legislation. Where the shares of the OFC are to be offered to the public, it must also be authorised by the SFC under the SFC Handbook. The SFC should ensure that its registration process for OFCs is efficient and sufficiently streamlined to facilitate the increasing number of public and private fund managers who wish to domicile their funds in Hong Kong when the new framework is in place. SFC authorization of public OFCs will presumably occur on the same basis as existing SFC authorized funds.

It is proposed that the investment scope of an OFC should align with those types of investment activities of the investment manager licensed by or registered with the SFC. The asset classes in which a Hong Kong OFC may invest should fall within the definition of securities and futures (and OTC derivatives when the relevant proposed legislative amendments to the SFO become effective) under the SFO within the scope of Type 9 (asset management) regulated activity. However, given the investment nature of private funds, we believe that private funds should be allowed the flexibility to invest in any asset class subject only to self-imposed restrictions in their constitutional documents (and the appointed investment manager having the necessary licenses or approvals to manage those asset classes).

The Government also notes that the industry has expressed views that privately offered OFCs should be able to invest in any asset class.

For the purpose of incorporation, the OFC should have Articles covering the core elements of an OFC. The Articles will need to be submitted to the SFC during the registration process.

## Administration and operation

It is proposed that all OFCs should prepare an annual report and audited accounts. The OFCs would also make relevant statutory corporate filings with the Companies Registry (CR). Some of the applicable filings could be simplified due to the open-ended nature of OFCs.

An OFC will have the flexibility to vary its share capital in order to meet shareholder redemption requests subject to its Articles and terms and conditions set out in its offering document. OFCs may distribute out of share capital subject to solvency and disclosure requirements, in line with the practices of other major overseas fund jurisdictions.

## Protected cell regime for an umbrella company with sub-funds

There will be legally enforceable segregation of the assets and liabilities of each sub-fund, with a view to legally ring-fence the assets of one sub-fund from other sub-funds under the same umbrella, as well as from the umbrella itself should one sub-fund become insolvent. This segregation should make it easier for individual sub-funds to be wound up without impacting the overall umbrella OFC.

## Termination and winding up

The Government is proposing that subject to the SFC's prior approval, an OFC could be terminated under the new legislation in a more straight-forward and cost efficient manner, having regard to investor protection and creditors of OFCs.

## Regulators and regulatory framework

The SFC will be the primary regulator responsible for the registration and regulation of OFCs. As long as the OFC is registered with the SFC, it must comply with the new OFC legislation and the OFC Code which set out the key functions and duties of directors and other key operators of OFCs, as well as details on post-registration monitoring and supervision.

The OFC investment managers will need to comply with existing regulatory requirements including the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission and the Fund Manager Code of Conduct. Publicly offered OFCs would also be subject to ongoing post-authorisation requirements under the SFC Handbook.

Regarding enforcement powers, the Government is proposing that the SFC should be vested with (i) investigatory powers to investigate the affairs of OFCs and their directors as long as the SFC has reasonable suspicion of misconduct; (ii) the power to intervene in the business and management of OFCs; and (iii) criminal and civil powers.

The CR will be responsible for taking enforcement action against an OFC for failing to comply with relevant statutory corporate filings requirements to be set out in the new legislation.

The Official Receiver's Office (ORO) will administer compulsory winding-up procedures under the CO. The ORO will also administer relevant breaches under its existing enforcement procedures.

## Tax regime

Tax will be a key issue for the new OFC regime; OFCs must be tax neutral.

The existing profits tax exemption for public funds will apply to publicly offered OFCs.

For privately offered OFCs, profits tax exemption will be available under the existing regime for offshore funds with its central management and control (CMC) located outside Hong Kong; however, this would seem to be a critical hurdle for the success of private funds structured as Hong Kong OFCs – requiring that CMC be outside Hong Kong.

For privately offered OFCs with CMC located onshore the Government notes that it will consider carefully the exemption or the extent of exemption that should be applied having regard to possible "read-across" implications.

Another oddity is the proposal to charge stamp duty on the transfer of shares of an OFC. Of course, stamp duty is charged under the Stamp Duty Ordinance on transfers of Hong Kong stocks, and because shares in OFCs by definition are Hong Kong stock, their transfers are subject to stamp duty.

## Contacts

### Mark Shipman

T: +852 2825 8992

E: [mark.shipman@cliffordchance.com](mailto:mark.shipman@cliffordchance.com)

### Matt Feldmann

T: +852 2825 8859

E: [matthias.feldmann@cliffordchance.com](mailto:matthias.feldmann@cliffordchance.com)

### Teresa Leung

T: +852 2826 3475

E: [teresa.leung@cliffordchance.com](mailto:teresa.leung@cliffordchance.com)

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Clifford Chance, 27th Floor, Jardine House, One Connaught Place, Hong Kong

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