

SFC CONSULTS ON RULES AND CODE ON OPEN-ENDED FUND COMPANIES

About a year after the gazettal of the Securities and Futures (Amendment) Ordinance 2016 (Amendment Ordinance) which sets out the legal framework on the open-ended fund company (OFC) regime, the Securities and Futures Commission (SFC) commences its Consultation¹ on the detailed legal and regulatory requirements for the new OFC vehicles.

BACKGROUND

The Financial Services and the Treasury Bureau (FSTB) conducted a public consultation on the proposed legal and regulatory framework to introduce an OFC structure in Hong Kong in March 2014. The consultation conclusions paper was published in January 2016 and set out the final proposals from the Government. In June 2016, the Amendment Ordinance was gazetted and introduced, amongst other things, a new Part IVA into the Securities and Futures Ordinance (SFO) which covers the following key requirements:

- An OFC must be registered with the SFC and incorporated by the Companies Registry (CR);
- An OFC must not have a name which is misleading or undesirable or is the same as the name of another existing OFC;
- An OFC must have at least two individual directors. Directors of an OFC are subject to fiduciary duties and the duty to exercise reasonable care, skill and diligence;
- An OFC must be managed by an investment manager who is licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity;
- An OFC must have a custodian to whom all scheme property must be entrusted for safe-keeping. The custodian must take reasonable care, skill and diligence to ensure the safe-keeping of the scheme property so entrusted to it;
- An OFC must appoint an auditor for each financial year of the OFC;
- The instrument of incorporation of an OFC must include certain mandatory contents;

Key issues

- The OFC regime aims to attract more funds to domicile in Hong Kong.
- OFC Code proposes to take a principles-based approach, in particular regarding the regulation of private OFCs.
- Public OFCs will continue to comply with the Code on Unit Trusts and Mutual Funds.
- Investment scope of the private OFCs should be largely aligned with Type 9 (asset management) regulated activity.
- The OFCs, established and incorporated under the SFO, will not be “companies” incorporated under the Companies Ordinance. OFCs are not subject to the Companies Ordinance unless otherwise provided in Part IVA of the SFO.
- An OFC must have a board with at least two directors.
- The proposed eligibility requirements for the custodian are essentially those applicable to custodians of SFC-authorized funds in the SFC Products Handbook.
- An OFC must be managed by an investment manager licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity.
- A one-stop approach is used for processing OFC registration, incorporation and business registration. The OFC applicant only needs to deal with the SFC.

¹ [SFC Consultation Paper on the Securities and Futures \(Open-ended Fund Companies\) Rules and Code on Open-ended Fund Companies, June 2017](#)

- A solvent OFC may make an application to the SFC for the termination of its registration under a streamlined process; and
- The Financial Secretary may make regulations relating to the charging or collection of fees by the SFC, CR and Official Receiver's Office.

On this basis, the SFC proposes to make the Securities and Futures (Open-ended Fund Companies) Rules (OFC Rules) and to issue a Code on Open-ended Fund Companies (OFC Code) detailing the legal and regulatory requirements applicable to the new OFC structure.

PROPOSED OFC RULES

The OFC Rules will be subsidiary legislation made under the SFO and will set out the more detailed statutory requirements concerning company formation and maintenance, the key operators of the OFC, the functions of the CR, the segregated liability feature for umbrella and sub-funds structures and cross-investments of sub-funds of OFCs, disqualification of directors, arrangements and compromises, winding-up and offences.

As OFCs will be established and incorporated under the SFO, they are not "companies" incorporated under the Companies Ordinance (CO) and hence not subject to the CO. The CO provisions which are relevant to the operations of an OFC will be helpfully set out in the OFC Rules.

For winding-up and disqualification orders the Companies (Winding Up and Miscellaneous Provisions) Ordinance, including its subsidiary legislation, will apply to OFCs on a wholesale basis, except where modifications are necessary.

PROPOSED OFC CODE

The proposed non-statutory OFC Code will be divided into two main sections. Section I will set out the general principles and certain key structural and ongoing requirements which all OFCs and their key operators are expected to comply with in the management and operation of OFCs. The basic investment restrictions, disclosure and operational requirements applicable only to private OFCs will be set out in Section II.

Unless an exemption applies, all OFCs which are to be offered to the public will have to obtain the SFC's authorisation under Part IV of the SFO and comply with the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (SFC Products Handbook), which includes the ongoing post-authorisation requirements.

Given that the investment management function of an OFC must be delegated to an investment manager who is licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity, the investment manager must also comply with all relevant conduct requirements, including the Fund Manager Code of Conduct and the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission in carrying out their functions for the OFC.

TAX MATTERS

Competitive tax conditions in Hong Kong compared to other global investment fund centres are crucial to the success of the OFC regime. To this end, the Government gazetted on 23 June 2017 the Inland Revenue (Amendment) (No. 4) Bill 2017 (the Bill) to extend the profits tax exemption to private OFCs

with their central management and control exercised in Hong Kong. The Bill seeks to create a level playing field for all kinds of OFCs by allowing onshore privately offered ones (similar to offshore ones) to enjoy profits tax exemption. This is a positive move by the Government in enhancing Hong Kong's competitiveness in respect of the domiciliation of privately offered funds in the form of an OFC and is entirely consistent with fostering a strong local governance environment.

POINTS TO CONSIDER

The OFC regime is part of a bigger jigsaw to enhance the market infrastructure to further develop Hong Kong as a full-service international asset management centre and a preferred fund domicile. It is important that the proposed legal and regulatory framework for OFCs should go far enough to render the structure attractive for fund managers worldwide, including Mainland China fund managers.

There are certain aspects of the proposals that may potentially deter private funds from domiciling in Hong Kong through structuring as OFCs. In particular, under the OFC Code it is required that 90% of the gross asset value of a private OFC must consist of: (i) asset types that fall within the definition of securities, futures (and OTC derivative products once the relevant legislative amendments to the SFO have become effective) under the SFO within the scope of Type 9 regulated activity (asset management); and/or (ii) cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts. Other asset classes that a private OFC might invest are subject to a "10% de minimis limit". The investment scope requirement appears to be more onerous than that of other global investment fund centres. In our view, and in line with other overseas jurisdictions, private OFCs should only be subject to self-imposed investment and borrowing restrictions contained in their constitutional documents.

Moreover, in respect of the eligibility requirements for custodians of OFCs, thought will need to be given to the relationship between the custodians and prime brokers in the context of OFCs used for hedge funds.

NEXT STEPS

The consultation period will end on 28 August 2017. Upon the completion of the legislative process that follows and subject to any changes made during the process, the OFC Rules and the OFC Code will become effective upon a commencement date to be gazetted. It is currently envisaged that the new OFC regime will be implemented in 2018 after the OFC Rules and the OFC Code become effective.

Clifford Chance is preparing a response to the Consultation. If you need further information, please speak to your usual Clifford Chance contact, or one of the contacts listed on the next page.

CONTACTS



Matt Feldmann
Partner

T +852 2825 8859
E matthias.feldmann
@cliffordchance.com



Mark Shipman
Partner

T +852 2825 8992
E mark.shipman
@cliffordchance.com



Helen Fok
Consultant

T +852 2825 8934
E helen.fok
@cliffordchance.com



Teresa Leung
Consultant

T +852 2826 3475
E teresa.leung
@cliffordchance.com



Viola Lui
Senior Associate

T +852 2825 8842
E viola.lui
@cliffordchance.com



Rocky Mui
Senior Associate

T +852 2826 3481
E rocky.mui
@cliffordchance.com

This publication does not necessarily deal with every important topic or cover every aspect of the topics with which it deals. It is not designed to provide legal or other advice.

www.cliffordchance.com

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

© Clifford Chance 2017

Clifford Chance

Abu Dhabi • Amsterdam • Bangkok •
Barcelona • Beijing • Brussels • Bucharest •
Casablanca • Dubai • Düsseldorf • Frankfurt •
Hong Kong • Istanbul • Jakarta* • London •
Luxembourg • Madrid • Milan • Moscow •
Munich • New York • Paris • Perth • Prague •
Rome • São Paulo • Seoul • Shanghai •
Singapore • Sydney • Tokyo • Warsaw •
Washington, D.C.

*Linda Widyati & Partners in association with
Clifford Chance.

Clifford Chance has a co-operation agreement
with Abuhimed Alsheikh Alhagbani Law Firm
in Riyadh.

Clifford Chance has a best friends relationship
with Redcliffe Partners in Ukraine.