HONG KONG NEW OPEN-ENDED FUND COMPANY STRUCTURE GOES LIVE IN JULY 2018

Currently a Hong Kong domiciled open-ended investment fund may be established in the form of a unit trust but not in the form of a corporate vehicle due to the capital protection provisions of Hong Kong incorporated companies under the Hong Kong Companies Ordinance. To further develop Hong Kong as a full-service asset management centre the Government is introducing the open-ended fund (OFC) structure with an objective to attract more funds to domicile in Hong Kong.

Key issues

- Under the OFC regime, fund managers will have the option of setting up a Hong Kong domiciled fund in the form of a company, in addition to the form of a unit trust.
- The fund industry is supportive of the introduction of the new OFC structure in Hong Kong, however the level of take up by the private sector remains to be seen.
- Given the rapid developments of comparable structures in the region, the OFC regime is expected to face competition when Singapore's S-VACC and Australia's CCIV company regimes go live.

INTRODUCTION

On 18 May 2018 the Government and the Securities and Futures Commission (SFC) gazetted three pieces of subsidiary legislation[1] to bring into effect all provisions in the Securities and Futures (Amendment) Ordinance from 30 July 2018. On the same day, the SFC concluded the consultation on its proposed Securities and Futures (Open-ended Fund Companies) Rules (OFC Rules) and non-statutory Code on Open-ended Fund Companies (OFC Code)[2]. The key modifications and clarifications to the SFC proposals are set out in Appendix I of this briefing.

KEY FEATURES OF THE OFC STRUCTURE

The key features of the OFC regime include the following:

- An OFC must be registered with the SFC and incorporated by the Companies Registry.
- An OFC must not have a name which is misleading or undesirable or is the same as that of another existing OFC.
- An OFC must have at least two individual directors including at least one independent director. The directors must be of good repute, appropriately qualified, experienced and proper for the purpose of

[1](a) the Securities and Futures (Amendment) Ordinance 2016 (Commencement) Notice (the Commencement Notice); (b) the Securities and Futures (Open-ended Fund Companies) Rules (the OFC Rules); and (c) the Securities and Futures (Open-ended Fund Companies) (Fees) Regulation (the Fees Regulation).

[2] See our briefing SFC consults on rules and code on open-ended fund companies, July 2017

carrying out the business of the OFC. They are subject to fiduciary duties and the duty to exercise reasonable care, skill and diligence.

- The independent director is required to be independent of the custodian, but not of the investment manager[3].
- An OFC must be managed by an investment manager that 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.
- A private OFC must not be a business undertaking for general commercial or industrial purpose.
- A non-resident director and a non-Hong Kong custodian of an open-ended fund company must have a process agent.
- A solvent OFC may make an application to the SFC for the termination of its registration under a streamlined process.

IMPLICATIONS

Strengthening Hong Kong's position as a full-service asset management centre

The OFC regime is part of the Government’s bigger commitment to ensure the financial regulations in Hong Kong are up-to-date and aligned with those of major overseas markets. In view of international and local market developments, the SFC has introduced a host of changes to strengthen Hong Kong's position as an international asset management centre. For example, the SFC consulted publicly on amendments to its Fund Manager Code of Conduct and Code on Unit Trusts and Mutual Funds (UT Code) in 2016 and 2017 respectively. Also as an important part of the strategy, the Government introduced the mutual recognition of funds arrangements with the Mainland in July 2015 and with Switzerland and France in December 2016 and July 2017 respectively. These platforms have enabled the local fund industry to tap overseas markets and provide additional investment opportunities in Hong Kong for both domestic and overseas investors.

Hong Kong’s status as a preferred domicile for investment funds is growing, with the number of Hong Kong-domiciled SFC-authorized funds increased by 12% year-on-year to 735 as at 31 March 2017[4]. With the new OFC structure, the industry will benefit from this additional fund structuring option.

Publicly offered OFCs (public OFCs)

Consistent with other SFC-authorized public funds, public OFCs must obtain an authorization from the SFC and observe the applicable requirements in the UT Code. The fees chargeable by the SFC in respect of public OFCs will also be the same as the authorization fee for other public funds and no new fees will be charged if the public fund is an OFC. Public OFCs are likely to attract interest particularly for fund managers and their custodian/trustee of existing

[3] Clarification in paragraph 38 of SFC Consultation Conclusions on Securities and Futures (Open-ended Fund Companies) Rules and Code on Open-ended Fund Companies, May 2018
[4] SFC Fund Management Activities Survey 2016, July 2017

authorized funds given they are already accustomed to the authorization process and the level of SFC supervision for authorized publicly offered funds.

Privately offered OFCs (private OFCs)

Funds structured as a unit trust in Hong Kong can be marketed to professional investors without having to comply with any registration and complex regulatory requirements. In contrast, the establishment of a private OFC will involve more supervision by the SFC. There is concern that the establishment and ongoing operation of a private OFC are more burdensome than similarly structured private fund vehicles in other domiciles. For Hong Kong and Asia based managers, the preferred equity and hedge funds domicile is predominantly the Cayman Islands which provides for structures that are comparatively more flexible and lightly-regulated.

Some challenges that private OFCs potentially face include the expectation of the custodian of private OFCs to comply with requirements under the OFC Code that are comparable with those applicable to a custodian under the UT Code. The need for the investment manager of a private OFC in Hong Kong to be licensed with the SFC for Type 9 (asset management) regulated activity may also decrease the attractiveness of OFCs for global fund management groups, although the same requirement applies to Hong Kong based investment managers that take investment decisions for offshore funds.

The investment scope for private OFCs is designed for funds whose objective is to manage asset types which fall under a Type 9 (asset management) regulated activity, with a 10% buffer to invest in other asset classes. This will be fine for most equity or hedge funds, but will be problematic for other asset classes, such as real estate, infrastructure, commodities, etc.

Other jurisdictions

From the region, similar developments are seen in the Monetary Authority of Singapore's proposed framework for Singapore variable capital companies (S-VACC) and the Australian government's framework for corporate collective investment vehicles (CCIV). Both jurisdictions are keen to introduce the new framework in 2018. Hong Kong is expected to face some intense competition when the Singapore and Australia company type funds go live.

Given the increased choice of fund structures available to fund managers in the region generally, it remains to be seen whether the new OFC regime will result in significantly more Hong Kong-domiciled funds as the Government had intended.

Tax Implications

Since 2016, the Hong Kong government has been consulting the public on an appropriate OFC tax framework to enable Hong Kong OFCs to be competitive compared to other global investment fund centres. Hong Kong provides a tax exemption framework for offshore private funds and publicly offered funds authorized under Section 104 of the SFO (Securities and Futures Ordinance). However, no comparable preferential tax regime was available for privately offered onshore funds. To address this, the Government gazetted the Inland Revenue (Amendment) (No.2) Ordinance 2018 on 29 March 2018 to extend the profits tax exemption to privately offered OFCs (OFC Tax Exemption). The OFC Tax Exemption grants profits tax exemption on income from qualifying transactions of non-closely held OFCs that exercise their central management and control in Hong Kong. Separately, the Government is proposing to remove the ring-fencing features under the existing tax regimes for offshore funds and offshore private equity funds. This means that the tax exemption will be provided to privately offered funds regardless of the fund structure or their location of central management and control.

One of the key qualifying conditions under the OFC Tax Exemption is that an OFC be not closely held. This condition aims to ensure that OFC tax benefits are available only to bona fide funds and not to closely held groups that might restructure their businesses as OFCs just to take advantage of the OFC tax exemption.

The quantitative thresholds required to satisfy the "not closely held" condition was subject to considerable discussion during the consultation phase for the OFC Tax Exemption. The eligibility criteria differentiate OFCs based on whether or not the OFC has a "qualified investor" (ie, a large institutional investor). OFCs with one or more "qualified investors" investing more than HK$200 million each only need to have a minimum of five investors (not including the originator and its associates), whereas OFCs without a qualified investor will need at least ten investors. An OFC must meet the "not closely held" test within 24 months of receiving its first investor; failure to do so will cause the OFC to lose its tax exemption from day one.

Qualifying OFCs enjoy profits tax exemption on profits derived from transactions in qualifying asset classes as defined in the OFC Tax Exemption, which include securities, shares in private companies, and other investments permitted under the OFC Code. The original OFC tax proposal was highly restrictive where any investments in non-permissible assets exceeding a 10% de minimis threshold could "taint" the entire fund and cause an OFC to be taxed on all of its transactions, including qualifying transactions. This tainting effect has been removed from the final OFC Tax Exemption, although an OFC must still adhere to the requirements under the OFC Code in order to maintain its tax exemption status.

The OFC Tax Exemption also relaxes ring-fencing measures that restrict investments in Hong Kong private companies. However, a complex set of exceptions apply to prevent OFCs from indirectly investing in Hong Kong real estate and certain short-term assets through private companies.

The removal of the tainting threat and relaxation of ring-fencing measures represent an improvement over the limitations of Hong Kong's current offshore funds tax exemption regime. However, challenges remain in navigating the complex set of eligibility criteria under the OFC Tax Exemption. Guidance from the Inland Revenue Department to clarify how the new tax rules will be applied in practice will be welcome.

APPENDIX I

Key Modifications and Clarifications to SFC Proposals

Streamlined Process

- In respect of the alteration of the instrument of incorporation, the SFC has removed the requirement for its approval and replaced it with post-change filing with the SFC instead. Material changes to the instrument of incorporation would only require the shareholders' approval.
- Mindful of the private OFCs' needs to customise their investment policy and operations from time to time to meet the demands of private investors, the SFC is allowing scheme changes to be effected in accordance with the offering documents and/or the instrument of incorporation. For an immaterial scheme change, the board of directors will need to certify that the change is immaterial and also obtain the custodian's confirmation that it has no objection to such alteration. Material scheme changes will need reasonable prior notice to the shareholders.

Ultra Vires Provision

- The SFC proposed that any transaction entered into by the OFC which falls outside its operation as a collective investment scheme will be invalid. In practice, it is very difficult to determine for a third party whether a transaction falls within the OFC's operation as a collective investment scheme, and the potential unenforceability of contracts is more likely to be to the detriment of a third party. For good reason, the SFC has removed the ultra vires provision.

Key Operators Eligibility

Investment managers

- The SFC has confirmed that there is no separate approval by the SFC for sub-delegation arrangements by the investment managers; the key operators have to exercise due care in the selection, appointment, and ongoing monitoring of the performance of the delegate and remain fully liable for complying with the applicable regulatory requirements.
- Certain duties that are currently performed by the board of directors for private funds (for example, valuation and pricing duties) must be delegated to an investment manager licensed by or registered with the SFC for Type 9 (asset management) regulated activity under the new regime. To emphasise that the directors remain ultimately legally responsible in overseeing the investment manager's activities, the directors' general duty of oversight over the investment manager (and the custodian) has been reflected in the revised OFC Code.

Custodians

- In respect of the relationship between the custodians and prime brokers (for example in the context of OFCs used for hedge funds), the SFC notes that custodians' eligibility requirements are essential baseline requirements for the protection of the scheme property. Accordingly, prime brokers acting as custodians will be expected to meet the eligibility requirements as set out in the OFC Code.

- The custodians of public OFCs must observe the UT Code's requirements. The SFC confirmed that the requirements under the proposed OFC Code are comparable to the custodian's duties in the proposed revised UT Code, consistent with the compliance obligations of the custodians of other SFC-authorized publicly-offered funds.

Process agent

- The SFC has helpfully confirmed that the appointment of the process agent is imposed on the custodian and not on the sub-custodian. The primary duty to safeguard the OFC's assets remains with the custodian.

Disqualification and Winding-up

- Due to some technical issues relating to the proposed incorporation of the disqualification and winding-up provisions from the Companies (Winding Up and Miscellaneous Provisions) Ordinance (C(WUMP)O) into the OFC regime, a phased approach will now be adopted. In phase one, OFCs will be subject to the disqualification and court winding-up process as an "unregistered company" under the C(WUMP)O. A separate legislative exercise will be launched to amend the SFO and/or the C(WUMP)O as well as the OFC Rules to enable the winding-up of OFCs as conventional companies in phase two.

Investment scope of private OFCs

- The SFC clarified that given an OFC is not designed to operate as a corporate entity for the purposes of general commercial business or trade, the SFC is retaining its 10% de minimis limit in other asset classes[5]. To reflect this more clearly, the OFC Code has been revised to provide expressly that an OFC should not be a business undertaking for general commercial or industrial purpose.

Segregated liability of sub-funds and cross sub-fund investments

- Under the OFC regime the SFC provides for the segregation of liability of sub-funds for an OFC with an umbrella and sub-funds structure. The SFC has enhanced transparency by including a new disclosure requirement for cross sub-fund investments in the OFCs' annual reports. Separately, as an umbrella OFC may have both publicly-offered and privately-offered sub funds, OFCs will need to disclose whether a particular sub-fund is a public or private fund.

[5] At least 90% of the gross asset value of a private OFC must consist of (1) those asset types the management of which would constitute a Type 9 regulated activity, and/ or (2) cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts.

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