



Hong Kong

March 2016

## NEW OPEN-ENDED FUND COMPANY STRUCTURE FOR HONG KONG FUNDS TO BE INTRODUCED UNDER THE SECURITIES AND FUTURES (AMENDMENT) BILL 2016

### Introduction

In March 2014, the Financial Services and Treasury Bureau (FSTB) conducted a public consultation on allowing open-ended fund companies (OFCs) to be established under the Securities and Futures Ordinance (SFO). Following the publication of the FSTB's Consultation Conclusions<sup>1</sup> in January 2016, the Securities and Futures (Amendment) Bill 2016<sup>2</sup> (Amendment Bill) was introduced into the Legislative Council on 27 January 2016.

Currently, a Hong Kong fund can be established as an open-ended investment fund in the form of a unit trust, but not in corporate form due to the restrictions on capital reduction under the Companies Ordinance (Cap. 622) (the CO). Internationally, however, corporate fund structures are more popular and are available in most international fund centres. The introduction of the new OFC structure is therefore aimed at encouraging more funds to domicile in Hong Kong and boost Hong Kong's position as an international fund centre. One particular advantage of a Hong Kong domicile is that it renders certain SFC-authorized funds eligible for retail distribution in Mainland China under the Mainland-Hong Kong Mutual Recognition of Funds Initiative. For further information on that initiative, please see our June 2015 newsletter.<sup>3</sup>

1 FSTB. Consultation Conclusions on Open-ended Fund Companies. January 2016 available at [http://www.fstb.gov.hk/fsb/ppr/consult/doc/ofc\\_conclu\\_e.pdf](http://www.fstb.gov.hk/fsb/ppr/consult/doc/ofc_conclu_e.pdf)

2 <http://www.gld.gov.hk/egazette/pdf/20162002/es3201620022.pdf>

3 Charltons. Mainland-Hong Kong Mutual Recognition of Funds Initiative to Launch on 1 July 2015 available at <http://www.charltonslaw.com/mainland-hong-kong-mutual-recognition-of-funds-initiative-to-launch-on-1-july-2015/>.

### Open-ended Fund Company Structure

An OFC is an open-ended collective investment scheme set up in the form of a company, but with the flexibility to create and cancel shares in order to meet shareholder subscription and redemption requests, which is not currently possible for conventional companies incorporated under the CO. In addition, OFCs will not be bound by the restrictions on distributions out of share capital applicable to companies formed under the CO, and may distribute out of share capital subject to solvency and disclosure requirements. An OFC could be a publicly or privately offered fund.

### Key features of an Open-ended Fund Company

OFCs are investment vehicles and thus have greater flexibility than conventional companies. They are entitled to:

- vary their share capital to meet investor subscription and redemption requests;
- distribute assets out of share capital subject to solvency and disclosure requirements;
- adopt an umbrella fund structure, allowing for sub-funds, where the assets of each sub-fund are managed in accordance with the investment objectives and policies specific to that sub-fund; and
- take the form of a publicly or privately offered fund.

### Securities and Futures (Amendment) Bill 2016

The Amendment Bill sets out the broad framework for OFCs in Hong Kong. The detailed operational and procedural requirements will be set out in subsidiary legislation (the **OFC Rules**) and a new OFC Code following a separate public consultation by the Securities and Futures Commission (**SFC**).

The Amendment Bill provides for: (i) the incorporation, registration, management, operation and regulation of OFCs; and (ii) a profits tax exemption for OFCs, an exemption from

stamp duty for transfers relating to the sale or purchase of shares or units of OFCs under specified conditions and other related matters.

To provide for the establishment of OFCs under the SFO, Clause 6 of the Amendment Bill adds a new Part IVA (new sections 112A to 112ZT) to the SFO.

If passed, the Amendment Bill will come into operation on a day to be appointed by notice in the gazette.

The Amendment Bill contains the following key provisions:

Section	Provision
S112A: Definition of an OFC	S112A defines an OFC as a collective investment scheme constituted as a corporation that holds a certificate of incorporation issued by the Registrar of Companies ( <b>CR</b> ) under new section 112C.  S112A defines a "Proposed Company" as a company intended to be incorporated under the new Part IVA.
S112D Registration	S112D provides for the registration of proposed OFCs with the SFC before incorporation. Once registration takes place, the SFC will notify the CR. Registration takes effect on the date of issue of the certificate of incorporation by the CR.
S112C Incorporation	S112C provides that to incorporate an OFC, an incorporation form and a copy of the instrument of incorporation should be submitted to the CR. A certificate of incorporation can only be issued after the CR has received notification from the SFC that it has registered the proposed company under S112D.
S112B: Penalty	S112B prohibits carrying on business as an OFC without being registered under S112D. Breach of S112B is an offence subject to a maximum fine of HK\$5 million and to imprisonment for seven years.
S112P and S112Q: Share capital and shareholder's liability	S112P provides that shares in an OFC have no nominal value and that the amount of paid-up share capital of an OFC is at all times equal to the net asset value of the company.  S112Q provides that the liability of the shareholders of an OFC is limited to any amount unpaid on the shares held by the shareholders.
S112R: Sub-funds and segregated liability of sub-funds	S112R permits an OFC to divide its scheme property into separate parts and each separate part is a sub-fund of the OFC.  S112S provides that the assets of a sub-fund belong exclusively to the sub-fund and must not be used to discharge the liabilities of the OFC or any other sub-fund of the OFC, and any liability incurred on behalf of a sub-fund may only be discharged out of the assets of the sub-fund. It also provides that a sub-fund is not a legal person separate from OFC but its assets may be subject to orders of the court as if it were a separate legal person.

<p>S112U to S112ZA: Key operators</p>	<p><b>Directors</b> An OFC must have at least 2 directors who are individuals over the age of 18. OFCs are not permitted to have corporate directors. S112U provides that a director of an OFC owes the OFC the same fiduciary and other duties that are owed by a director of an ordinary company formed and registered under Cap. 622 to the ordinary company.</p> <p><b>The Investment Manager</b> S112Z requires the management of the scheme property of an OFC to be delegated to an investment manager who must be an intermediary licensed or registered with the SFC for Type 9 regulated activity (asset management) under the SFO.</p> <p><b>Custodian</b> S112ZA requires OFCs to have a custodian. The custodian is entrusted with the safekeeping of all the scheme property of the OFC, such that the OFC's assets are segregated from that of the investment manager to avoid potential conflicts of interest. While it was originally proposed that the custodian should be incorporated in Hong Kong, this proposal was revised in the Consultation Conclusions. Overseas custodians will be allowed subject to meeting specified eligibility requirements.</p> <p><b>Auditor</b> S112ZB requires an auditor to be appointed for each financial year of the OFC.</p>
<p>S112ZF to S112ZJ: Supervision by SFC</p>	<p>S112ZF to S112ZJ contain provisions relating to the supervision of OFCs by the SFC, the primary regulator of OFCs.</p> <p>S112ZF, in particular, empowers the SFC to give directions to OFCs, their investment managers or directors in specified circumstances. These may include a direction to cease issuing or redeeming shares of an OFC.</p>
<p>S112ZK to S112ZM, I S112ZR: SFC may make rules, publish codes and guidelines</p>	<p>S112ZK to S112ZM empower the SFC to make rules to provide for, among others, the carrying on of collective investments by means of OFCs and the regulation of OFCs.</p> <p>Under S112ZN, the rules may prescribe offences and provide for defences to the prescribed offences.</p> <p>S112ZR empowers the SFC to publish codes and guidelines to provide guidance in respect of matters relating to the incorporation, management, operation and business of OFCs.</p>
<p>S112ZM and S112ZH: Termination and winding up of OFCs</p>	<p>S112ZM empowers the SFC, with the consent of the Official Receiver (OR), to make rules to provide for the functions of the OR in relation to the winding up and dissolution of OFCs and their sub-funds.</p> <p>S112ZH provides that an OFC may apply to the SFC to cancel its registration under S112D upon its termination.</p> <p>The SFC is also able to present a petition for an OFC to be wound up under the OFC Rules if it appears to the SFC that its winding up is desirable in the public interest (new S212(1A)).</p>

S112H Naming OFCs	The name of an OFC which only has an English name must end with "Open-ended Fund Company" or "OFC", while an OFC which only has a Chinese name must end with the Chinese equivalent.
S121I Registered Office	OFCs must have a Hong Kong registered office.

The Amendment Bill will also amend certain other Ordinances including the Inland Revenue Ordinance, the Stamp Duty Ordinance and the Business Registration Ordinance.

### **Profits Tax Exemption**

The profits tax exemption under section 26A of the Inland Revenue Ordinance (Cap. 112) will apply to publicly offered OFCs and to privately offered OFCs whose central management and control is located outside Hong Kong. Onshore privately offered OFCs will remain subject to profits tax.

### **Stamp Duty**

The Stamp Duty Ordinance (Cap. 117) will be amended so that the stamp duty treatment of OFCs will be the same as for unit trusts. That is to say that:

- Transfers of OFC shares will be subject to stamp duty. However allotments and redemptions of OFC shares will be exempt from stamp duty and thus transfers of OFC shares which are effected by way of allotment and redemption will also be exempt.
- Where an OFC is authorised by the SFC for public offering, in-kind allotments and redemptions of shares will not be subject to stamp duty.

### **Business Registration**

An OFC is required to register for business under the Business Registration Ordinance (Cap. 310).

### **Proposed investment scope of OFCs**

It is proposed that the asset classes in which an OFC can invest should fall within the definition of securities, futures (and over-the-counter derivatives once the relevant legislative amendments to the SFO have become effective) under the SFO which are within the scope of Type 9 regulated activity (asset management). Privately offered OFCs will also be allowed a 10% *de minimis* limit (i.e. a maximum of 10% of the fund's total

gross asset value) for investing in other asset classes, such as cash deposits and currencies which are not inconsistent with Type 9 regulated activity.

Publicly offered OFCs will be subject to the investment restrictions set out in the SFC Handbook on Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (the **SFC Handbook**). Investment managers of privately offered OFCs will have the flexibility to follow their own investment strategies, subject to compliance with basic governance principles which will include conduct and disclosure requirements.

### **Regulation of OFCs**

#### ***SFC as the primary regulator***

As proposed in the Consultation Paper, the SFC will be empowered under the SFO and the OFC Rules to register OFCs and to approve the appointment and replacement of key operators of the OFC including individual board directors, the OFC custodian and SFC-licensed or registered investment managers.

OFCs which are seeking to offer their shares to the public must obtain SFC authorization under Part IV of the SFO unless an exemption applies, and comply with the SFC Handbook.

The SFC will undertake the securities-related enforcement matters relating to OFCs.

#### ***The Companies Registry (CR) to be responsible for incorporation and corporate filings***

The CR will be responsible for the incorporation and relevant statutory corporate filings of OFCs. The aim is to ensure that those dealing with OFCs will have access to basic corporate information regarding OFCs which is included in the corporate public filings kept by the CR. The relevant corporate filings functions proposed to be undertaken by the CR for OFCs will include:

- a) maintaining a register for OFCs which will be in line with the existing arrangement for companies registered under the CO;
- b) accepting and registering relevant statutory corporate filings and registering company documents which are applicable to OFCs; and
- c) providing the public with services to access the OFC information held by the CR.

The CR will administer relevant corporate filing breaches under its existing enforcement procedures.

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