

Investment Management Alert

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SFC Issues Consultation Conclusions on the Hong Kong Open-Ended Fund Company Regime

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Key Points:

- The introduction of an OFC structure in Hong Kong is intended to further develop Hong Kong as an international asset management centre and fund domicile.
- The OFC provides Hong Kong Type 9 licenced managers seeking to establish a corporate investment fund with a Hong Kong-domiciled alternative to establishing funds in traditional offshore domiciles, using the Private OFC model.
- For managers of SFC-authorized collective investment schemes, the Public OFC model provides an alternative to the existing Hong Kong unit trust structure.
- The amendments to SFO, a new Open-Ended Fund Company Rules and a new Open-Ended Fund Company Code are expected to come into effect on 30 July 2018, subject to negative vetting by the Hong Kong Legislative Council.

1. Introduction and Background

The Securities and Futures Commission (SFC) issued the consultation conclusions on the open-ended fund company (OFC) regime in Hong Kong (the “Consultation Conclusions”) in May 2018. The Consultation Conclusions append the final versions of the Securities and Futures (Open-Ended Fund Companies) Rules (“OFC Rules”) and the SFC’s Code on Open-Ended Fund Companies (“OFC Code”). Together with corresponding amendments to the Securities and Futures Ordinance (Cap. 571) (“SFO”), which are also expected to come into effect at the end of July 2018 (“SFO Amendment Ordinance”)¹, the OFC Rules and the OFC Code comprehensively set out the regulatory requirements for establishing and operating a Hong Kong-domiciled OFC.

Hong Kong companies have, to date, been unsuitable for the purposes of operating an open-ended investment fund, due to the absence of a legal mechanism providing for redeemable shares. Accordingly, the only vehicle, to date, available to a manager seeking to establish a Hong Kong-domiciled investment fund has been the unit trust model, and it has, to date, only made sense, from a Hong Kong profits tax perspective,

to establish such a fund as a public fund authorised by the SFC for offer to the retail public.

In the absence of an available corporate open-ended investment vehicle in Hong Kong, Hong Kong-based asset managers have historically established corporate funds in offshore jurisdictions, such as the Cayman Islands and such funds have typically been run as private funds.

The introduction of the OFC model provides Hong Kong SFC-licensed fund managers with a viable option for establishing open-ended corporate investment funds in Hong Kong, either in the form of public funds (i.e., a collective investment scheme authorised by the SFC) or in the form of private funds (available to only non-retail investors).

2. Establishment of an OFC (Public OFC and Private OFC)

The OFC Code and OFC Rules prescribe two types of OFC: “Private OFCs” (“Private OFC”) and “Public OFCs” (“Public OFC”). The following requirements apply to both types of OFC.

Application Process

The OFC Rules require a single application (“Application for Registration”) to the SFC, enclosing: (i) a submission to the SFC for registration of the OFC (which is filed prior to the actual incorporation of the OFC); and (ii) a submission to the Hong Kong Registrar of Companies (“Companies Registrar”) for the incorporation of the OFC.

The SFC will separately forward the relevant documents and business registration fees to the Companies Registrar in order to complete the establishment of the OFC. Since an OFC is treated as a “collective investment scheme” for the purpose of the SFO, it is the SFC (rather than the Companies Registrar) that has overall responsibility for the establishment and oversight of OFCs. Subject to the SFC being satisfied that the requirements for registration are met by the Application for Registration, the SFC will then instruct the Companies Registrar to register the company. The OFC is incorporated on the date on which the Companies Registrar issues the Certificate of Incorporation for the OFC.

The OFC application process is intentionally streamlined and efficient.

Documentation and Minimum Disclosure Requirements

Every OFC must have an Instrument of Incorporation (IOI), which serves as the key constitutive document of an OFC (equivalent to the articles of association for a limited company).

The IOI, which may be in English or Chinese, must include certain minimum information, including, but not limited to: (i) the name and objects of the OFC; (ii) the type of property in which the OFC may invest; (iii) a statement that the object of the

OFC is the operation of the company as a collective investment scheme; (iv) the procedures and notices for meetings and voting; (v) the procedures for the creation and issuance of shares in the OFC; and (vi) the appointment and removal of directors.

An OFC must have an offering document (“Offering Document”), being any document that invites offers (or is calculated to invite offers) to subscribe for, or purchase, shares in an OFC, for cash or other consideration (such as the private placement memorandum). Minimum disclosure requirements apply to the Offering Document of an OFC (in addition to applicable minimum disclosure requirements arising from other codes, circulars, guidelines and FAQs issued by the SFC, in particular the recent changes to the Fund Managers Code of Conduct).

The Offering Document and other disclosures of an OFC (both for a Private OFC and a Public OFC) must comply with the General Principles in the OFC Code which require that disclosures in the Offering Document be: (i) clear, concise and effective, containing information necessary for investors to be able to make an informed judgement; and (ii) kept up-to-date.

OFC Board

The board of an OFC must have a minimum of two individual directors, each of whom must be at least 18 years old, and each of whom must be of good repute, and be appropriately qualified, experienced and proper for the purpose of carrying out the business of an OFC . At least one director of an OFC must be an independent director (and must not be an employee or a director of the custodian). Corporate directors are not permitted. The SFC must approve, in advance, all appointments to the board of an OFC.

All board appointments and removal must also be notified by the OFC to the SFC.

Service Providers to an OFC

An OFC must appoint an investment manager to manage the scheme property of the OFC.

The investment manager of an OFC must be an intermediary licenced or registered in Hong Kong for Type 9 (asset management) regulated activity. This prohibits asset management companies domiciled outside of Hong Kong from serving as the investment manager of an OFC.

An OFC must enter into a written investment management agreement with the investment manager. As a minimum, the management functions delegated by the OFC to the investment manager must include responsibility for the investment management of the OFC and responsibility for the valuation and pricing of the scheme property of the OFC. The manager of an OFC must carry out the investment management functions of the OFC in accordance with the OFC’s IOI and the investment management agreement, at all times in the best interests of the OFC and its shareholders.

The initial investment manager is stated in the IOI. Any subsequent appointment of an investment manager is made by the directors of the OFC, subject to the SFC giving its

prior written consent. In the event that an investment manager ceases to manage an OFC, the OFC must provide the SFC with notice of such a cessation within 15 days.

An OFC must appoint a custodian to be responsible for holding the assets and all of the scheme property of the OFC. The custodian is required to meet the eligibility requirements as prescribed in the SFC's "Code on Unit Trusts and Mutual Funds" for SFC authorised funds ("UT Code") for an SFC-authorised collective investment scheme, being that it:

1. must be: (a) a bank licenced under Section 16 of the Banking Ordinance (Chapter 155 of Laws of Hong Kong); (b) a trust company that is a subsidiary of such a bank; (c) a trust company registered under Part VIII of the Trustee Ordinance; or (d) a banking institution or trust company incorporated outside of Hong Kong that is acceptable to the SFC;
2. must be independently audited and have a minimum issued and paid-up capital and non-distributable capital reserves of HK\$10 million, or its equivalent in foreign currency, subject to certain exemptions (equivalent to approximately US\$1,275,000);
3. may not retire, except upon the appointment of a new custodian and subject to the prior approval of the SFC;
4. must be independent of the investment manager (subject to limited certain exemptions).

An OFC must appoint an auditor to prepare an audited annual report (a copy of which must be filed with the SFC). The auditor must be independent from the investment manager, the custodian and the directors of the OFC.

An OFC must maintain a registered office in Hong Kong to which all communications and notices must be addressed.

Umbrella OFCs

Both forms of OFC (Public OFCs and Private OFCs) may be established as an "umbrella" OFC. An umbrella OFC permits the creation of an unlimited number of sub-funds within the OFC, each of which benefits from statutory segregation from the assets and liabilities of the other sub-funds within that OFC. The establishment and termination of each sub-fund within an umbrella OFC requires the prior approval of the SFC. In this respect, the umbrella OFC is similar to the Cayman Islands segregated portfolio company (SPC), which has proven popular with managers as a platform through which to launch a number of separate fund strategies within separate segregated portfolios of an SPC. As with the Cayman Islands SPC structure, each sub-fund of an umbrella OFC is not a separate legal person from the OFC.

In order to reinforce the concept of statutory segregation between the sub-funds of an umbrella OFC, the OFC Rules imply certain minimum terms into all contracts, arrangements or transactions entered into by an umbrella OFC.

3. Additional Requirements (Private OFCs)

Restrictions on Use

Private OFCs may be used only in the context of a collective investment scheme (i.e., an investment fund). Private OFCs may not be used as a “*business undertaking for general or industrial purposes*”, including “predominantly” engaging in activities such as the purchase, sale and/or exchange of goods or services, or the production of goods or the construction of properties.

Offering Document and Restrictions on Investment Objective

Although a Private OFC does not need to be separately authorised by the SFC under the UT Code, a copy of the Offering Document for a Private OFC must be filed with the SFC as soon as possible following incorporation. Any changes to the offering document for a Private OFC must be filed with the SFC within seven days from the date of issuance of the revised Offering Document. This “filing only” requirement is the same as the regulatory standard imposed in many offshore jurisdictions, whereby a copy of the Offering Document is simply filed with the relevant regulator at the time of the launch of the investment fund and upon any subsequent updates, without the need for a formal review of the Offering Document by the regulator.

In addition to the minimum disclosure requirements generally applicable to all OFCs, the Offering Document for a Private OFC must also disclose: (i) the investment scope and the investment strategies adopted by the investment manager, including a disclosure of the 10% De Minimis Limit (see below); (ii) operational information, including pricing, dealing, the issuance and redemption of shares, valuation, distribution policy, use of leverage, fees and charges incurred; and (iii) the basis for asset valuation, asset pricing, and the redemption of shares in the Private OFC. A breach of the OFC Code requirements (due to a deficient Offering Document) may lead to disciplinary action by the SFC against the investment manager to that OFC.

Although a Private OFC has considerable flexibility in terms of the scope of its investment activities, it remains subject to the requirement that: (i) at least 90% of the gross asset value of a Private OFC must consist of: (a) those asset types the management of which would constitute a Type 9 regulated activity (i.e., “securities” and/or “futures contracts” as defined in the SFO), (b) cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts; and (ii) a Private OFC may invest in other asset classes not set out in (i)(a) and (i)(b), up to a maximum of 10% of its gross asset value (“10% De Minimis Limit”).

The investment scope and investment strategies for a Private OFC (including the 10% De Minimis Limit) must be disclosed in both the Offering Document and in the IOI.

In the case of an umbrella OFC, the 10% De Minimis Limit applies to the gross asset value of each sub-fund of the OFC, as well as to the gross asset value of the umbrella OFC, as a whole. The investment manager of an OFC is responsible for managing and monitoring the OFC’s investments on an ongoing basis in order to ensure compliance with the 10% De Minimis Limit.

Tax Treatment

Private OFCs (which are not authorised by the SFC) do not benefit from any existing profits tax exemption from the Hong Kong tax authorities. Accordingly, together with the SFO Amendments and the implementation of the OFC Rules and OFC Code, Hong Kong's Inland Revenue (Amendment) (No. 2) Ordinance 2018 sets out the circumstances in which a Private OFC will be treated as being exempt from the payment of profits tax in Hong Kong. This legislation will become effective contemporaneously with the SFO Amendment Ordinance.

Subject to the Private OFC meeting certain conditions (including that the Private OFC is "*non-closely held*"), a Private OFC will be exempt from the payment of profits tax in Hong Kong with respect to both "*qualifying transactions*" and transactions incidental to the carrying out of such transactions.

Managers should note that the Inland Revenue (Amendment) (No. 2) Ordinance 2018 does not provide an exemption to the Hong Kong stamp duty applicable to a transfer of shares in a Private OFC. In the absence of amending legislation, a transfer of shares in a Private OFC remains subject to Hong Kong *ad valorem* stamp duty (as would also be the case for a Hong Kong unit trust and a Public OFC) at a rate of 0.2% of the value of the stock (shared equally between the vendor and the purchaser). By comparison, transfers of shares in offshore fund vehicles are generally not subject to stamp duty.

4. Additional Requirements (Public OFCs)

SFC Authorisation

Because a Public OFC is a collective investment scheme authorised by the SFC, the incorporation of a Public OFC must also be accompanied with an application to the SFC for authorisation of the Public OFC as a "collective investment scheme", in compliance with the requirements of the UT Code and the application checklists, SFC circulars, guidelines and FAQs applicable to authorised collective investment schemes.

The SFC will consider the authorisation application for a Public OFC separately from the OFC incorporation application, although, in practice, the two applications will likely be filed contemporaneously with the SFC and handled in tandem by the SFC.

Offering Document and Restrictions on Investment Objective

For a Public OFC, the draft Offering Document must be filed with the SFC as part of the authorisation application. As an authorised collective investment scheme, the SFC will fully review and comment on the Offering Document for a Public OFC, and the Offering Document must be fully signed-off by the SFC before shares can be issued to investors. As such, the Offering Document for a Public OFC must also meet the minimum disclosure requirements for an authorised collective investment scheme, as set out in the UT Code, and the applicable circulars and FAQs issued by the SFC from

time to time with respect to authorised collective investment schemes, including but not limited to Chapters 5 and 6 of the Overarching Principles of the UT Code (General Requirements and Disclosure Requirements) and Chapter 11 of the UT Code (Documentation and Reporting).

The Public OFC model is permitted for use only with respect to retail offerings, and as such must be authorised by the SFC as a collective investment scheme. Accordingly, the investment objective/investment strategies of a Public OFC must comply with the requirements set out in the UT Code (in particular Chapters 7 and 8, as applicable), which prescribe certain restrictions and limitations on the investment strategy for different types of investment funds.

Tax Treatment

A profits tax exemption is currently granted by the Hong Kong tax authorities with respect to publicly offered funds that are authorised by the SFC. As a fund that is authorised by the SFC, a Public OFC will be considered a “publicly offered fund” and will benefit from the existing profits tax exemption.

Conclusions

The OFC regime is designed to further develop Hong Kong as an international asset management centre and fund domicile by providing fund structures that will appeal to Hong Kong-licenced managers. On a practical level, the OFC model will be considered attractive by some managers, given the requirement to interact only with a single regulator (the SFC) with respect to both the fund entity and the investment manager, and the regulator being based in the same time-zone as the manager (Hong Kong). Certainly from a cost perspective, the OFC is intentionally positioned to be competitive in terms of the government registration fees and associated hard costs that apply both to the establishment of an OFC, and on an ongoing basis. In many cases, the total amount of filing fees and associated hard costs will be lower than the corresponding fees and hard costs imposed on funds in a number of offshore jurisdictions.

For Hong Kong SFC-licenced managers managing SFC authorised funds, one of the anticipated advantages of the OFC model will be the ability to use an OFC (in the form of a Public OFC) to access retail investors in Mainland China, through the mutual recognition of funds regime (MRF) established between the SFC and the China Securities Regulatory Commission (CSRC). As such, the Public OFC is expected to be an attractive vehicle through which to access retail investors in Mainland China, in particular when compared with other types of funds which currently cannot be distributed directly to such investors.

A further advantage of using a Public OFC (over a Hong Kong unit trust) is that there is no requirement to appoint a trustee for a Public OFC. This is expected to save time and costs, during both establishment and during the lifetime of an OFC as well as providing the manager of a Public OFC with greater control over the fund.

For Hong Kong SFC-licenced managers establishing investment funds for professional investors, the Private OFC offers a Hong Kong-domiciled alternative to the popular route of domiciling an investment fund in an established offshore jurisdiction.

In light of increased regulation applicable to European investors, the OFC model, which benefits from regulatory oversight from a major securities regulator (the SFC), may be considered a more attractive alternative investment vehicle for a Hong Kong-licensed manager seeking to attract European investors. Also applicable to Europe-based investors is the advice issued in July 2016 by the European Securities and Markets Authorities (ESMA) regarding the extension of passporting rights to third-party countries under the EU Alternative Investment Fund Managers Directive (in order to allow non-EEA managers to market investment funds (EEA and non-EEA domiciled funds) to investors in the EU)), and indicating that Hong Kong is a jurisdiction in which there are “*no significant obstacles*” to extending EEA passporting rights. Although consultation on the extension of passporting rights remains ongoing and appears to have been delayed due to the Brexit negotiations, the 2016 ESMA advice positions Hong Kong-based fund managers ahead of managers domiciled in certain offshore jurisdictions in the context of access to EEA-based investors.

Another potential advantage of using the Private OFC model is that there is currently no intention to make the register of shareholders of an OFC publicly available. This feature of an OFC will likely be considered positively by investors in light of proposals in certain offshore jurisdictions to establish a publicly accessible register of the beneficial ownership of companies registered in the jurisdiction.

Prior to implementation it is anticipated that the SFC will issue a set of FAQs with respect to the OFC regime.

The full text of the Consultation Conclusions (including the OFC Code and the OFC Rules) can be accessed via the following link:

<http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=17CP5>

¹ The Securities and Futures (Amendment) Ordinance, 2016.