

# **OPEN-ENDED FUND COMPANIES CONSULTATION PAPER**

Financial Services and the Treasury Bureau

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## ABOUT THIS DOCUMENT

1. This consultation paper is published by the Financial Services and the Treasury Bureau ("FSTB") of the Government of the Hong Kong Special Administrative Region to consult on the proposal to introduce a new open-ended fund company structure to expand Hong Kong's legal structure for investment fund vehicles.
2. A list of the questions raised in this consultation paper is set out for ease of reference at **Annex**. Interested parties are invited to provide comments on the proposals discussed in this consultation paper or on matters related.
3. Comments should be provided in writing **no later than 19 June 2014**, by any one of the following means -

By mail to: Consultation on Open-ended Fund Companies  
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Financial Services and the Treasury Bureau  
24/F Central Government Offices  
2 Tim Mei Avenue, Tamar, Hong Kong

By fax to: +852 2294 0460

By email to: [ofc@fstb.gov.hk](mailto:ofc@fstb.gov.hk)

4. Any person providing comments on behalf of any organisation is requested to provide details of the organisation they represent.
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7. Any personal data submitted will only be used for purposes which are directly related to this consultation. Such data may be transferred to the Securities and Futures Commission and other Government departments/agencies for the same purposes. For access to or correction of personal data contained in your submissions please contact:

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## Abbreviations

Articles	Articles of Incorporation
AUM	Asset Under Management
CIS	Collective Investment Schemes
CMC	Central Management and Control
CO	Companies Ordinance (Cap. 622)
Code of Conduct	Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission
CR	Companies Registry
C(WUMP)O	Companies (Winding Up and Miscellaneous Provision) Ordinance (Cap. 32)
FCA	Financial Conduct Authority
FMAS	Fund Management Activities Survey
FSTB	Financial Services and the Treasury Bureau
HKFRS	Hong Kong Financial Reporting Standards
IOSCO	International Organization of Securities Commissions
IRO	Inland Revenue Ordinance (Cap. 112)
MFC	Mutual Fund Company
OEIC	Open-ended investment company
OFC	Open-ended fund company
ORO	Official Receiver's Office
OTC	Over-the-Counter
RQFII	Renminbi Qualified Foreign Institutional Investor
SDO	Stamp Duty Ordinance (Cap. 117)
SFC	Securities and Futures Commission
SFC Handbook	Securities and Futures Commission Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products including the Code on Unit Trusts and Mutual Funds
SFO	Securities and Futures Ordinance (Cap. 571)
SICAV	Société D'investissement À Capital Variable
UCITS	Undertakings for Collective Investment in Transferable Securities
UK	United Kingdom
VCC	Variable Capital Company

## Executive Summary

### *Overview*

1. Currently, an open-ended investment fund may be established under the laws of Hong Kong in the form of a unit trust but not in corporate form due to various restrictions on capital reduction under the Companies Ordinance (“CO”) (Chapter 622). As an international financial centre, Hong Kong could benefit from more choices on the legal forms of investment funds to fund managers worldwide.
2. This consultation paper aims to put forth proposals to enhance Hong Kong’s legal infrastructure for investment fund vehicles by introducing a new open-ended fund company (“OFC”) structure to complement the existing unit trust structure. It is hoped that the additional option, which will provide market participants more flexibility in establishing and operating funds in Hong Kong, would attract more funds to domicile in Hong Kong. This will be conducive to Hong Kong’s further development as an international asset management centre.

### *Structure of this Consultation Paper*

3. **Section A** outlines the background to introducing OFCs, and the **overarching principles** that have been taken into account in developing the policy framework for OFCs and formulating the regulatory approach -
  - (a) OFCs to be introduced as an additional legal structure to complement the existing unit trust structure and provide more flexibility in the choice of fund legal structures. OFCs may be set up as a public or private fund;
  - (b) while publicly offered OFCs will be subject to the same regulatory requirements applicable to existing publicly offered funds, it is proposed that privately offered funds be given some flexibility to pursue their investment strategies subject to compliance with basic governance principles and conduct requirements to be observed by their managers that are in line with international regulatory standards;
  - (c) adherence to international regulatory practices and standards for the regulation of collective investment schemes (“CIS”) including fundamental International Organization of Securities Commissions principles which for example, set out the general requirements in respect of –
    - (i) standards for the eligibility, governance, organisation and operational conduct of those who wish to market or operate a CIS;
    - (ii) rules governing the legal form and structure of CIS and the segregation and protection of client assets;
    - (iii) disclosure requirements so that investors may evaluate the suitability of a CIS and the value of a shareholder’s interest in the CIS; and
    - (iv) appropriate oversight of fund managers.

4. **Section B** sets out the **proposed framework for OFCs**. The new OFC vehicle will be established under the Securities and Futures Ordinance (“SFO”) and be regulated and supervised by the Securities and Futures Commission (“SFC”). The enabling provisions will be provided in the SFO to facilitate the making of a separate piece of OFC subsidiary legislation governing the detailed regulation of these new vehicles. The SFO and the OFC subsidiary legislation will set out the full scheme of the OFC and cover matters relating to the creation and regulation of OFCs except for certain winding up provisions which will be by reference to the existing winding up procedures under the “Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32).
5. To supplement the SFO and the OFC subsidiary legislation, the more detailed requirements relating to OFCs and their operation will be set out in a separate OFC Code to be issued under the SFO, subject to further public consultation. The OFC Code will be applicable to all SFC-registered OFCs, whether publicly or privately offered.
6. **Section C** sets out the **proposed roles and functions of the regulators involved in the OFC regime**. Given that OFCs are set up as an investment fund vehicle, SFC will be the primary regulator responsible for the registration and regulation of OFCs under the SFO. The Companies Registry (“CR”), as the corporate registry of companies registered under the CO, will be responsible for the incorporation and administering the relevant statutory corporate filings of OFCs. In relation to the termination and winding up of OFCs, the Official Receiver’s Office (“ORO”) will administer compulsory winding-up procedures similar to those applicable to conventional companies formed under the CO. The ORO will also administer relevant breaches under its existing enforcement procedures.
7. **Section D** outlines the **proposed legal structure for OFCs**. It is proposed that the OFC will be structured in corporate form with limited liability and variable share capital. The proposed structure will have characteristics similar to a conventional limited company in that it will have a separate legal personality; it will be governed by a board of directors; the liability of its shareholders will be limited to their shares in the company and its constitutional documents will consist of Articles of Incorporation (“Articles”).
8. Given the nature of an OFC as an investment vehicle, the day-to-day management and investment functions of the OFC must be delegated to an investment manager licensed by or registered with SFC to carry out Type 9 (asset management) regulated activity, and appointed by the OFC board. The proposed governance structure aims to enable the day-to-day management and investment functions of the OFC to be carried out by a qualified professional investment manager; and the OFC board to provide an additional layer of oversight for shareholders.



9. The board of the OFC will only comprise natural persons (i.e. corporate directors will not be allowed for better transparency), and they will be subject to the same statutory and fiduciary duties owed to a conventional company by its directors under the law, including the duty to exercise reasonable care, skill and diligence. The board of the OFC will be legally responsible for all the affairs of the OFC. Individual directors on the OFC board will not be required to be licensed under the SFO.
10. To strengthen investor protection, 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.
11. **Section E** outlines the **proposed incorporation and registration arrangements for OFCs**. As the OFC is proposed to be a pure legal vehicle for investment, it would not be required to be licensed as a licensed corporation under the SFO. It would however be required to be registered with SFC under the new legislation, and if the shares of the OFC are to be offered to the public, it must also be authorised by SFC under the SFO in accordance with the existing requirements under Part IV of the SFO. Considering that the investment activities will be required to be delegated to an investment manager licensed by or registered with SFC, it is proposed that the investment scope of an OFC should align with those types of investment activities, which are subject to licensing and regulation by SFC under the SFO, namely, securities, futures (and over-the-counter (“OTC”) derivatives once the relevant legislative amendments to the SFO have become effective) as defined under the SFO. Being an investment vehicle, the OFC is not designed to engage in activities undertaken by conventional companies, such as commercial trade and business.
12. **Section F** outlines the **proposed arrangements regarding administration and operation of OFCs**. The share capital rules in the CO relating to capital maintenance, increase and reduction of capital are not applicable to OFCs because of its open-ended nature. OFCs will have the flexibility to vary its share capital in order to meet shareholder redemption requests. Also, OFCs will not be bound by restrictions on the distribution out of share capital applicable to companies formed under the CO. OFCs may distribute out of share capital subject to solvency and disclosure requirements.
13. **Section G** outlines the **proposed protected cell regime for OFCs established as an umbrella company with sub-funds**. The arrangements in relation to protected cells would be mandated by the new OFC legislation, such that there will be a legally enforceable segregation of the assets and liabilities of each sub-fund. This aims to legally ring-fence the assets of sub-funds from other sub-funds under the same umbrella as well as from the umbrella itself so should one sub-fund become insolvent, it should not impact the operation of another sub-fund or lead to the insolvency of the umbrella OFC.
14. **Section H** outlines the **proposed arrangements for terminating and winding up solvent and insolvent OFCs**, having regard to the protection to investors and creditors of OFCs.

15. **Section I** proposes the **regulatory framework for OFCs**, including **supervision and enforcement**. The proposed regulatory framework has been designed with the intention to strike a balance between protecting investors with an appropriate level of regulatory oversight whilst encouraging market development and product innovation in the asset management industry.
16. On supervision of OFCs, the new OFC legislation and the OFC Code will set out the key functions and duties of directors and other key operators of OFCs, which must be complied with for so long as the OFC remains registered with the SFC. The OFC investment managers, with are either SFC licensed or registered will also need to comply with existing regulatory requirements including the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (“Code of Conduct”) and the Fund Manager Code of Conduct. The OFC will be subject to post-registration monitoring and supervision under the new legislation and the OFC Code. Publicly offered OFCs would also be subject to ongoing post-authorisation requirements under the SFC Handbook.
17. Regarding the enforcement powers in relation to OFCs, it is proposed that SFC should be vested with –
  - (a) investigatory powers to investigate the affairs of OFCs and their directors as long as the SFC has reasonable suspicion of misconduct;
  - (b) the power to intervene in the business and management of OFCs; and
  - (c) the criminal and civil powers.
18. In addition to SFC’s powers relating to securities-related enforcement matters relating to OFCs, 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, and the ORO will administer any compulsory winding-up procedures similar to those applicable to conventional companies formed under the CO and relevant breaches under its existing enforcement procedures.
19. **Section J** presents **the tax regime applicable to OFCs**. 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. We will consider carefully the exemption or the extent of exemption that should be applied to privately offered OFCs with CMC located onshore having regard to possible read-across implications.
20. For the **proposed stamp duty treatment on transfer of shares in OFCs**, considering that stamp duty is charged under that Stamp Duty Ordinance on transfers of Hong Kong stocks, and that shares in OFCs by definition are Hong Kong stocks, *prima facie*, their transfers should be subject to stamp duty.

### *Way Forward*

21. We welcome responses to the proposed OFC structure during the three-month consultation period ending **19 June 2014**.
22. After considering submissions in response to this consultation, the Financial Services and the Treasury Bureau, SFC and relevant departments will work on the details of the proposals.

## **A. Introduction**

1. To further develop Hong Kong as an international asset management centre of choice, this consultation paper aims to put forth proposals to enhance Hong Kong's legal infrastructure for investment fund vehicles by introducing a new open-ended fund company ("OFC") structure to complement the existing unit trust structure. This additional option will give market participants more choice and better flexibility in establishing and operating funds domiciled in Hong Kong.
2. In developing the proposals in the ensuing paragraphs, we have considered the legal framework and regulatory regimes of other major asset management jurisdictions, including the United Kingdom ("UK"), Ireland, Luxembourg and Cayman Islands, the relevant securities regulation principles published by the International Organization of Securities Commissions ("IOSCO")<sup>1</sup> and the market landscape in Hong Kong, with the aim of reaching a balance between facilitating market development and maintaining Hong Kong's competitiveness on one hand, and ensuring market integrity and protecting investors on the other.

### **Existing investment fund structure in Hong Kong**

3. Currently, an open-ended investment fund may be established under the laws of Hong Kong in the form of a unit trust by way of a trust deed but not in corporate form due to the various restrictions on capital reduction under the Companies Ordinance ("CO") (Chapter 622). As an open-ended investment fund needs the flexibility to vary its capital in order to meet investor applications and redemptions, the current legal regime for companies does not enable such funds to be established in corporate form.
4. Open-ended funds constituted in unit trust form have long existed in Hong Kong which has well-established trust law. The structure is widely understood and accepted also in other jurisdictions which practise or historically have an English common law background, for example Australia, Ireland and the UK.
5. On the other hand, the more popular fund structure from an international perspective is the corporate fund structure. This structure is available in most major fund centres for example the Cayman Islands, Ireland, Luxembourg and the United States. In the past couple of decades and since the introduction of Undertakings for Collective Investment in Transferable Securities ("UCITS"), we have observed that an increasing number of common law jurisdictions, which have traditionally only offered unit trust funds, have expanded their legal framework and regulatory regimes to cater for the establishment of corporate fund vehicles. Ireland established investment companies with variable capital in 1990 and the UK introduced open-ended investment companies in 1997.

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<sup>1</sup> IOSCO Objectives and Principles of Securities Regulation (June 2010).

## Development of asset management in Hong Kong

6. Hong Kong is already an established asset management centre. Our free economy, simple and transparent tax system and robust legal system and regulatory framework have made Hong Kong a popular location for asset management activities. As of 31 March 2013, Hong Kong had 1,847 publicly offered unit trusts and mutual funds authorised by the Securities and Futures Commission (“SFC”) with a total asset under management (“AUM”) of US\$1,238 billion, of which 305 were Hong Kong domiciled.<sup>2</sup>
7. There has been a growing trend in the number of funds domiciling in Hong Kong. The total number of Hong Kong-domiciled funds has increased by around 61% between the three years 2011-2013 and the proportion of Hong Kong-domiciled funds as a percentage of total number of SFC-authorized unit trust and mutual funds has also gone up by 7.5% for the same period. This also coincided with the introduction of Renminbi Qualified Foreign Institutional Investor (RQFII) funds in 2011.
8. From fund management business figures collected, Hong Kong has traditionally been a destination for fund distribution. This is reflected in the number of offshore domiciled funds (almost 83% of publicly offered funds) and the high percentage of the domestic asset management workforce employed in sales and marketing (nearly 74%)<sup>3</sup>.
9. We hope that the addition of a new fund structure could further open up Hong Kong’s capacity for asset management activities. The proposal aims to -
  - (a) create a more flexible business environment for fund managers to meet market demand, which in turn could attract more mutual funds and private funds choosing to domicile in Hong Kong;
  - (b) build up Hong Kong’s fund manufacturing capabilities to complement the existing fund distribution network and develop Hong Kong into a full fund service centre, which would increase opportunities for fund administration and fund servicing work, and thus, creating more employment opportunities in those areas; and
  - (c) enhance Hong Kong’s fund platform and infrastructure to facilitate the increasing number of public and private fund managers who wish to domicile their funds in Hong Kong, hence further deepening Hong Kong’s funds market.

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<sup>2</sup> SFC 2012-2013 Annual Report.

<sup>3</sup> Fund Management Activities Survey (“FMAS”) 2012 published by the SFC in July 2013.

## Overarching principles in the development of OFCs in Hong Kong

### Regulatory approach

10. In developing the policy framework for OFCs and formulating the regulatory approach, we have taken into account the following overarching principles -
- (a) OFCs to be introduced as an additional legal structure to complement the existing unit trust structure and provide more flexibility in the choice of fund legal structures. OFCs may be set up as a public or private fund.
  - (b) While publicly offered OFCs will be subject to the same regulatory requirements applicable to existing publicly offered funds, it is proposed that privately offered funds be given some flexibility to pursue their investment strategies subject to compliance with basic governance principles and conduct requirements to be observed by their managers that are in line with international regulatory standards.
  - (c) Adherence to international regulatory practices and standards for the regulation of collective investment schemes (“CIS”) including fundamental IOSCO principles which, for example, set out the general requirements in respect of -
    - (i) standards for the eligibility, governance, organisation and operational conduct of those who wish to market or operate a CIS;
    - (ii) rules governing the legal form and structure of CIS and the segregation and protection of client assets;
    - (iii) disclosure requirements so that investors may evaluate the suitability of a CIS and the value of a shareholder’s interest in the CIS including the requirement to have a proper and disclosed basis for asset valuation and the pricing and the redemption of units in a CIS; and
    - (iv) appropriate oversight of fund managers.

<p><b>Question 1: Do you agree with the overarching principles for OFCs as set out above?</b></p>
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## What is an OFC

11. An OFC is an open-ended CIS which is structured in corporate form with limited liability and variable share capital. The main purpose of an OFC is to serve as an investment fund and manage investments for the benefit of its shareholders. OFC shareholders do not have any day-to-day management rights or control over the underlying assets held by the OFC but they do have the right to participate in the income/profits arising from the management of and transactions in the fund property which is typically paid via distributions.
12. OFC shares are typically priced at net asset value which, broadly speaking, is the market value of the underlying assets divided by the number of shares issued less any costs.
13. The OFC structure is popular in the asset management industry and available in most major international fund centres, for example –
  - (a) Variable Capital Company (“**VCC**”) in Ireland
  - (b) Mutual Fund Company (“**MFC**”) in the United States
  - (c) Open-ended investment company (“**OEIC**”) in the UK
  - (d) Société D’investissement À Capital Variable (“**SICAV**”) in Luxembourg
14. The concept of an OFC is not new to Hong Kong since offshore domiciled OFCs and similar investment vehicles such as VCCs, OEICs and SICAVs have been authorised by the SFC for public offering.

## Key proposals for a Hong Kong OFC

15. The key proposals set out below are developed and guided by the principles as mentioned above. We have taken into account current practices adopted in comparable international fund centres such as Ireland, Luxembourg and the UK when formulating these proposals.
  - (a) The legal framework for the establishment and regulation of OFCs will be provided for under the SFO. The enabling provisions would be set out in the primary legislation while the detailed operational and procedural matters would be set out through new subsidiary legislation to be enacted under the SFO.

- (b) The OFC's primary purpose is to be an investment fund, investing in securities and futures contracts (and OTC derivatives once the relevant proposed legislative amendments to the SFO have become effective<sup>4</sup>), within the remit of the SFO.
- (c) Given the nature of an OFC as an investment fund vehicle, we propose that 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<sup>5</sup>, and appointed by the OFC board. As such, we propose that individual directors on the OFC board will not be required to be licensed under the SFO.
- (d) The OFC itself will be a neutral platform, a pure legal vehicle and therefore not required to be licensed as a licensed corporation under Part V of the SFO. The OFC will however have to be registered with the SFC under the SFO/new subsidiary legislation, and if the shares of the OFC are to be offered to the public, it must also be authorized by the SFC under section 104 of the SFO.
- (e) The OFC's structure will be a body corporate, and the structure will be similar to conventional company forms in that it will have a constitutional document namely, Articles of Incorporation ("**Articles**"). The OFC will be governed by a board of directors who are subject to fiduciary duties; and it will have a legal personality.
- (f) Being an investment vehicle, other key features of the OFC include -
  - (i) the OFC will be a CIS investing its assets in securities and futures contracts (and OTC derivatives once the relevant proposed legislative amendments to the SFO have become effective), rather than engaging in activities undertaken by conventional companies such as commercial trade and business;
  - (ii) the OFC will not be bound by restrictions on the reduction of share capital applicable to companies formed under the CO, and instead will have the flexibility to vary its share capital in order to meet shareholder redemption requests; and
  - (iii) the OFC will not be bound by restrictions on the distribution out of share capital applicable to companies formed under the CO and instead, may distribute out of share capital subject to solvency and disclosure requirements.

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<sup>4</sup> The Securities and Futures (Amendment) Bill 2013 is currently laid before the Legislative Council and seeks to amend the SFO to provide for the regulation of activities and other matters connected with OTC derivative products.

<sup>5</sup> Type 9 regulated activity is on asset management, including managing a portfolio of securities or futures contracts for clients on discretionary basis.



## **B. Proposed Framework for Hong Kong OFC**

### **Legislative framework**

#### **The amended SFO and OFC subsidiary legislation under the SFO**

16. We propose that the new OFC vehicle be established under the SFO and be regulated and supervised by the SFC. This will be in line with the approach taken in other comparable overseas jurisdictions<sup>6</sup>.
17. We propose that enabling provisions will be provided in the SFO to facilitate the making of a separate piece of OFC subsidiary legislation governing the detailed regulation of this new vehicle. Consideration will also be given to amending certain provisions of the SFO (such as those dealing with the SFC's investigation powers) so as to extend their application to OFCs and key operators (e.g. directors, investment manager and custodian) where necessary.
18. We envisage that the amended SFO and the OFC subsidiary legislation will set out the full scheme of the OFC and cover matters relating to the creation and regulation of OFCs except for certain winding up provisions which will be by reference to the existing winding up procedures under the "Companies (Winding Up and Miscellaneous Provisions) Ordinance ("C(WUMP)O")" (Chapter 32).

#### **Core requirements under the SFO and the OFC subsidiary legislation**

19. We propose that the SFO and the OFC subsidiary legislation will cover the core structural requirements for OFCs, regulatory powers of the SFC in relation to OFCs and key ongoing compliance obligations. Some of the key areas which are envisaged to be covered under the new legislation are set out below.
  - (a) Core structural requirements
    - (i) Basic registration requirements;
    - (ii) Corporate requirements e.g. naming convention, directors' duties and powers, shareholder register, registered office, etc.;
    - (iii) Requirements in relation to key operators e.g. board of directors, SFC-licensed investment manager and custodian;
    - (iv) Segregation of liabilities within sub-funds; and
    - (v) Termination and winding up requirements.

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<sup>6</sup> For example, in the UK, the equivalent OFC vehicle is established and regulated under regulations made under the Financial Services and Markets Act 2000, which is the primary legislation and comparable to Hong Kong's SFO.

- (b) Key ongoing compliance obligations
  - (i) Compliance with basic content requirements for the OFC's Articles;
  - (ii) Compliance with basic disclosure standards in any marketing or offering document and continuous disclosure obligations;
  - (iii) Compliance with basic governance standards; and
  - (iv) Mandatory corporate filing and reporting obligations.
- (c) SFC regulatory powers
  - (i) Make rules and regulations (including codes and guidelines) relating to OFCs;
  - (ii) Registration and deregistration of OFCs including the revocation of registration and the power to impose, amend or revoke registration conditions;
  - (iii) Approval of changes to OFCs; and
  - (iv) Enforcement powers (supplementing existing provisions in the SFO which already apply or are extended to OFCs, their officers and other key operators).

<p><b>Question 2: Do you consider it agreeable to set out the legislative framework for OFC in the SFO and the relevant subsidiary legislation in the proposed manner?</b></p>
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### **Supplementary requirements under an OFC Code**

20. We propose to supplement the SFO and the OFC subsidiary legislation by implementing more detailed requirements relating to the OFC and its operation in a separate OFC Code, to be issued under section 399 of the SFO. The OFC Code, which will be administered by the SFC would be applicable to all SFC-registered OFCs whether publicly or privately offered. Publicly offered OFCs required to seek SFC-authorisation would also have to comply with the applicable requirements under the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products including the Code on Unit Trusts and Mutual Funds ("SFC Handbook").

21. Some of the key requirements proposed to be included in the OFC Code issued by the SFC are listed in the table below. The final requirements will be subject to further public consultation.

Proposed chapters	Indication of requirements to be included
Overarching principles	<ul style="list-style-type: none"> <li>This chapter will set out the overarching principles applicable to an OFC and its operators for example, acting fairly, ensuring compliance with regulatory requirements and avoiding conflicts of interests, etc.</li> </ul>
Registration requirements	<ul style="list-style-type: none"> <li>This chapter will set out the detailed registration requirements.</li> </ul>
Corporate governance	<ul style="list-style-type: none"> <li>This chapter will set out the corporate governance requirements, including the composition of the OFC board, director qualification criteria and the functions and duties of the board, investment manager and custodian including applicable independence requirements.</li> </ul>
Investment scope and restrictions	<ul style="list-style-type: none"> <li>This chapter will set out the detailed investment scope and restrictions applicable to OFCs.</li> </ul>
Operational matters	<ul style="list-style-type: none"> <li>This chapter will deal with the operation of the OFC as an investment fund and set out detailed valuation and pricing, dealing and distribution requirements.</li> </ul>
Documentation and reporting	<ul style="list-style-type: none"> <li>This chapter will cover the documentation requirements of OFCs e.g. basic disclosure in the OFC offering document and shareholder notifications.</li> </ul>
Termination	<ul style="list-style-type: none"> <li>This chapter will set out the detailed requirements and procedures applicable to OFCs in the case of termination</li> </ul>

**Question 3: Do you think the proposed scope of the code and guidelines could adequately cater for the OFC regime? If not, what other essential features should the codes and guidelines include?**

## C. Regulators

### Primary regulator

22. Given that OFCs are set up as an investment fund vehicle, we propose that the SFC will be the primary regulator responsible for the registration and regulation of OFCs under the SFO. We propose that the SFC will be empowered under the SFO/OFC subsidiary legislation 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.
23. In addition to registration, OFCs which are seeking to offer their shares to the public must obtain SFC authorisation under Part IV of the SFO unless an exemption applies, and comply with the SFC Handbook.
24. Details on the SFC's supervisory approach for OFCs and proposed enforcement powers are discussed under Section I (Regulatory Regime) of this paper.

<p><b>Question 4: Do you agree with the proposal that the SFC should be the primary regulator of OFCs?</b></p>
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### Incorporation and Corporate filings

25. We propose that the Companies Registry ("CR"), as the corporate registry of companies registered under the CO, will be responsible for the incorporation and relevant statutory corporate filings of the OFC.
26. This proposal aims to ensure that all those who contract or deal with an OFC for example, the creditors and shareholders will be able to access some basic corporate information included in the corporate public filings of the OFC kept by the CR, which also keeps the information of all companies registered under the CO. It will mean that the public will be able to continue dealing with the corporate registry on corporate filings.
27. The proposed arrangement of having the corporate registry to administer the incorporation and relevant corporate filings functions and the securities regulator administer the registration and securities regulation for OFC-like vehicles is largely in line with the model adopted in other comparable overseas fund jurisdictions such as Ireland and Luxembourg.
28. We propose that the CR would incorporate and register the OFCs upon receipt of specified documents and SFC's issuance of an approval-in-principle.
29. The relevant corporate filings functions proposed to be undertaken by the CR for OFCs (details are discussed under Section F (Administration and Operation) of this paper) 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.
30. We propose that the CR will administer relevant corporate filing breaches under its existing enforcement procedures. As the primary regulator, the SFC will undertake the securities-related enforcement matters relating to OFCs.

**Question 5: Do you agree with the proposed role and functions of CR in the OFC regime?**

### **Termination and winding up**

31. The procedures for termination of an OFC under the new legislation and winding up of an OFC (solvent or insolvent) under the CO and the C(WUMP)O are discussed in Section H (Termination and Winding Up). In relation to termination of an OFC, it is proposed to be subject to SFC's prior approval. Regarding the procedures applicable to the compulsory winding up of OFCs, it is proposed that the ORO will administer any court ordered compulsory winding up procedures similar to those applicable to conventional companies formed under the CO.
32. The ORO will administer relevant breaches under its existing enforcement procedures. The SFC, following the practice as set out in relation with CR in paragraph 30, will undertake the securities-related enforcement matters relating to OFCs.

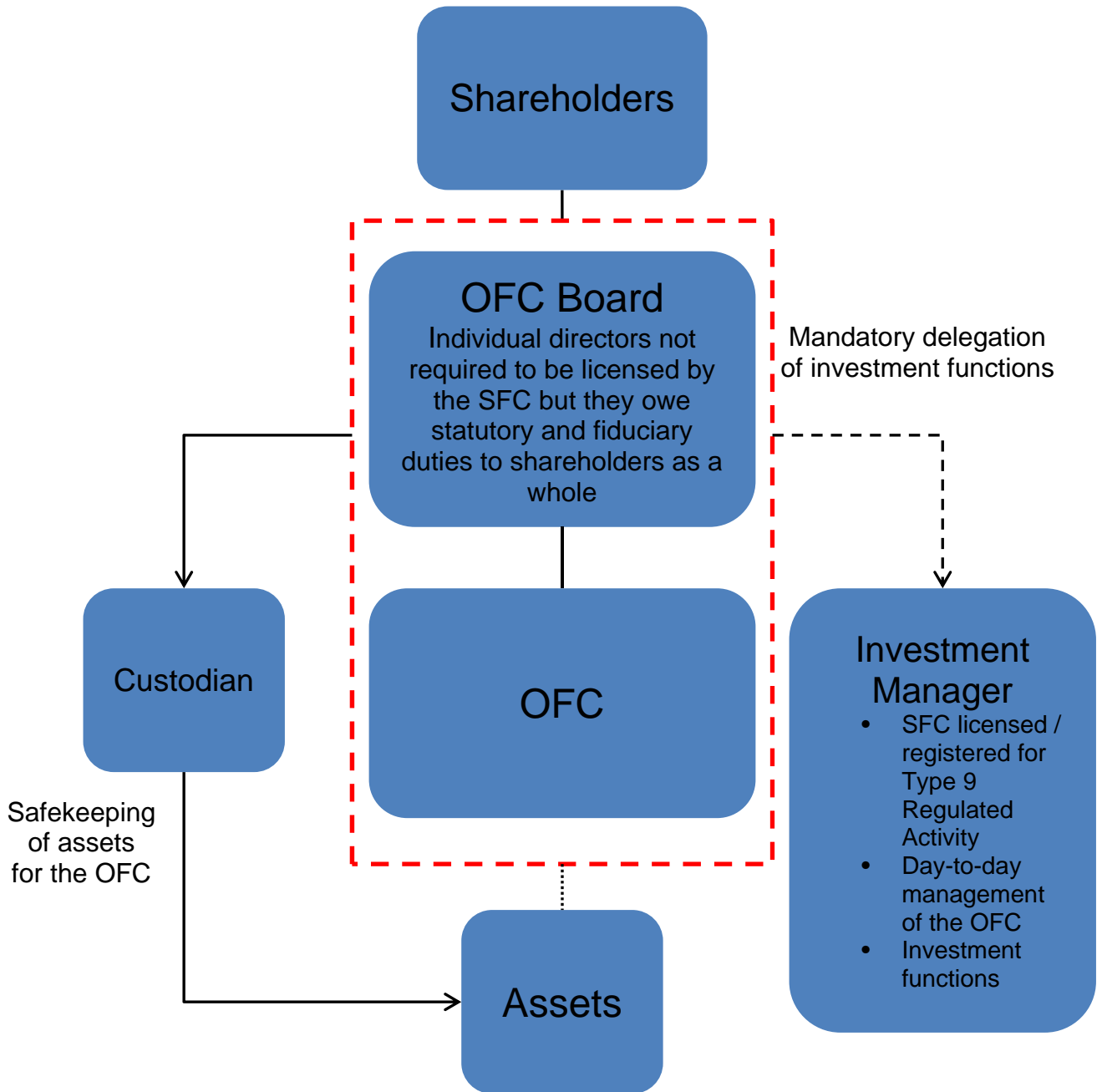
**Question 6: Do you agree with the proposed role of ORO and SFC in respect of proposed termination and winding up arrangements for OFCs?**

## **D. Legal Structure**

### **Proposed Hong Kong OFC structure**

33. As discussed above, an OFC is an open-ended CIS which is structured in corporate form with limited liability and variable share capital. The main purpose of an OFC is to serve as an investment fund vehicle managed by a professional investment manager.
34. While the proposed structure will include characteristics of a conventional limited company in that, it will have its own legal personality, be governed by a board of directors and shareholder liability will be limited to their shares in the company, the activities of the OFC will reflect a traditional investment fund. This means that the vehicle will be managed by a professional investment manager on behalf of shareholders and the assets of the OFC will be held by an independent custodian.
35. The proposed OFC structure illustrated below is a structure commonly used by the fund industry internationally. The registration requirements for the OFC vehicle and each key operator are discussed in the ensuing paragraphs.

**Proposed OFC structural diagram**



**OFC fund**

36. The OFC is proposed to be a pure legal vehicle for investment. As such, it would not be required to be licensed as a licensed corporation under Part V of the SFO. The OFC would, however, have to be registered with the SFC under the amended SFO/new subsidiary legislation. To apply for registration, it is proposed

that certain basic registration requirements will be required subject to the SFC's vetting.

37. To become a SFC-registered OFC, we propose that the entity would be required to meet the following key structural requirements -
- (a) have Articles which comply with rules set out in the new legislation and the OFC Code including a statement that -
    - (i) the company is an open-ended fund company with variable capital;
    - (ii) shareholders will not be liable for the debts of the company; and
    - (iii) shareholders must be entitled to have their shares redeemed or repurchased at a price based on the net asset value of the fund.
  - (b) have the registered office situated in Hong Kong;
  - (c) be governed by a board of directors; and the board of directors must at all times delegate the investment and management functions of the OFC to an investment manager licensed by or registered with the SFC under Part V of the SFO to carry out Type 9 (asset management) regulated activities; and
  - (d) properties of the OFC must be entrusted to a Hong Kong incorporated custodian acceptable by the SFC for separate and independent safekeeping of the assets belong to the OFC.
38. When formulating these registration requirements, current international practices for open-ended investment funds constituted in company form including those from Ireland, Luxembourg and the UK and also the IOSCO principles were taken into account.
39. In addition to registration, if the OFC wishes to offer its shares to the public, it will also have to seek SFC's authorisation under section 104 of the SFO and comply with the applicable requirements under the SFC Handbook.

<p><b>Question 7: Do you think the features as set out above comprise the essential features of an OFC? If not, what other essential features should an OFC possess?</b></p>
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## Board of Directors

40. Similar to the conventional company model, we propose that the OFC be governed by a board of directors. The board directors will only be natural persons (i.e. corporate directors will not be allowed for better transparency<sup>7</sup>) and they will be subject to the same statutory and fiduciary duties owed to a conventional company by its directors under the law, including the duty to exercise reasonable care, skill and diligence.
41. The board of the OFC will be legally responsible for all the affairs of the OFC. Given the nature of OFC as an investment fund vehicle, we propose that the day-to-day management and investment functions of the OFC be delegated to an investment manager licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity appointed by the OFC board. As such, it is proposed that the individual directors on the OFC board will not be required to be licensed under the SFO.
42. The proposed governance structure aims to enable the day-to-day management and investment functions of the OFC to be carried out by a qualified professional investment manager; and the OFC board to provide an additional layer of oversight for shareholders. This would help safeguard the interest of investors, as it separates the investment functions and day-to-day management from that of supervision.
43. This proposed structure is also commonly adopted by investment funds which take the corporate form. Further, industry feedback has suggested that this structure better resembles the structure of traditional funds and is more familiar to the industry.
44. As an investment vehicle, we propose that the following basic eligibility criteria be applicable to the OFC board –
  - (a) directors must be natural persons;
  - (b) directors must be over the age of 18;
  - (c) there must be at least two directors;
  - (d) at least one director must be independent of the investment manager and the custodian;
  - (e) at least one director must be a Hong Kong resident<sup>8</sup>; and
  - (f) directors must be of good repute, be appropriately qualified and experienced for the purpose of carrying out the business of the OFC.

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<sup>7</sup> This is in line with the requirements in the Companies Ordinance (Cap. 622).

<sup>8</sup> The same director may satisfy the independence and residency requirement.

45. We also propose that the OFC board should be subject to corporate governance standards consistent with international standards for investment funds.
46. Details of the eligibility criteria of OFCs' individual directors, their functions and duties, and corporate governance standards applicable to OFCs will be set out in the new OFC legislation and the OFC Code to be issued under section 399 of the SFO and subject to further public consultation.
47. In addition, individual directors on the OFC board will be subject to disqualification and other sanctions under the proposed regulatory regime, which is discussed under Section I (Regulatory Regime) of this paper.

**Question 8: Do you agree with the proposed features for the Board of Directors? Do you think the proposed structure of the Board and the proposed criteria of directors will be able to render adequate investor protection to those investing in OFCs? Or do you think the proposed structure is too onerous, and would hinder the development of OFCs in Hong Kong?**

## **Investment Manager**

48. As an investment fund vehicle, we propose that a qualified professional investment manager must be appointed to carry out the day-to-day management and investment functions of the OFC, subject to the oversight of the OFC board.
49. Given the OFC will be investing in securities and futures contracts (and OTC derivatives once the proposed relevant legislative amendments to the SFO have become effective) which fall within the remit of the SFO, the investment manager must be licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity under Part V of the SFO.
50. The investment manager is proposed to be responsible for the day-to-day management of the OFC investment activities, including all investment functions, valuation of assets, risk management and regulatory compliance in accordance with the OFC Code and other applicable regulations. While the investment manager may delegate one or more of these functions to a third party, it must exercise care in the selection of delegates and properly monitor the performance by the delegate and remain fully liable.
51. It is envisaged that the detailed duties and functions of the investment manager will be set out in the OFC Code. As SFC licensed or registered persons, the investment manager will be subject to the applicable requirements under the Code of Conduct of Persons Licensed by or Registered with the SFC (Code of Conduct), the Fund Manager Code of Conduct and other applicable regulations under the SFO and other SFC regulations. This will be consistent with requirements on investment managers of both public and private funds in Hong Kong.

**Question 9: Do you agree that the OFC board must delegate the day-to-day management and investment functions of the OFC to an investment manager who is licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity?**

## **Custodian**

52. A key IOSCO principle for the regulation of CIS is to provide for rules governing the segregation and protection of client assets<sup>9</sup>. To strengthen investor protection and avoid potential conflicts of interest, we propose that the assets of the OFC must be segregated from that of the investment manager and entrusted to a separate, independent custodian for safe keeping.
53. Given the significance of the role of the custodian, we propose that the custodian must be incorporated in Hong Kong and acceptable to the SFC. The custodian will be subject to the same basic eligibility requirements as required under the SFC Handbook<sup>10</sup>, for example the custodian will have to be substantial financial institutions such as banks or their subsidiaries and the custodian should be independent from the investment manager. These basic eligibility criteria are broadly in line with requirements in major overseas fund jurisdictions such as Ireland and Luxembourg.
54. The custodian shall be primarily responsible for -
- (a) taking into custody or under its control all the assets of the OFC and hold them in accordance with the provisions of the constitutional document; and
  - (b) maintaining proper segregation and independent custody of the OFC's assets.
55. The detailed functions and duties of the custodian as well as independence criteria will be set out in the OFC Code. Custodians of publicly offered OFCs will have the additional responsibilities and duties of oversight under the existing requirements in the SFC Handbook.
56. To safeguard investors' interests, we also propose that the custodian of an OFC may not retire except upon the appointment of a new custodian acceptable to the SFC.

**Question 10: Do you think the proposal to require a custodian in the OFC structure could foster the protection of investors in an OFC? Do you consider the proposed requirements and duties for a custodian adequate to meet this objective?**

<sup>9</sup> Principle 25 of the *IOSCO Objectives for Securities Regulation* (June 2010).

<sup>10</sup> Please refer to chapter 4: Trustee / Custodians under the Section II: Code on Unit Trusts and Mutual Funds.

## **E. Formation & Incorporation**

### **Incorporation and Registration**

57. To set up an OFC, we propose that the applicant should apply to SFC for approval. The SFC would review the application, including whether it meets the regulatory requirements to be stipulated in the SFO and relevant subsidiary legislation, rules, regulations and codes. Upon CR's receipt of specified documents and SFC's issuance of an approval-in-principle for registration, CR would incorporate and register the OFC. The registration of the specified form and the constitutional documents and the issuance of a certificate of incorporation by the CR confer corporate status upon the applicant entity from the date of the incorporation (i.e. the date of the certificate of incorporation). As such, the body corporate may exercise all the functions of an incorporated company as a full legal person.
58. Once incorporated, SFC will include the OFC's name into SFC's list of registered OFCs. The CR will also include the OFC's name into CR's list of OFCs and make relevant documents available for public search (e.g. constitutional documents and the certificate of incorporation).
59. It should be noted that this registration status is not the same as an authorisation under section 104 of the SFO. If the OFC wishes to offer its shares to the public, we propose that the OFC will have to seek authorisation under section 104 of the SFO which can be processed concurrently with its application for registration as an OFC.

<b>Question 11: Do you agree with the proposed arrangements in relation to the incorporation of OFC?</b>
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### **Naming convention**

60. We propose to introduce naming conventions for OFCs under the new legislation or the OFC Code to -
  - (a) distinguish OFCs from companies formed under the CO; and
  - (b) require OFC names not to be misleading or undesirable.
61. Given the difference between the business nature and capital structure of an OFC compared to conventional companies formed under the CO, the name of the OFC must end with "open-ended fund company" or the abbreviation of "OFC", so as to distinguish it from conventional companies incorporated under the CO. The practice of having an identifying title is adopted in other fund jurisdictions such as Ireland, Luxembourg and the UK. This is to distinguish investment funds formed as a company with variable capital from conventional companies. We

also propose that no person should use the title “open-ended fund company” or “OFC” without being registered with the SFC as an OFC.

62. Prospective OFC applicants should also consider whether the OFC name is in line with its investment objective and strategies from an investment product standpoint to ensure that investors are not likely to be misled about the investment purpose of the fund. One of the registration requirements is that the OFC’s name must not be misleading or undesirable.
63. The SFC will vet the acceptability of the OFC name as part of the review of the OFC registration application.

**Question 12: Do you consider the proposed naming convention provides sufficient level of clarity to investors?**

### **Articles of incorporation**

64. For the purpose of incorporation, we propose that the OFC should have Articles. The new legislation will set out the basic mandatory content requirements for the OFC Articles by covering the core elements of an OFC, such as operating as an open-ended fund company with variable capital, the investment scope, having segregation of liabilities between sub-funds<sup>11</sup>, limiting shareholders’ liability to their investments in the OFC; and entrusting the OFC’s property to a separate, independent custodian for safe keeping, etc.
65. The Articles will be submitted to SFC during the registration process and any subsequent material amendments to the Articles must be approved by SFC before being filed with the CR. Similar to conventional companies, any changes to the Articles will be subject to shareholders’ approval by way of a special resolution and changes to the individual sub-fund within an umbrella OFC would require the approval of the shareholders of that sub-fund.

**Question 13: Do you agree that the Articles proposed are adequate? What features should the Articles include?**

### **Investment scope and strategies**

66. Under this proposal, OFC will be established under the SFO and the OFC and its key operators primarily regulated by the SFC. The investment activities will be required to be delegated to an investment manager licensed by or registered with the SFC. As such, we propose that the investment scope of an OFC should align with those types of investment activities which are subject to licensing and regulation by the SFC under the SFO, namely securities, futures (and OTC

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<sup>11</sup> See Section G (Protected Cells) of this paper.

derivatives once the relevant proposed legislative amendments to the SFO have become effective) as defined under the SFO.

67. The proposed investment scope aims to ensure the current regulatory handle of the SFC in terms of licensing, supervision and enforcement, etc. could also be applicable to investment managers of OFCs. This would also enable all existing fund managers licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity to apply to manage OFCs without the need to apply for any new licences.
68. We note there are views from the industry that privately offered OFCs should be able to invest in any asset class (subject to any self-imposed restrictions contained in the constitutional documents)<sup>12</sup>. It should however be noted that the primary purpose of a Hong Kong OFC (regardless of whether it is publicly or privately offered) will be to operate as an investment fund. In addition, the OFC is not designed to operate as a corporate entity for the purposes of general commercial business or trade. Therefore, we propose that the asset classes in which a Hong Kong OFC may invest should fall within the definition of securities and futures (and OTC derivatives once the relevant proposed legislative amendments to the SFO have become effective) under the SFO within the scope of Type 9 (asset management) regulated activity under the SFO.
69. In terms of investment strategies and policies, publicly offered OFCs must comply with applicable investment restrictions set out in the SFC Handbook. The investment managers of privately offered OFCs may have the flexibility to pursue their own investment strategies, subject to compliance with basic governance principles as well as conduct and disclosure requirements that are in line with international regulatory standards and within the investment scope as described in paragraph 66 above.

<p><b>Question 14: Do you consider the proposed investment scope and strategies could provide a competitive framework for OFCs in Hong Kong with sufficient safeguards for investor protection?</b></p>
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## **Offer of OFC shares**

70. We propose that in line with the existing arrangement adopted for investment fund offerings in Hong Kong, OFC share offerings would be made under an offering document, which is consistent with practices adopted in overseas jurisdictions for corporate fund offerings.
71. Basic disclosure requirements to be set out in the new legislation / the OFC Code will apply to offering documents and any misrepresentations will be subject to liability under sections 107 and 108 of the SFO.

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<sup>12</sup> "Proposals on legal and regulatory framework for open-ended investment companies in Hong Kong", Financial Services Development Council research paper, 18 November 2013.

72. The basic disclosure requirements applicable to OFCs would be based on the overarching principle that any disclosure made to investors should be clear, concise and effective. As such, the OFC offering document is expected to contain information necessary for investors to be able to make an informed judgement of the investment. As open-ended OFCs are offered on a continuous basis, the offering document should also be up-to-date.
73. Offering documents of publicly offered OFCs will also have to comply with the disclosure requirements in the SFC Handbook and obtain the SFC's authorisation under section 105 of the SFO prior to issue similar to all investment funds offered to the public in Hong Kong. We propose that the offering documents of publicly offered OFCs, after obtaining SFC's authorization, should be filed with the CR prior to issue.
74. To allow certain flexibility for privately offered OFCs, it is proposed that privately offered OFCs will not be required to file their offering documents with the CR nor have their offering documents authorized by the SFC. This would also be consistent with the current regulatory approach with respect to offerings of private funds.

<b>Question 15: Do you agree with the proposed arrangements in relation to the offer of OFC shares?</b>
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## **F. Administration and Operation**

### **Corporate administration**

#### **Meetings**

75. In view of the nature of OFCs, we propose that annual general meetings would be optional. However, shareholders with 5% of the voting rights of an OFC should have the right to requisition an extraordinary general meeting.
76. Notice of meetings, meeting quorums<sup>13</sup> and resolution thresholds<sup>14</sup> are proposed to be consistent with those that are currently under the CO and other administrative and procedural matters relating to member meetings may be determined by individual OFCs' Articles. We also propose that publicly offered OFCs will need to comply with existing meeting requirements under the SFC Handbook.

#### **Reports and accounts**

77. To keep investors informed of the development and performance of their investments, we propose that all OFCs should prepare an annual report and audited accounts. Unaudited interim report and accounts should also be prepared. All accounts must be prepared in accordance with the Hong Kong Financial Reporting Standards ("HKFRS") and audited accounts must be audited by an independent auditor, appointed by the OFC board. Publicly offered OFCs must also file their annual report and audited accounts with the CR.
78. We propose to prescribe some basic reporting requirements, including, among other things, a statement of assets and liabilities which will cover the OFC's investments, assets, liabilities and net asset value. The OFC's annual report is also expected to contain both qualitative and quantitative information on the investment portfolio and assets of the OFC to enable shareholders to make an informed judgement on the development of the activities and the results of the OFC's performance.
79. For OFCs that are formed as umbrella OFCs, the accounts for umbrella OFCs must cover the consolidated view as well as the accounts of each individual sub-fund. OFCs which are authorised by the SFC for public offering must also, comply with the reporting requirements under the SFC Handbook.
80. Furthermore, we propose that OFCs are expected to observe general continuing disclosure obligations and inform shareholders as soon as reasonably practicable of any information concerning the OFC which is necessary to enable shareholders to appraise the position of the fund.

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<sup>13</sup> Minimum of two members.

<sup>14</sup> Simple majority for ordinary resolutions and a majority of at least 75% for special resolutions.



## **Corporate filings**

81. As mentioned in section C (Regulators) above, we propose that OFCs should make relevant statutory corporate filings with the CR, similar to the practice of conventional companies. However, in view of the open-ended nature of OFCs as investment funds, we propose that a number of the corporate filings currently applicable to conventional companies would not be applicable to OFCs and some of the applicable filings could also be simplified.
82. In general, it is proposed that OFCs would have to comply with relevant statutory corporate filings requirements such as annual return, notification of change of directors or change of address of the registered office so that all those who contract or deal with an OFC (e.g. shareholders, creditors and any other stakeholders) would be able to access the relevant information kept by the CR as in the case of a conventional company.
83. Given OFCs would have to comply with the OFC Code and other relevant regulatory requirements on an ongoing basis, OFCs would have to seek SFC's approval prior to making these filings with the CR including, for example, appointment and/or replacement of a director and any notification to commence winding up. The SFC and the CR will conduct a further review to formulate the detailed corporate filing requirements for OFCs.

<p><b>Question 16: Do you agree with the proposed arrangements regarding corporate administration?</b></p>
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## **Fund operation**

### **Share capital**

84. The share capital rules in the CO relating to capital maintenance, increase and reduction of capital are not applicable to OFCs because of its open-ended nature.
85. In determining whether to set a minimum or maximum share capital value for OFCs, we have examined practices in other jurisdictions and the results vary ranging from no requirement to prescriptive requirements. Given that the OFC is a pure legal vehicle for an investment fund, we propose not to prescribe a minimum or maximum share capital value but allow this to be determined by market needs.

## **Valuation and pricing**

86. Valuation and pricing is a fundamental aspect of an investment fund's operation and as such, there should be no fundamental differences in the treatment between public and private OFCs. Broadly speaking, it is proposed that the offer and redemption prices be calculated on the basis of the OFC's net asset value divided by the number of shares outstanding and that such prices may be adjusted by fees and charges, provided the amount or method of calculating such fees and charges is clearly disclosed in the offering document.
87. Public funds should follow the requirements set out in the SFC Handbook and valuation rules for both public and private OFCs would be set out in the Articles. Investment managers of all OFCs are also expected to observe applicable requirements under the SFC Code of Conduct and Fund Manager Code of Conduct.

## **Issue and redemption of shares**

88. As it is proposed that OFCs will not be subject to any capital restrictions, an OFC may create and cancel shares according to the investment demands of the market, subject only to any constraints under its Articles. As an OFC will be an open-ended fund, its shares should be redeemable at the request of shareholders on each dealing day subject to the terms and conditions set out in the offering document.
89. We have not proposed a prescribed maximum interval between dealing periods for private OFCs. However, we propose that publicly offered OFCs would be subject to the dealing frequency requirements under the SFC Handbook.
90. Outside normal dealing arrangements, the ability for shareholders to subscribe and redeem shares can also be disrupted by suspension and deferral of dealings. Currently for SFC-authorized public funds, dealing may only be suspended in exceptional circumstances and having regards to the interests of shareholders and redemption requests may be deferred to the next dealing day where redemption requests exceed 10% of the total shares in issue.
91. It is noted that in the UK, privately offered OFCs may defer redemptions provided that this information is clearly set out in the Articles and offering documents. In order to allow more flexibility for privately offered OFCs to manage fund liquidity, we propose to allow suspension or deferral of dealings in such funds subject to full disclosure of the circumstances in which dealing may be deferred or suspended in the OFC's Articles and offering document. The OFC board would be expected to approve any decision to suspend or defer dealings (which can be on advice from the investment manager) having regard to their fiduciary duties.

## **Distributions**

92. As distributions to shareholders are usually based on a commercial decision made by the investment manager, we do not intend to make prescriptive rules on how and when an OFC should make distributions to shareholders. However, in view of the nature of an OFC being an investment fund, we propose that OFCs should be allowed to make distributions out of capital subject to solvency and disclosure. This is in line with the position in other major overseas fund jurisdictions.
93. An OFC's distribution policy (including whether distributions may be made out of capital) and any associated risks must be clearly disclosed in the OFC's offering documents.

<p><b>Question 17: Do you agree with the proposed arrangements in relation to fund operation? Are the proposed principles and arrangements adequate to cater for the practical operation for OFCs?</b></p>
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## **G. Protected Cells**

### **Segregation of liabilities between sub-funds**

94. The OFC may be created as an umbrella fund meaning that the OFC could consist of a number of separately pooled sub-funds and each sub-fund would have a pool of assets that is managed in accordance with the investment objectives and policies for that particular sub-fund. Operationally, each sub-fund would also be distinct, for example, separate accounts would be maintained and valuations and share prices produced for each share class within the sub-fund.
95. Whilst there is a commercial benefit to being able to create new sub-funds under one OFC umbrella without having to register each sub-fund separately with the SFC, umbrella structures can also pose potential contagion risk to investors unless there is a legal segregation of liabilities between different sub-funds.
96. For example, if an umbrella fund has two sub-funds: a conservative bond fund only investing in high quality government bonds; and a highly leveraged emerging markets equity fund, and the emerging markets equity fund collapses with liabilities exceeding its assets, without legal segregation of liabilities, the assets of the bond fund could be utilised to meet the claims of the collapsed equity fund.
97. A protected cell regime addresses this contagion risk by providing for a legally enforceable segregation of the assets and liabilities of each sub-fund. The protected-cell concept is not new and major overseas fund jurisdictions such as Ireland, Luxembourg and the UK already have legal segregation of liabilities between sub-funds.

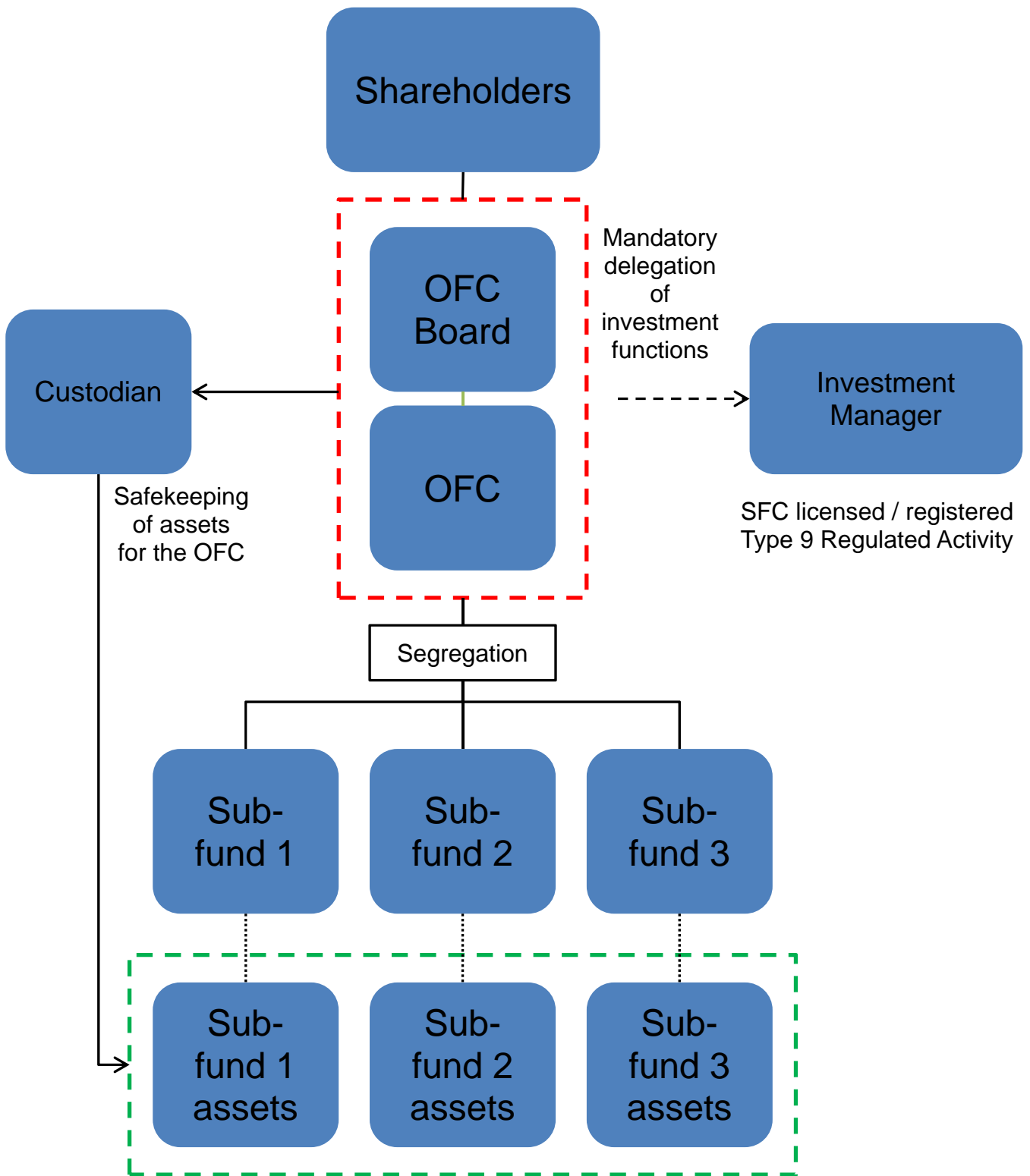
### **Proposed protected cell regime for Hong Kong**

98. We propose that the new OFC legislation will mandate the following if an OFC is established as an umbrella company -
  - (a) the assets of a sub-fund will belong exclusively to that sub-fund and cannot be used to discharge the liabilities of any other person, including the OFC itself or another sub-fund;
  - (b) a liability incurred on behalf of a sub-fund must be discharged solely out of the assets of that sub-fund; and
  - (c) where assets or liabilities are not attributable to any particular sub-fund, the OFC may allocate them in a manner which it considers to be fair to shareholders.

99. This will legally ring-fence the assets of sub-funds from other sub-funds under the same umbrella as well as from the umbrella itself so should one sub-fund become insolvent, it should not impact the operation of another sub-fund or lead to the insolvency of the umbrella OFC.
100. This segregation will also make it easier for individual sub-funds to be wound up as if it were a legal person in its own right and therefore any winding up of a sub-fund could be done more efficiently and without much impact to the umbrella OFC.
101. The concept of protected cells is adopted in a number of major fund centres. For example, the protected-cell regime is currently used in the UK for OEICs under which the OEIC sub-fund is treated as a separate legal person under the UK OEIC Regulation for the purpose of winding up. Nevertheless, we note that it is uncertain whether other jurisdictions will share Hong Kong's interpretation of a protected cell regime or that their courts would uphold contract terms to this effect in light of the different laws in other jurisdictions which may become applicable. Therefore we propose that the OFC prospectus include a disclosure warning that such protected cells may not be upheld in foreign courts to ensure that accurate information is available to investors.

**Question 18: Do you agree with the proposed arrangements in relation to protected cells?**

**Proposed structure - OFC umbrella with segregated liabilities**



## H. Termination and Winding Up

### Streamlined termination of a solvent OFC

102. Investment funds are usually terminated for commercial reasons, for example, changes in the market conditions resulting in the investment strategy becoming unviable; the size of the fund dropping below a certain level; or changing investment trends, etc.
103. Given the nature of OFCs as investment funds, we propose that an OFC could be terminated under the new legislation (subject to SFC's prior approval) in a more straight-forward and cost efficient manner, and without compromising investor protection, where -
- (a) the OFC is to be terminated in accordance with the specific provisions in the OFC Articles. For example, if the fund size falls below a particular threshold and it is no longer economical or in the interest of shareholders for the fund to continue to operate or if the fund is a fixed term fund upon effluxion of time, the board may resolve to terminate the fund;
  - (b) the OFC is solvent as certified by the OFC board and an independent, qualified auditor; and
  - (c) reasonable prior notice has been given to shareholders.
104. Once the OFC assets have been fully distributed to shareholders and all liabilities have been settled, the OFC board would be able to make an application to the SFC for de-registration of the OFC together with -
- (a) the final accounts of the OFC accompanied by the auditor's report; and
  - (b) a declaration signed by the OFC board and the investment manager confirming that all assets have been distributed to shareholders in accordance with the OFC Articles and the OFC has no outstanding liabilities.
105. The OFC would be dissolved as soon as practicable after SFC's approval for de-registration of the OFC. The SFC would notify the CR after the OFC has been dissolved so as to enable CR to update the OFC's status.

<b>Question 19: Do you think the proposed termination procedures are adequate to provide an expedient way for terminating a solvent OFC?</b>
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## **Winding up of an OFC**

106. A conventional company may be dissolved in various ways under the CO and the C(WUMP)O, including winding up, court order, striking off<sup>15</sup> and de-registration<sup>16</sup>, dependent primarily on whether the company is solvent or insolvent and the reason for the dissolution. Detailed requirements and procedures in this connection are provided in the CO and the C(WUMP)O for the protection of shareholders and creditors.
107. Similar to conventional companies, it is proposed that shareholders of an OFC also have the right to wind up the OFC on a voluntary basis, subject to SFC's prior approval. It is proposed that the established requirements and procedures set out in the C(WUMP)O that are applicable to members' voluntary winding up of conventional companies should apply in the case of voluntary winding up of OFCs for protection of shareholders and creditors. These would include the shareholders' approval, appointment of liquidator, notices, final meeting and final accounts requirements.
108. In cases where an OFC is insolvent, we propose that winding up would be in accordance with the requirements and procedures set out in the C(WUMP)O.
109. Both solvent and insolvent OFCs may be wound up by the court in a similar manner as for conventional companies. Given the SFC will be the primary regulator of OFCs, we propose that the SFC would have the power to wind up an OFC on application to the court. In addition, given the nature of an OFC as an investment fund and the significant role of the custodian as a safekeeper of the OFC's assets, we propose that the custodian may also present a petition to the court for the winding up of an OFC. This is largely in line with the models adopted in for example Ireland and the UK, where a petition for winding up may be presented by the custodian/depositary (petition to court is not necessary for the respective regulators). We propose that the SFC will notify the CR after the OFC has been wound up so CR can update the OFC's status.

## **Dissolution in other circumstances**

110. In addition to dissolution by way of termination and winding up as described above, an OFC may also be dissolved by being struck off the register by the SFC where the OFC is defunct or in other circumstances as specified under the new legislation. We propose that the SFC will notify CR after it has struck off an OFC to enable CR to update the OFC's status.

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<sup>15</sup> Striking off the name of a company from the register of companies by the Registrar of Companies under Division 1 of Part 15 under the CO.

<sup>16</sup> In the case of defunct private companies under Division 2 of Part 15 under the CO.



**Question 20: Do you have any comments on the proposed termination, winding up and dissolution arrangements for OFCs, including the proposed power to be given to the custodian to petition to the court to wind up an OFC?**

## **I. Regulatory Regime**

111. To preserve Hong Kong's status as an international finance centre, it is important to maintain a robust regulatory system and commitment towards investor protection. The regulatory regime for OFCs has been designed with the intention to strike a balance between protecting investors with an appropriate level of regulatory oversight whilst encouraging market development and product innovation in the asset management industry.
112. In designing the proposed regulatory framework for OFCs, we have taken into account the regulations in other major overseas fund jurisdictions as well as SFC's obligations under the IOSCO's Principles of Securities Regulation<sup>17</sup> which, SFC is assessed against as a member of IOSCO.

### **Supervision**

113. The OFC investment managers, which are either SFC licensed or registered, will need to comply with existing regulatory requirements including the Code of Conduct, the Fund Manager Code of Conduct and the proposed OFC Code.
114. The new OFC legislation and the OFC Code would set out the key functions and duties of directors and other key operators of OFCs which must be complied with for so long as the OFC remains registered with the SFC. We propose that the OFC be subject to post-registration monitoring and supervision under the new legislation and the OFC Code. Publicly offered OFCs would also be subject to ongoing post-authorisation requirements under the SFC Handbook.

### **Enforcement**

115. The SFC will require adequate powers to properly oversee the OFC and its activities. Under the proposed regime, while there will be a mandatory delegation of all investment functions and the day-to-day management of the OFC to a SFC-licensed or registered investment manager, neither the OFC itself nor its directors will be required to be licensed by the SFC.
116. Since the SFC's existing powers over licensees will not apply to the OFC or its directors, the SFC has proposed that it should have additional enforcement powers over the OFC vehicle itself and the individual directors to safeguard investor interests.

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<sup>17</sup> IOSCO Objectives and Principles of Securities Regulation (June 2010).

117. It was noted from a study on the enforcement powers of overseas regulators from the Cayman Islands, Ireland, Luxembourg and the UK that each regulator has intervention and investigation powers; criminal and civil enforcement powers; and disciplinary powers over corporate funds. It is therefore proposed that the SFC be vested with the following additional enforcement powers for the reasons set out below.

## **Proposed enforcement powers**

### **Investigatory powers**

118. It is proposed that the SFC should be vested with investigatory powers to investigate the affairs of OFCs and their directors as long as the SFC has reasonable suspicion of misconduct. This is similar to the Financial Conduct Authority's ("FCA") investigatory powers under the UK OEIC regime, as well as powers granted to regulators under the respective regimes in Ireland, Luxembourg and Cayman Islands.
119. The SFC's existing powers to compel the provision of information relating to transactions and the production of documents and/or answers to questions during investigations and to apply to the courts for warrants to search premises and seize documents under the SFO would then apply to OFCs.

### **Powers of restriction**

120. The SFC's current powers to issue restriction notices apply only to firms that the SFC licences. These powers allow the SFC to intervene in the business and management of a licensed firm by issuing notices to restrict the firm from carrying on its business or preventing the firm from dealing with or disposing of its assets or requiring the firm to maintain its assets in a specific manner without the involvement of the court. Given it is proposed that OFCs will not be licensed by the SFC, the SFC's current powers to issue restriction notices will not apply to OFCs.
121. It is proposed that the SFC should be vested with the power to intervene in the business and management of an OFC. The powers that will apply include -
- (a) requiring an OFC to cease the issue and/or redemption of shares; and
  - (b) requiring a director of an OFC to cease transfers to and/or from his own shareholding in the OFC.
122. The proposed powers will allow the SFC to take action swiftly and give the SFC greater flexibility to determine the most effective action to take in order to safeguard investor interests. The power to intervene in the business and affairs of an OFC without involving the courts, such as the power to require the issue and/or redemption of shares to be ceased, can also be found in the UK, Luxembourg and Ireland.

## **Criminal and civil powers**

123. OFCs and OFC investment managers will be subject to the SFC's existing powers to bring criminal proceedings for offences that include fraudulent or reckless misrepresentations to investors or potential investors; holding out as a licensed person when unlicensed and suspected manipulation of the market asset value of an OFC<sup>18</sup>.
124. Similarly, the SFC's existing powers to bring market misconduct proceedings for misconduct such as disclosure of false or misleading information inducing transactions and to present a petition to wind up a company on just and equitable ground will apply to OFCs and OFC investment managers<sup>19</sup>.
125. Currently, the SFC can bring civil proceedings for protective and remedial orders against a person who has contravened any provision of the SFO or licensing or registration terms and conditions or any other condition, notice or requirement imposed under section 213 of the SFO. As such, we propose that the OFC legislation will provide appropriate coverage to ensure section 213 of the SFO can be triggered in all appropriate cases against OFCs. This may include the establishment of bespoke remedial orders to deal with the consequences of misconduct in the affairs of an OFC. The power of the regulator to bring civil proceedings for protective and remedial orders is available in other jurisdictions such as the UK and Ireland.
126. To combat misfeasance by OFCs and their directors, we propose that remedies similar to those available under section 214 of the SFO in respect of listed corporations be available in respect of OFCs and their directors. This will enable the SFC to seek remedies from the court to protect the interests of shareholders of OFCs where the SFC suspects the business of a company is conducted in a manner which is unfairly prejudicial or oppressive to its shareholders or involves defalcation, fraud, misfeasance or other misconduct towards its shareholders or where the company has not given its shareholders any information that they might reasonably expect in relation to its business.

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<sup>18</sup> Section 107 of the SFO; Part XIV of the SFO; section 300 of the SFO.

<sup>19</sup> Section 108 of the SFO; Part XIII of the SFO; section 212 of the SFO.

127. It is proposed the SFC should be vested with the power to apply to court for appropriate orders, similar to those available in the UK, Luxembourg or the Cayman Islands, to -
- (a) remove and replace directors of OFCs;
  - (b) remove and replace custodians of OFCs in circumstances such as the failure to comply with eligibility requirements; and
  - (c) requiring investments in an OFC to be realised and the proceeds distributed to its shareholders.
128. This will ensure the OFC's business is managed and conducted in the interests of its shareholders and the underlying assets of the OFC are properly safeguarded. The proposed powers are consistent with the powers of the FCA regime.
129. Under the CO, a failure to file annual returns and other statutory returns on time would amount to a criminal offence. As discussed above, the acceptance of relevant statutory corporate filings will be undertaken by the CR. We propose that 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.

**Question 21: Do you consider the proposed powers are essential and proportionate?**

## **J. Tax and Other Issues**

### **Profits Tax exemption for OFCs authorized by SFC or OFCs with its central management and control outside Hong Kong**

130. Currently, profits tax exemption is given under section 26A of the Inland Revenue Ordinance (IRO) (Cap. 112) to public funds, including mutual funds, unit trusts or similar CIS authorized by the SFC under section 104 of the SFO or similar bona fide widely held investment schemes which comply with the requirements of a supervisory authority within an acceptable regulatory regime. Profits tax exemption is also provided under section 20AC of the IRO to offshore funds, whether public or private, but the exemption is restricted to profits derived from specified transactions transacted through specified persons.
131. As such, the exemption regimes provided under section 26A and section 20AC of the IRO equally could be considered for application to OFCs which are either CIS authorized under section 104 of the SFO or offshore funds with its central management and control located outside Hong Kong. For the purpose of section 20AC of the IRO, the central and management control (CMC) test is applied to the fund itself (i.e. at the OFC level). If the CMC of the OFC is not exercised in Hong Kong, the OFC can qualify for the profits tax exemption under section 20AC notwithstanding that the OFC is incorporated in Hong Kong and its asset portfolios are managed by a SFC-licensed/registered Hong Kong fund manager with full discretionary power. We will consider carefully the exemption or the extent of exemption that should be applied to privately offered OFCs with CMC located onshore having regard to possible read-across implications.

**Question 22: Do you think the existing profits tax exemption regimes for public funds authorised under section 104 of the SFO / bona fide widely held regulated funds and offshore funds are adequate to cater for OFCs?**

## Stamp duty on transfer of OFC shares

132. Stamp duty is charged under Stamp Duty Ordinance (“SDO”) (Cap. 117) on transfers of Hong Kong stocks (i.e. the transfers are required to be registered in Hong Kong). For stamp duty purposes, the term “stocks” covers investments like shares, stocks, funds, units under a unit trust scheme and rights and options of the aforesaid investments. A “unit” under a “unit trust scheme” is included in the definition of “stock” under section 2(1) of SDO. It follows that if the transfer of a unit is required to be registered in Hong Kong, then that unit is “Hong Kong stock” and instruments effecting the transfer thereof are liable to duty in accordance with Head 2 of the First Schedule of SDO. The rules relating to contract notes as set out in section 19 of SDO generally apply to dealings in the units. Transfers of ETF instruments are not stampable if the value of Hong Kong stocks does not exceed 40% of the aggregate value of the underlying portfolio<sup>20</sup>
133. The initial allotment of a unit by the trustees is not subject to stamp duty because according to section 19(16) of SDO, “sale or purchase” is defined to mean any disposal or acquisition (other than an allotment) for valuable consideration. Where the unit is surrendered to the trustees or managers (e.g. in the case of redemption) and the unit is then extinguished, no ad valorem duty (i.e. 0.1%) is payable by the managers as section 19(1A)(a) of SDO provides that section 19(1) of SDO (which requires a person effecting the sale or purchase of Hong Kong stock to make, execute, and stamp contract notes) does not apply to a sale or purchase of a unit under a unit trust scheme where the transaction is effected by extinguishing the unit. Only a fixed duty of \$5 is payable on the surrender of a unit where this involves extinguishing the unit.
134. Shares in OFCs by definition are Hong Kong stocks. Prima facie, their transfers should be subject to stamp duty. Shares in OFCs and units in unit trusts are similar in nature since they can be reissued after redemption or extinguishment. Thus, for stamp duty purposes, allotments, transfers and surrenders (e.g. in the case of redemptions) of shares in OFCs or units in unit trusts may be treated in the same way as described in paragraphs 132-133 above.

**Question 23: Do you consider that the proposed stamp duty treatment on sale and transfer of shares in OFCs can cater for the market needs?**

<sup>20</sup> The Financial Secretary has proposed in the 2014-15 Budget to waive the stamp duty for the trading of all exchange traded funds (ETFs). The Administration aims to put forward legislative amendments to the Legislative Council to effect the proposed waiver in the legislative year 2014-15.

## **Tax filing**

135. While OFC is an investment fund vehicle, it takes a corporate form and we therefore propose that OFCs should be required to register for business under the Business Registration Ordinance and complete tax returns to report income accrued to employees and profits whether fully or partially exempt from profits tax.

<b>Question 24: Do you consider the proposed tax filing arrangement agreeable?</b>
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## **K. Way Forward**

136. FSTB, the SFC and relevant departments will work on the details of the proposals set out above, taking into account comments received during the public consultation.



## **Annex: Consultation Questions**

- Question 1:** Do you agree with the overarching principles for OFCs?
- Question 2:** Do you consider it agreeable to set out the legislative framework for OFC in the SFO and the relevant subsidiary legislation in the proposed manner?
- Question 3:** Do you think the proposed scope of the code and guidelines could adequately cater for the OFC regime? If not, what other essential features should the codes and guidelines include?
- Question 4:** Do you agree with the proposal that the SFC should be the primary regulator of OFCs?
- Question 5:** Do you agree with the proposed role and functions of CR in the OFC regime?
- Question 6:** Do you agree with the proposed role of ORO and SFC in respect of proposed termination and winding up arrangements for OFCs?
- Question 7:** Do you think the proposed features comprise the essential features of an OFC? If not, what other essential features should an OFC possess?
- Question 8:** Do you agree with the proposed features for the Board of Directors? Do you think the proposed structure of the Board and the proposed criteria of directors will be able to render adequate investor protection to those investing in OFCs? Or do you think the proposed structure is too onerous, and would hinder the development of OFCs in Hong Kong?
- Question 9:** Do you agree that the OFC board must delegate the day-to-day management and investment functions of the OFC to an investment manager who is licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity?

- Question 10:** Do you think the proposal to require a custodian in the OFC structure could foster the protection of investors in an OFC? Do you consider the proposed requirements and duties for a custodian adequate to meet this objective?
- Question 11:** Do you agree with the proposed arrangements in relation to the incorporation of OFC?
- Question 12:** Do you consider the proposed naming convention provides sufficient level of clarity to investors?
- Question 13:** Do you agree that the proposed Articles are adequate? What features should the Articles include?
- Question 14:** Do you consider the proposed investment scope and strategies could provide a competitive framework for OFCs in Hong Kong with sufficient safeguards for investor protection?
- Question 15:** Do you agree with the proposed arrangements in relation to the offer of OFC shares?
- Question 16:** Do you agree with the proposed arrangements regarding corporate administration?
- Question 17:** Do you agree with the proposed arrangements in relation to fund operation? Are the proposed principles and arrangements adequate to cater for the practical operation for OFCs?
- Question 18:** Do you agree with the proposed arrangements in relation to protected cells?
- Question 19:** Do you think the proposed termination procedures are adequate to provide an expedient way for terminating a solvent OFC?
- Question 20:** Do you have any comments on the proposed termination, winding up and dissolution arrangements for OFCs, including the proposed power to be given to the custodian to petition to the court to wind up an OFC?

**Question 21: Do you consider the proposed powers are essential and proportionate?**

**Question 22: Do you think the existing profits tax exemption regimes for public funds authorised under section 104 of the SFO / bona fide widely held regulated funds and offshore funds are adequate to cater for OFCs?**

**Question 23: Do you consider that the proposed stamp duty treatment on sale and transfer of shares in OFCs can cater for the market needs?**

**Question 24: Do you consider the proposed tax filing arrangement agreeable?**