

Open-ended Fund Companies – New Initiative to Further Develop HK’s Asset Management Industry

Introduction

Asset management has become increasingly prominent in the international financial landscape, and Hong Kong is well placed to establish itself as a premier international asset management centre. To diversify our fund management platform and legal infrastructure, the Government has launched a three-month public consultation on introducing a new open-ended fund company (OFC) structure to expand Hong Kong’s legal structure for investment fund vehicles.

Hong Kong Advantages: Stronghold in asset management industry

With the fast economic growth and wealth creation in Asia, increase in portfolio allocation into the Asian market, and continued financial market liberalisation in the Mainland, Hong Kong possesses unique strengths in further developing the asset management industry.

As at end March 2013, the number of unit trust and mutual funds authorised by the Securities and Futures Commission (SFC) reached 1,847, with a total asset under management at US\$1,238 billion. There has also been a growing trend in funds domiciling in Hong Kong. The total number of Hong Kong-domiciled funds increased by around 61% in the three years between 2011-2013 and the proportion of Hong Kong-domiciled funds as a percentage of total number of SFC-authorized unit trust and mutual funds went up by 7.5% for the same period.

It is our policy objective to attract funds of various types to domicile in Hong Kong, expand the fund distribution network and promote fund origination here to deepen and broaden our asset management industry. This will also drive demand for professional services such as fund management and investment advice, as well as legal and accounting services.

The Proposal

The OFC structure is a proposal in response to the market need for a more flexible choice of investment fund vehicle because under the

current law, an open-ended investment fund may be established only in the form of a unit trust but not in corporate form due to various restrictions on capital reduction under the Companies Ordinance. The OFC proposal will allow funds to be set up in an open-ended structure like a company, but with the flexibility not enjoyed by conventional companies to create and cancel shares for investors to trade the funds. This corporate fund structure is gaining popularity internationally. While working to introduce an extra option for fund structure in sharpening our competitive edge as an asset management hub, we will not lose sight of the need to ensure that investor protection would not be compromised when designing the details of this new structure.

What is an OFC?

An OFC is an open-ended collective investment scheme (“CIS”) –

- in corporate form
- with limited liability
- with variable share capital, and
- can be set up as a public or private fund.

The main purpose of an OFC is to serve as an investment fund and manage investments for the benefit of its shareholders.

Key benefits of OFCs

We see the following key benefits of OFCs that make this new fund structure attractive to fund managers –

- variable share capital to meet shareholder redemption requests
- ability to distribute out of share capital subject to solvency and disclosure requirements
- corporate form with legal personality
- shareholder liability will be limited to their shares in OFCs

- streamlined procedures for termination, and
- familiar structure to other fund jurisdictions, particularly those not familiar with trust law.

OFC structure

The proposed OFC 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. However, given the nature of OFCs as pure legal vehicle for investment, OFC shareholders do not have day-to-day management rights or control over the underlying assets, but they do have the right to participate in the income/profits arising from the management of and transactions in fund property via distributions.

Similar to the conventional company model, an OFC will be governed by a board of directors, who are subject to statutory and fiduciary duties. The OFC board will be legally responsible for all the affairs of the OFC and will provide an additional layer of oversight for shareholders. Given the nature of OFC as an investment fund vehicle, the day-to-day management and investment functions of the OFC must at all times be delegated to an investment manager licensed by or registered with the SFC, while individual directors on the OFC board will not be required to be licensed under the Securities and Futures Ordinance (SFO). This is a common structure for corporate funds.

Investment scope

As the primary purpose of a Hong Kong OFC will be to operate as an investment fund and not designed for general commercial business or trade, we propose that the asset classes in which an OFC may invest should be broadly in line with those of a traditional investment fund within the remit of the SFO. Furthermore, given that the investment activities of the OFC will be required to be delegated to an investment manager licensed by or registered with the SFC, we propose that the investment scope of OFCs 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 over-the-counter derivatives (once the Securities and Futures (Amendment) Bill 2013 commences operation) as defined under the SFO.

Some of you may ask why, under our proposal, OFCs are not allowed to invest in alternative assets. Besides the rationale of the proposed investment scope explained above, I would also like to point out that the scope of securities and futures currently defined under the SFO is indeed fairly broad. It covers shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority unless such instruments fall within any of the specific exclusions set out in the definition.

Setting up an OFC

To set up an OFC, the applicant would have to apply to the 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 the Companies Registry's receipt of specified documents and SFC's issuance of an approval-in-principle for registration, the Companies Registry would incorporate and register the OFC. In addition to registration, like other SFC-authorized unit trusts and mutual funds, OFCs which seek to offer their shares to the public must seek SFC authorisation under the SFO.

The Companies Registry, as the corporate registry of companies registered under the Companies Ordinance, would be responsible for the incorporation and administering the statutory corporate filings of OFCs. The Companies Registry would also maintain a register for OFCs and provide the public with services to access the OFC information that it holds.

Protected cell regime

An OFC may be created as an umbrella fund, which means that the OFC can consist of a number of separately pooled sub-funds and each sub-fund will 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 will also be distinct. We propose to introduce a protected cell regime to address any possible contagion risk by providing for a legally enforceable segregation of the assets and liabilities of each sub-fund.

Streamlined termination of a solvent OFC

Given the nature of OFCs as investment funds, which are often terminated for commercial reasons, OFCs can be terminated under the new legislation in a more straight-forward and cost efficient manner, and without compromising investor protection, where -

- the OFC is to be terminated in accordance with the specific provisions in the Articles
- the OFC is solvent as certified by the OFC board and an independent and qualified auditor, and
- reasonable prior notice has been given to shareholders.

Investor Protection

As mentioned at the beginning, we will not lose sight of the need to ensure investor protection, and introduce the key investor protection measures –

- mandatory delegation of day-to-day management and investment functions of OFCs to an investment manager licensed or registered with the SFC, subject to the oversight of the OFC board. This would help safeguard the interest of investors, as it separates the investment functions and day-to-day management from that of supervision
- basic eligibility criteria applicable to the OFC board, investment manager and custodian
- segregating assets of the OFC from that of the investment manager and entrusted to a separate, independent custodian for safekeeping. This aims to strengthen investor protection and avoid potential conflict of interest
- alignment of investment scope with those types of investment activities which are subject to licensing and regulation by the SFC under the SFO, namely securities, futures and over-the-counter derivatives, and

- publicly offered OFCs seeking SFC-authorisation will also have to comply with the applicable requirements under the SFC Handbook, including disclosure requirements.

Legislative framework

Given that OFCs are set up to function as an investment fund vehicle, the new OFC vehicle will be established under the SFO and be regulated and supervised by the 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.

To supplement the SFO and the OFC subsidiary legislation, 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.

Regulatory framework

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 so long as the OFC remains registered with the SFC. The OFC investment managers will also need to comply with existing regulatory requirements including the Code of Conduct for Persons Licensed by or Registered with the SFC 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 will also be subject to ongoing post-authorisation 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.

Tax regime for OFCs

Regarding the tax regime for OFCs, it is an area which the fund industry is of particular interest. Currently, section 26A(1A)(a)(i) of the Inland Revenue Ordinance provides profits tax exemption for mutual

funds, unit trusts or similar investment schemes authorised by the SFC under section 104 of the SFO, i.e. publicly offered CIS. Under the OFC proposal, if an OFC wishes to offer its shares to the public, it will also have to seek SFC's authorisation under section 104 of the SFO as a publicly offered CIS. As such, we consider that the existing tax exemption regime for publicly offered CIS can be equally applied to publicly offered OFCs authorised under section 104 of the SFO as long as the OFCs can satisfy the prescribed conditions for exemption.

For privately offered OFCs, profits tax exemption will be available under the existing regime for offshore funds with its central management and control located outside Hong Kong. As for privately offered OFCs with their central management and control located onshore, the Administration will consider carefully the exemption or the extent of exemption that should be applied to such OFCs, having regard to possible read-across implications.

Welcome Your Views

The proposed framework for the introduction of the OFC regime 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.

The public consultation period will end on 19 June 2014. We look forward to receiving views from the public and market participants. Together with the SFC and relevant departments, we will work on the details of the proposals set out above, taking into account comments received during the public consultation. I appeal to you to give us feedback to allow us to formulate an OFC regime that can best suit your needs.

Salina Yan, Deputy Secretary for Financial Services and the Treasury (Financial Services), Financial Services and the Treasury Bureau