



Hong Kong

July 2018

## NEW OPEN-ENDED FUND COMPANY REGIME EFFECTIVE 30 JULY 2018

### New Hong Kong Corporate Fund Regime to Take Effect 30 July 2018

Hong Kong's new corporate fund regime allowing investment funds to incorporate as open-ended fund companies (**OFCs**), as an alternative to the currently permitted unit trust form, will take effect on 30 July 2018, subject to the legislative process. Currently, a Hong Kong open-ended investment fund cannot be established in corporate form due to restrictions on capital reduction under the Companies Ordinance (Cap. 622) (the **CO**). Internationally, however, corporate fund structures are more popular and are available in most international fund centres. The introduction of the new open-ended fund company structure is thus aimed at encouraging more funds to domicile in Hong Kong and to boost Hong Kong's position as a full service international asset management centre.

The new regime for open-ended fund companies comprises:

- New Part IVA of the Securities and Futures Ordinance (**SFO**) which sets out the legal framework for establishing an open-ended fund company. This will be implemented by the Securities and Futures (Amendment) Ordinance 2016 (**Amendment Ordinance**).
- The Securities and Futures (Open-ended Fund Companies) Rules (**OFC Rules**) and the Code on Open-ended Fund Companies (**OFC Code**) which contain the detailed legal and regulatory requirements for OFCs. The OFC Code and OFC Rules are subsidiary legislation under the SFO which were gazetted on 18 May 2018

following the SFC's publication of its conclusions<sup>1</sup> on the June 2017 SFC consultation on the OFC Rules and Code.<sup>2</sup>

- The Securities and Futures (Open-ended Fund Companies) (Fees) Regulation which provides for the fees chargeable by the SFC and the Companies Registry in respect of OFCs.

All of the above are proposed to take effect on 30 July 2018.

The new regime provides for OFCs which are to be publicly offered (**public OFCs**) and more relaxed provisions for non-public OFCs (**private OFCs**). Public OFCs will be subject to the requirements of the Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (**SFC Products Handbook**). The non-statutory OFC Code is divided into two sections, Section 1 of which will apply to all OFCs, while Section II will apply only to private OFCs.

For further details of the original consultation proposals, please refer to Charltons' June 2017 newsletter.<sup>3</sup> The following is a summary of the regime that will come into effect in July.

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

2 <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=17CP5>

3 <https://www.charltonslaw.com/sfc-proposes-rules-and-code-for-ofcs/>

### Establishment process and OFC names

The SFC will adopt a one-stop process for OFC registration, incorporation and business registration, which only requires direct dealings with the SFC.

The SFC will notify the Companies Registry (**CR**) of the registration of OFCs, the CR will issue certificates of incorporation, and the SFC will then complete the registration process. Business registration with the Inland Revenue Department will be conducted in the same manner.

The name of an OFC must: (i) end with “*open-ended fund company*” or “*OFC*”; (ii) not be the same as that of an existing OFC; and (iii) not be misleading or undesirable. An OFC’s name, and any subsequent change to it, is subject to review and approval by the SFC only. The process for change of name will also be conducted under the one-stop approach.

As to processing times, the SFC has said that public OFC applications should be processed in the same time frame as other public funds, i.e. between one and three months from application receipt. Private OFCs will normally be registered as soon as practicable, normally within one month.

### Instrument of incorporation

Under Part IVA of the SFO, an open-ended fund company must have an instrument of incorporation containing:

- a) the name of the company;
- b) a statement that the registered office of the company is situated in Hong Kong;
- c) the objects of the company;
- d) provision as to the kinds of property which the company will invest in;
- e) a statement that the company is an open-ended fund company with variable share capital;
- f) a statement that the amount of the paid-up share capital of the company is at all times equal to the net asset value of the company;
- g) a statement that the company’s shareholders are not liable for the debts of the company;
- h) a statement that the company’s scheme property is entrusted to a custodian of the company for safe keeping in compliance with the law; and
- i) any other matters prescribed by the OFC Rules.

The OFC Rules require that the instrument of incorporation states that “the object of the OFC is the operation of the company as a collective investment scheme”.

An OFC’s instrument of incorporation can be amended and any material change must be filed with the SFC within 15 days of the change (rather than prior to the amendment as was originally proposed).

### OFCs’ legal capacity

The legal capacity of an OFC is similar to that of a conventional company under the Companies Ordinance. The SFC will not adopt the proposed OFC Rules provision that a transaction of an OFC will be ultra vires if it is entered into outside the OFC’s operation as a collective investment scheme.

The template of an OFC instrument of incorporation will be made available on the SFC’s website.

### General principles for OFCs and their key operators

An open-ended fund company and its key operators will need to comply with the following General Principles of the OFC Code:

- acting fairly;
- diligence and competency;
- proper protection of assets;
- managing conflicts of interest;
- disclosure;
- regulatory compliance; and
- complying with constitutive documents.

### Key operators

The first key operators of an OFC will be those stated in an OFC's incorporation form. Both offering documents and the instrument of incorporation must include the circumstances in which the key operators will cease to hold office and the removal procedures.

### *Directors*

An OFC's board of directors must have at least two directors who are natural persons over 18 years old. A director of an OFC cannot be an undischarged bankrupt except with leave of the court. At least one director must be an independent director who is not a director or employee of the custodian.

To be eligible as an OFC director, a person must have technical knowledge, the ability to perform their duties, and satisfactory expertise in the relevant business. A director's qualifications will be assessed in the context of the fund's nature, investment objectives and its policy. Appointed directors will owe the OFC fiduciary duties and the duty to exercise reasonable care, skill and diligence, and will have to comply with their statutory duties and applicable codes and guidelines when discharging their functions in respect of an OFC.

Overseas directors must appoint a process agent, who may be: (a) an individual whose usual residential address is in Hong Kong; (b) a company formed and registered under the CO in Hong Kong; or (c) a firm of solicitors or certified public accountants in Hong Kong. The OFC must keep a record of process agents appointed.

Subsequent board appointments may be made by the OFC's board or by shareholders' resolution, subject to SFC approval. A register of directors must be kept, and the current index of directors will need to be made available to the CR, with which the OFC will need to file notice of any change of directors.

### *Investment manager*

An OFC's investment management function must be delegated to an investment manager which is licensed or registered with the SFC for carrying on Type 9 (asset management) regulated activity. A written investment management agreement must be in place at all times, stating the delegation of the investment management functions to the investment manager. An investment manager must retire if it ceases to meet the eligibility requirements under the SFO.

The investment manager must comply with the General Principles and other relevant provisions of the OFC Code. It will also have to comply with the Fund Manager Code of Conduct, the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, and other applicable SFC codes and guidelines.

### *Custodian*

The investment scheme property of the OFC will need to be entrusted to a custodian for safe-keeping as required by Part IVA of the SFO. The eligibility requirements for custodians are similar to those for custodians of SFC-authorized funds, as set out in the SFC Products Handbook. The custodian will be responsible for the proper segregation and safekeeping of the OFC's assets, and will be expected to exercise due care in the selection, appointment and monitoring of its delegates, including sub-custodians.

A custodian incorporated outside of Hong Kong should appoint a process agent, unless it is a registered non-Hong Kong company under Part 16 of the CO, where it has an authorised representative on whom documents may be served. The eligibility requirements and requirements regarding record-keeping and notification of changes for the process agent of an overseas custodian are the same as those for the process agent of an overseas director.

Upon cessation of office, the custodian will have to provide either a "statement of circumstances" if it considers there are circumstances to be brought to the attention of the OFC's shareholders or creditors, or a statement to the OFC that there are no such circumstances.

### **Corporate administration matters**

All of the Consultation Paper's proposals regarding corporate administration matters have been adopted.

An OFC will thus be able to issue multiple classes of shares, and to specify the rights attached to its shares in its instrument of incorporation. The rights attached to shares of a class of shares may be varied only as far as the company's instrument of incorporation's provisions for the variation of those rights allow. The ownership of shares of an OFC will be recorded by noting shareholders' particulars and holdings in the register of shareholders, which must be kept at the OFC's registered office, or at another address filed with the CR. The register must be kept in English or Chinese. There is no requirement

for the issue of share certificates. Shareholders of an OFC will have access to their own shareholding information in the register.

The process for transferring shares will include lodging an instrument of transfer with the OFC, which will have to register the transfer or send a refusal notice to the transferee and transferor.

### Meetings and resolutions

All of the proposed fundamental matters relating to meetings and resolutions of OFCs<sup>4</sup>, such as the notice period for holding meetings, the passage of resolutions and voting thresholds, and the rights of relevant parties to attend meetings, have been adopted.

Detailed meeting logistics<sup>5</sup> must be set out in the instrument of incorporation of an OFC. Public OFCs will need to comply with relevant requirements of the SFC Products Handbook.

### Filings with the Companies Registry

As proposed, there will be two types of filings with the CR: Type 1 filings that require SFC approval and Type 2 filings that do not require approval.

The SFC and CR websites will provide further guidance on which filings need to be made to the SFC and the CR, respectively.

### Auditors and financial reports

Under Part IVA of the SFO, the directors of an OFC must appoint an auditor for each financial year.

The OFC Rules require that the auditor must be independent of the investment manager, the custodian, and the directors of the OFC. The auditor will have the right to attend and be heard at general meetings, the right of access to information and other relevant qualified privileges. The auditor may either resign or be removed by an ordinary resolution at a general meeting. The OFC Rules set out provisions as to auditors' eligibility, rights and cessation of office, which are similar to those for conventional companies.

If an auditor resigns, it will need to provide a "statement of circumstances" to the OFC indicating circumstances to be brought to the attention of shareholders and creditors, or a statement that no such circumstance exists. A copy of the "statement of circumstances" must be submitted to the SFC at the same time.

An OFC will need to prepare an annual report for each financial year, unless the SFC agrees that it need not file a financial report, and must publish it within four months of the end of the OFC's financial year. Financial statements of the OFC and the auditor's report on the financial statements will need to be included in the annual report. Hong Kong Financial Reporting Standards or International Financial Reporting Standards may be used for preparing the report. Public OFCs will also need to prepare an interim report as per the SFC Products Handbook, while private OFCs will be given discretion to determine whether preparation of an interim report is necessary.

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

Part IVA of the SFO allows OFCs with an umbrella and sub-fund structure to segregate the liability of sub-funds (protected cells). An umbrella OFC is permitted to have both publicly-offered and privately-offered sub-funds, and the OFC will need to disclose the type of sub-funds. Any addition, change of name or termination of sub-funds must be approved by the SFC under the OFC Rules.

The following terms are implied in an umbrella OFC's contracts and transactions under the OFC Rules:

1. The party contracting with the OFC agrees not to seek to have recourse to any assets of a sub-fund to discharge any liability not incurred on behalf of that sub-fund;
2. If the party contracting with the OFC succeeds in having recourse to assets of a sub-fund in discharge of a liability not incurred on behalf of that sub-fund, the party is liable to pay to the OFC a sum equal to the value of the benefit it obtained; and
3. If the party contracting with the OFC succeeds in seizing or attaching or otherwise levying execution against any assets of a sub-fund in respect of a liability which was not incurred on behalf of that sub-fund, it will hold those assets or the proceeds of the sale of such assets on trust for the OFC, and will keep those assets or proceeds separate and identifiable as trust property.

<sup>4</sup> The OFC Rules, Part 5

<sup>5</sup> The OFC Code, Divisions 3 and 4

An OFC's offering document(s) must include a statement as to the segregated liability of its sub-funds, and a warning that such protected cells may not be recognised by foreign courts.

The OFC Rules enable cross sub-fund investments by an umbrella OFC, and the OFC Code requires disclosure of such investments.

An OFC can propose to enter into an arrangement or compromise with its creditors, its shareholders or both. The court may order the summoning of a meeting of creditors or shareholders and require an explanatory statement to accompany the notice summoning the meeting. If 75% of the creditors, or shareholders, or both, that are a party to the proposed arrangement or compromise, agree to that arrangement or compromise, the court may sanction it.

The court may facilitate a reconstruction or amalgamation if:

- a) the arrangement or compromise is proposed for the purpose of, or in connection with, a scheme for the reconstruction of one or more OFCs; and
- b) the property or undertaking of any OFC concerned in the scheme is to be transferred to another OFC.

### Termination and winding-up

Under Part IVA of the SFO, an OFC can be terminated via an application to the SFC.

The OFC Rules prescribe that the OFC and its key operators must ensure that the termination is carried out fairly, and takes due account of the best interests of its shareholders. The directors and investment manager are required to ensure fair valuation of assets and to address any conflicts of interests. The termination process should be disclosed to investors in an appropriate and timely manner.

Termination procedures are set out in section I of Chapter 10 of the OFC Code. They require a termination proposal to be submitted to the SFC supported by justifications and a solvency statement (i.e. a confirmation that the open-ended fund company will be able to meet all its liabilities within 12 months from the date of the confirmation), and notice to be given to shareholders. The termination of an OFC must be conducted in accordance with its instrument of incorporation. An application for termination can be submitted to the SFC only after the OFC's assets have been fully distributed to shareholders.

The SFC will have the right to cancel registration of an open-ended fund company in any of the circumstances described in section 112ZI of the SFO, i.e. if:

- a) it appears to the SFC that, with respect to the company, the requirements for registration are no longer met;
- b) it appears to the SFC that the company or a director, an investment manager, a custodian or a sub-custodian of the company has contravened:
  - i) any of the relevant provisions (being any provision of the SFO);
  - ii) any notice or requirement given or made by the SFC under or pursuant to the SFO; or
  - iii) any of the conditions imposed in respect of the registration of the company;
- c) it appears to the SFC that the company or a director, an investment manager, a custodian or a sub-custodian of the company has knowingly or recklessly provided to the SFC any information that is false or misleading in a material particular in purported compliance with:
  - i) any of the relevant provisions (being any provision of the SFO);
  - ii) any notice or requirement given or made by the SFC under or pursuant to the SFO; or
  - iii) any of the conditions imposed in respect of the registration of the company;
- d) the SFC is not satisfied that the continued registration of the company is in the interest of the investing public; or
- e) an order for the winding up of the company has been made by the court under the OFC Rules.

The OFC's registration with the CR will be automatically removed when the cancellation of its registration takes effect.

The provisions of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)(**C(WUMP)O**) relating to the winding-up of an open-ended fund company

will be applied to the OFC on a wholesale basis under a phased approach. During phase one, which will start on the commencement of the OFC regime this year, the disqualification and court winding-up provisions of C(WUMP)O for “unregistered companies” will apply to OFCs. The voluntary winding-up procedures of the OFC Rules Part 11 Divisions 1 and 2 will also apply. During phase two, relevant amendments to the SFO, C(WUMP)O and the OFC Rules will be proposed to tailor provisions to OFCs.

The previously proposed requirement to include an auditor’s opinion in the annex of the solvency statement has been removed given respondents’ comments and the position under the CO.

### Requirements for private OFCs

Basic investment restriction and disclosure and operational requirements for private OFCs are set out in Section II of the OFC Code. Public OFCs, on the other hand, must comply with the requirements of the SFC Products Handbook.

Fund operations, such as pricing, dealing arrangements, valuation, distribution policy, use of leverage and fees and charges, should be clearly set out in a private OFC’s instrument of incorporation and offering documents. The offering documents of a private OFC are required to be filed with the SFC after registration of the OFC, and after any changes are made. Private OFCs will be allowed the flexibility to pursue the investment strategies set out in their instrument of incorporation and offering documents. The OFC Code provides flexibility to set out the operational matters of the fund, including fees and charges, in its offering documents and/or the instrument of incorporation, as appropriate.

The OFC Code provides that an OFC must not be a business undertaking for general commercial or industrial purposes, i.e. an OFC should not be used for a business which engages predominantly in:

- i) the purchase, sale and/or exchange of goods or commodities, and/or supply of services; and/or
- ii) the production of goods or construction of properties.

### Private open-ended fund companies: Investment scope

The investment scope of private OFCs must substantially consist of the asset classes typical of Type 9 (asset management) regulated activity. In particular:

1. At least 90% of an OFC’s gross asset value should consist of:
  - a) those asset types the management of which would constitute a Type 9 regulated activity; and
  - b) cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts;
2. An OFC may invest in other asset classes of a value not exceeding a maximum of 10% of the gross asset value of the OFC (**10% de minimis limit**);
3. For an umbrella OFC, the 10% de minimis limit applies to each sub-fund as well as to the umbrella OFC as a whole; and
4. The 10% de minimis limit must be set out in the OFC’s instrument of incorporation.

Non-compliance with the 10% de minimis limit will result in a breach of the instrument of incorporation and the OFC Code, and the relevant intervention powers of the SFC under the SFO may apply in the case of a contravention. The investment scope and investment strategies adopted by the investment manager, including the restriction of the 10% de minimis limit, must be clearly disclosed in an OFC’s offering documents.

Material changes to the instrument of incorporation of a private OFC will only be possible with shareholders’ approval, of which reasonable prior notice has been provided to shareholders and the scheme changes are effected in accordance with the offering document and/or the instrument of incorporation. For any immaterial scheme change, the board of director’s certification that it is an immaterial change will need to be obtained, as well as a confirmation of no objection from the custodian.

### Fees

With respect to the fees payable to the CR, charges for public OFCs will be equal to the authorisation fee for other public funds. Private OFC fees will consist of a fee for application for

registration and a single standard application fee for each post-registration change requiring the SFC's approval. A fee for an application for waiver from the OFC Rules will be the same as fees for similar waivers under SFO subsidiary legislation.

Fees categories will be similar to the categories for conventional companies, namely: incorporation, change of name, appointment of a receiver or manager, inspecting or obtaining documents or information, and miscellaneous.

Fees for the winding up of an OFC payable to the Official Receiver's Office will be equal to the similar fees for other unregistered companies under C(WUMP)O.

## **Supervision and Enforcement**

The SFC will have investigatory, supervisory and intervention powers, which it will be able to exercise in cases of non-compliance. The SFC will be able to exercise disciplinary powers against the investment manager of an OFC for misconduct which is prejudicial to the interest of the investing public, as per the provisions of Part IX of the SFO. Enforcement actions can also be undertaken by the SFC against the OFC and its key operators.

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