



Hong Kong

January 2020

SFC PUBLISHES CONSULTATION PAPER ON AMENDING THE REGIME FOR OPEN-ENDED FUND COMPANIES

On 20 December 2019, the Securities and Futures Commission (**SFC**) announced¹ the publication of a Consultation Paper² on Proposed Enhancements to the Open-ended Fund Companies (**OFC**) Regime. The consultation is open until 20 February 2020.

The proposed enhancements involve changes to the Code on Open-ended Fund Companies³ (**OFC Code**), the Securities and Futures Ordinance⁴ Cap. 571 (**SFO**) and the Securities and Futures (Open-ended Fund Companies) Rules⁵ (**OFC Rules**).

The SFC outlines the following four proposed enhancements in the consultation paper:

- Allow licensed or registered securities brokers to act as custodians for private OFCs;
- Expand the investment scope for private OFCs to include loans and shares and debentures of Hong Kong private companies;
- Introduce a statutory mechanism for re-domiciliation of overseas corporate funds to Hong Kong; and

- Require OFCs to keep a register of beneficial shareholders to enhance anti-money laundering and counter-terrorist financing measures.

The objectives of the proposed enhancements are to encourage more private funds to set up in Hong Kong in the form of OFCs, as part of the SFC's strategy of developing Hong Kong as a full-service international asset management centre and preferred fund domicile.

I. Hong Kong's Current Open-ended Fund Company Regime

The OFC regime came into effect⁶ on 30 July 2018, following the publication of the SFC Consultation Proposals⁷ in June 2017 and the Consultation Conclusions⁸ in May 2018. (For more information on both papers, please see Charltons' August 2017⁹ and July 2018¹⁰ newsletters, respectively).

Prior to the OFC regime, open-ended investment funds could not be established in Hong Kong in corporate form due to restrictions on capital reduction under the Companies Ordinance Cap. 622 (**CO**), although they could be established

1 <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=19PR120>

2 <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=19CP4>

3 <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-on-open-ended-fund-companies/code-on-open-ended-fund-companies.pdf>

4 <https://www.elegislation.gov.hk/hk/cap571>

5 https://www.cr.gov.hk/en/ofc/docs/GN20180518_2997-e.pdf

6 <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/corporate-news/doc?refNo=18PR90>

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

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

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

10 <https://www.charltonslaw.com/new-open-ended-fund-company-regime-effective-30-july-2018/>

as unit trusts. Given the general preference for corporate funds, this meant that many of the funds offered in Hong Kong were incorporated offshore, typically in the Cayman Islands.

The key aim of the OFC regime was thus to allow investment funds to incorporate as OFCs and encourage more funds to domicile in Hong Kong.

The OFC regime is comprised of the following:

- Part IVA¹¹ of the SFO, which sets out the legal framework for establishing an OFC;
- The OFC Rules¹² and OFC Code¹³, which provide the legal and regulatory requirements for OFCs; and
- The Securities and Futures (Open-ended Fund Companies) (Fees) Regulation¹⁴, which provides for fees chargeable by the SFC and the Companies Registry in respect of OFCs.

For more information on the current OFC regime, please see Charltons' July 2018¹⁵ newsletter and Charltons' July 2019¹⁶ Note on Establishing Funds in Hong Kong which provides a detailed overview of OFC funds, including the advantages and drawbacks, the regulatory regime, the establishment process and more.

II. SFC's Proposed Amendments to the Open-ended Fund Company Regime

a. Custodian Eligibility Requirements for Private OFCs

Currently, 7.1 of the OFC Code specifies that custodians of an OFC must meet the same eligibility requirements as custodians for SFC-authorized funds, as set out in the Code on Unit Trusts and Mutual Funds¹⁷ (**UT Code**).

Accordingly, a custodian of an OFC must be a Hong Kong or overseas bank or a trustee of a registered scheme under the Mandatory Provident Fund Schemes Ordinance (Cap. 485)¹⁸, and this requirement applies to both public and private OFCs.

The SFC received feedback on and acknowledged the practical difficulties for private OFCs in engaging custodians which meet the UT Code requirements, and also recognised the prevalence of private funds' assets being held by prime brokers which typically do not meet the requirements for custodians.

The SFC looked to developments in other jurisdictions and their eligibility requirements for custodians of private funds, notably the US, where registered broker-dealers and authorised investment firms providing broker-dealer type investment services in Europe can generally act as custodians for private funds, and Singapore, where under the proposed Variable Capital Company (**VCC**) regime, broker-dealers are eligible to act as custodians if they hold a capital markets services licence for providing custodial services.

The SFC therefore proposes to allow intermediaries which are licensed or registered to carry on Type 1 regulated activity (dealing in securities) to act as a custodian for private OFCs, provided the following criteria is met:

- The intermediary's licence is not subject to the condition that it must not hold client assets;
- Where the intermediary is a licensed corporation, it must have minimum paid-up share capital of HK\$10 million and minimum liquid capital of HK\$3 million;
- The private OFC must be a client of the intermediary in respect of its Type 1 regulated activity business at all times; and
- The intermediary must be independent of the investment manager.

The SFC also proposes to impose a condition on the intermediary's licence or registration to the effect that it must comply with all requirements applicable to it as a custodian of an OFC, including the requirements in the OFC Code and related guidance issued by the SFC.

¹¹ https://www.elegislation.gov.hk/hk/cap571?xid=ID_1532571525508_001

¹² https://www.cr.gov.hk/en/ofc/docs/GN20180518_2997-e.pdf

¹³ <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-on-open-ended-fund-companies/code-on-open-ended-fund-companies.pdf>

¹⁴ <https://www.elegislation.gov.hk/hk/cap571AR!en>

¹⁵ <https://www.charltonslaw.com/new-open-ended-fund-company-regime-effective-30-july-2018/>

¹⁶ <https://www.charltonslaw.com/hong-kong-law/establishing-investment-funds-in-hong-kong/>

¹⁷ <https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/section-ii-code-on-unit-trusts-and-mutual-funds/section-ii-code-on-unit-trusts-and-mutual-funds.pdf>

¹⁸ <https://www.elegislation.gov.hk/hk/cap485>

The SFC also proposes to introduce more detailed requirements in a new Appendix A to the OFC Code to further clarify the obligations of an OFC custodian.

The SFC notes the proposed introduction of the Regulated Activity 13 (**RA13**) (acting as a depositary (trustee/custodian) of an SFC-authorized Collective Investment Scheme) regime, with respect to which the SFC published a Consultation Paper¹⁹ in September 2019, the consultation period for which closed on 31 December 2019.

The SFC therefore states that if and when the RA13 regime comes into effect, an RA13 intermediary acting as a custodian of a private OFC must comply with the requirements of the OFC Code, including the new requirements of Appendix A, and a similar condition will be imposed on the RA13 intermediary's licence or registration.

Ultimately, the proposal is aimed at enhancing Hong Kong as a preferred fund domicile by providing for an OFC structure that can be practically and widely adopted by private funds.

b. Expansion of Investment Scope for Private OFCs

Presently, 11.1 of the OFC Code requires at least 90% of the gross asset value (**GAV**) of a private OFC to consist of:

- Asset types the management of which would constitute a Type 9 regulated activity, namely securities and futures contracts; and/or
- Cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts.

Further, 11.2 of the OFC Code states that a private OFC may invest in other asset classes (not specified in 11.1) of a value not exceeding 10% of the GAV of the OFC, known as the 10% *de minimis* limit.

The definition of "securities" under the Securities and Futures Ordinance excludes the shares and debentures of Hong Kong private companies. The SFC notes that it has received substantial feedback to the effect that private OFCs should be allowed to invest in loans, shares and debentures of Hong Kong private companies.

The feedback also anticipates that more private funds may consider moving onshore to Hong Kong due to the new unified profits tax regime for funds which took effect in April

¹⁹ <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=19CP3>

2019, which permits onshore and offshore funds to enjoy profits tax exemptions subject to meeting certain conditions, and the economic substance requirements of offshore fund jurisdictions such as the Cayman Islands and British Virgin Islands.

Accordingly, the SFC proposes to expand the investment scope of private OFCs to include loans and shares and debentures of Hong Kong private companies, provided that the private OFCs' assets include a portfolio of those asset types, the management of which constitutes a Type 9 regulated activity. This is expected to enhance Hong Kong's competitiveness as a preferred fund domicile for private funds.

The SFC however emphasises that a private OFC, despite the proposed investment scope expansion, must not engage in a money lending business, as the primary purpose of a private OFC is to operate as an investment fund (11.4 of the OFC Code).

c. Re-domiciliation of Overseas Corporate Funds to Hong Kong

Currently, corporate funds from overseas jurisdictions may re-domicile to Hong Kong by a number of methods, however the SFC has received calls for the introduction of a statutory re-domiciliation regime and notes that a similar mechanism is included in Singapore's proposed variable capital company regime.

The SFC considers a statutory re-domiciliation regime to be particularly important in light of regulatory developments in offshore fund jurisdictions, and so proposes to introduce a statutory mechanism for re-domiciliation of overseas corporate funds to Hong Kong using the OFC structure, which will be implemented by introducing new provisions to Part IVA of the SFO and supporting amendments to the OFC Rules.

The SFC clarifies that:

- There would be no need to establish a new legal entity as the fund's corporate identity, continuity and track record would be preserved;
- There would be no change in the legal personality of the corporate fund; and
- After an overseas corporate fund has re-domiciled in Hong Kong, it will become an OFC and must accordingly comply with all legal and regulatory requirements applicable to OFCs.

The SFC proposes that the re-domiciliation mechanism will take effect immediately following the completion of the legislative process.

d. Significant Controllers' Register Requirements for OFCs

Currently, Anti-Money Laundering (AML) and Countering Financing of Terrorism (CFT) obligations are imposed on investment managers of OFCs and SFC-licensed or registered intermediaries involved in the sale of OFC shares.

The SFC proposes to impose requirements on OFCs to keep a register of beneficial shareholders under the OFC Rules, to enhance the transparency of corporate beneficial ownership.

The proposal is similar to the Significant Controllers Register (SCR) requirements under the CO, which oblige a company incorporated in Hong Kong to obtain and maintain up-to-date beneficial ownership information by keeping an SCR and to inform the Companies Registry of where the SCR is kept.

The SFC proposes to adopt the same definition of beneficial owner as under the CO. A person will therefore be considered to have significant control over an OFC where one or more of the following conditions are met:

- The person holds, directly or indirectly, more than 25% of the issued shares in the OFC or, if the OFC does not have a share capital, the person holds, directly or indirectly, a right to share in more than 25% of the capital or profits of the OFC;
- The person holds, directly or indirectly, more than 25% of the voting rights of the OFC;
- The person holds, directly or indirectly, the right to appoint or remove a majority of the board of directors of the OFC;
- The person has the right to exercise, or actually exercises, significant influence or control over the OFC; or
- The person has the right to exercise, or actually exercises, significant influence or control over the activities of a trust or a firm that is not a legal person, but whose trustees or members satisfy any of the first four conditions (in their capacity as such) in relation to the OFC.

The aim of this proposal is to further enhance AML/CFT measures in respect of OFCs in line with the Financial Action Task Force (FATF) principles.

The SFC notes that there will be a six-month transition period for the SCR requirements to allow reasonable time for the industry to prepare for the implementation.

e. Winding-up Regime for OFCs

In the Consultation Conclusions²⁰, the SFC indicated that a phased approach would be adopted in implementing a winding-up regime for OFCs.

The SFC therefore states that they are working on legislative amendments to provide for the winding-up of OFCs in the same manner as conventional companies.

III. Responding to the SFC Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies Regime

The proposed amendments will be subject to a two-month public consultation, closing on 20 February 2020.

Responses are invited by email, fax, online and by mail, with the relevant details indicated below:

By Mail: The Securities and Futures Commission

35/F Cheung Kong Center

2 Queen's Road Central

Hong Kong

Re: Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies

By Fax: (852) 2877-0318

By Email: ofc-2019consultation@sfc.hk

By Online Submission: <http://www.sfc.hk/edistributionWeb/gateway/EN/consultation/>

²⁰ <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=17CP5>

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