



Hong Kong

September 2020

CHANGES TO HONG KONG'S OPEN-ENDED FUND COMPANIES REGIME TAKE EFFECT 11 SEPTEMBER 2020

Changes to Hong Kong's private open-ended fund companies (**OFCs**) regime took effect on 11 September 2020 removing all investment restrictions on private OFCs and enabling Type 1 licensees to act as their custodians. The changes are detailed in the SFC's Consultation Conclusions on Proposed Enhancements to the Open-ended Fund Companies Regime¹ and their implementation was announced by the SFC's press release² of 11 September 2020. A statutory re-domiciliation mechanism will also be implemented to allow overseas corporate funds to re-domicile in Hong Kong as OFCs. This requires amendments to Part IVA of the Securities and Futures Ordinance (**SFO**) which will take effect upon completion of the legislative process.

The SFC has decided against its original proposal to require OFCs to keep a significant controllers register. It is conducting a further consultation on a new proposal to align AML/CFT requirements for OFCs with those for Limited Partnership Funds (**LPF**) which would require OFCs to appoint a responsible person to carry out AML/CFT functions. Custodians of existing private OFCs have until 11 March 2021 to ensure compliance with the new safekeeping requirements set out in Appendix A

to the revised Code on Open-Ended Fund Companies³ (the **OFC Code**).

The SFC is conducting a further consultation on the customer due diligence (**CDD**) requirements to be imposed on OFCs. Responses to that consultation should be submitted on or before 5 October 2020.

The SFC has also issued a Circular on the Implementation of Changes to the OFC Regime⁴ setting out further details of how the changes will be implemented, which include updated Information Checklists, Template of Instrument of Incorporation for Umbrella Private OFCs and FAQs.⁵

The changes are intended to further boost Hong Kong's position as a leading asset management hub in Asia. The previous investment restrictions on private OFCs rendered them unsuitable for many funds, such as private equity funds and crypto funds. With the removal of the investment restrictions and the broadening of the custody eligibility requirements, more funds are likely to incorporate in Hong Kong using the OFC structure. According to the SFC's Asset

1 SFC. 2 September 2020. "Consultation Conclusions on Proposed Enhancements to the Open-ended Fund Companies Regime and Further Consultation on Customer Due Diligence Requirements". Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=19CP4>

2 SFC. 11 September 2020. "Changes to the open-ended fund companies regime take effect". Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/news-and-announcements/news/doc?refNo=20PR87>

3 SFC. "Code on Open-Ended Fund Companies" (September 2020 version) available at <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 SFC. 11 September 2020. "Circular on implementation of changes to the open-ended fund companies regime". Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=20EC56>

5 SFC. 11 September 2020. "Frequently Asked Questions relating to Open-ended Fund Companies". Available at: <https://www.sfc.hk/web/files/PCIP/FAQ-PDFs/FAQs%20relating%20to%20OFCs%2011092020.pdf>

and Wealth Management Activities Survey 2019, Hong Kong asset management saw strong growth in 2019, with a 20% year-on-year increase in AUM to HK\$28,769 billion and net fund inflows of HK\$1,668 billion.⁶ Looking ahead, a joint report by KPMG China and the Hong Kong Investment Funds Association (**HKIFA**) suggests that growth should continue, particularly given the opening up of Mainland China's asset management industry, the development of the Greater Bay Area, technology-driven change and ESG investing.⁷

For a summary of the December 2019 Consultation Paper's proposals and the previous OFC regime, please see Charltons' January 2020 newsletter.⁸

1. Custodian Eligibility Requirements for Private Open-ended Fund Companies

a. Expansion of Custodian Eligibility to Include RA 1 Intermediaries

The revisions to the OFC Code allow intermediaries licensed or registered for Type 1 (dealing in securities) regulated activity to act as custodians for private OFCs. Previously, custodians of both private and public OFCs had to be a Hong Kong or overseas bank or trustee of a registered scheme under the MPF Schemes Ordinance.

The change resulted from industry consensus that more flexibility on custodian eligibility was needed. Accordingly, paragraph 7.1 of the OFC Code permits Type 1-licensed/registered intermediaries to act as custodians for private OFCs if:

- i) their licence or registration is not subject to the condition that they cannot hold client assets;
- ii) they maintain paid-up share capital of HK\$10 million and liquid capital of HK\$3 million at all times;
- iii) the private OFC is the client of the intermediary in respect of its Type 1 regulated activity;

iv) they have at least one responsible officer or executive officer responsible for the overall management and supervision of their custodial function; and

v) they are independent of the investment manager.

In respect of (iii) a six-month grace period will be allowed to permit a Type 1-licensed intermediary to continue to act as a custodian for a private OFC after it ceases to be the intermediary's client in respect of its Type 1 business. The Type 1-licensed intermediary must inform the SFC prior to, or as soon as practicable upon, the private OFC ceasing to be its client and must arrange for the transfer of the scheme property to a new custodian as soon as practicable.

The SFC also expanded on the requirement for independence from the fund's investment manager requiring that:

- i) the custodian must be a separate legal entity from the investment manager of an OFC for investor protection purposes; and
- ii) internal controls must be in place to ensure that persons fulfilling the custodian function/safeguarding of the OFC's scheme property are functionally independent of those fulfilling the OFC's investment management functions, which includes ensuring distinct and separate reporting lines.

A Type 1-licensed intermediary applying to act as a custodian of a private OFC must provide:

- i) details of the responsible officers / executive officers responsible for overall management and supervision of its custodial function; and
- ii) an updated organisational chart and custody operational flowchart.

Some respondents suggested widening custodian eligibility further to include intermediaries licensed or registered for regulated activity Type 2 (dealing in futures contracts) and Type 11 (dealing in / advising on OTC derivative products). The SFC does not however consider it appropriate to expand the scope to include Type 2 and 11 intermediaries as they do not normally perform an incidental securities custodial function when carrying on their regulated activities.

⁶ SFC. August 2020. "Asset and Wealth Management Activities Survey 2019". Available at: https://www.sfc.hk/web/EN/files/ER/Reports/AWMAS_2019_EN.pdf

⁷ KPMG and the HKIFA. "Vision 2025: the future of Hong Kong's fund management industry". Available at: <https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2020/06/vision-2025-the-future-of-hong-kong-s-fund-management-industry.pdf>

⁸ <https://www.charltonslaw.com/sfc-publishes-consultation-paper-on-amending-the-regime-for-open-ended-fund-companies/>

The SFC confirmed in its consultation conclusions that overseas entities subject to equivalent regulation to Type 1-licensed intermediaries in their home jurisdiction are eligible to act as custodians for private OFCs if the requirements in 4.2(d) of the Code on Unit Trusts and Mutual Funds are met (i.e. that the entity is authorised to act as a trustee / custodian of a scheme and is prudentially regulated and supervised by an overseas supervisory authority acceptable to the SFC).

The SFC also confirmed that trust companies are currently eligible if they meet the requirements in 4.2(b) and 4.2(c) of the Code on Unit Trusts and Mutual Funds. However, under the proposed regime for regulated activity 13 regulating the trustees/custodians of SFC-authorised funds, trust companies will become ineligible unless they obtain a Type 13 licence. In brief, Type 13 will be a new regulatory activity covering intermediaries acting as trustees or custodians of public funds. The regime will cover SFC-authorised unit trusts, mutual funds, OFCs, REITs and pooled retirement funds.⁹

The SFC emphasised in the Consultation Conclusions that a custodian must be appointed, regardless of the type of assets underlying a private OFC (as per section 112ZA of the SFO).

b. Eligibility of Sub-custodians

The SFC clarified that there are no restrictions on the eligibility of sub-custodians appointed by custodians. As set out in new paragraph 5 of the OFC Code, a custodian of a private OFC must however be satisfied that any sub-custodian(s) appointed are suitably qualified and competent in safekeeping the fund's property and this must be subject to ongoing monitoring. Importantly, while a sub-custodian may be appointed, the responsibilities and obligations with respect to the safekeeping of the fund's property, remain with the private OFC custodian.

A custodian of a private OFC is required to take reasonable care, skill and diligence to ensure the safekeeping of the scheme property of the OFC to which it has been entrusted (Rule 117 of the Securities and Futures (Open-ended Fund Company) Rules (**OFC Rules**) and there must be written internal controls to:

- i) monitor the selection of sub-custodians for the safekeeping of the private OFC scheme property;

⁹ SFC. September 2019. "Consultation Paper on the Proposed Regulatory Regime for Depositaries of SFC-authorized Collective Investment Schemes". Available at: <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=19CP3>

- ii) monitor the sub-custodians on an on-going basis; and
- iii) address any actual or potential conflicts of interest arising from the appointment and oversight of the sub-custodian.

c. Requirements in Appendix A to the OFC Code

New Appendix A of the OFC Code (Requirements for Safekeeping of Private OFC Scheme Property under 7.3(g) of the OFC Code) contains guidance for custodians of private OFCs on the safe-keeping of assets, the main principle being that an OFC's assets must be segregated from the assets of the custodian. All custodians of private OFCs are required to comply with Appendix A which sets out the general requirements and expectations for custodians, in addition to requirements in relation to:

- i) the receipt / holding of money / securities on behalf of a private OFC;
- ii) the selection and appointment of sub-custodians;
- iii) the keeping of accounting and other records; and
- iv) risk management.

A respondent suggested that existing trustees and custodians of SFC-authorized funds should be exempt from the requirements of Appendix A on the basis that they are not currently subject to the requirements of the Securities and Futures (Client Money) Rules (**CMR**) and the Securities and Futures (Client Securities) Rules (**CSR**). The SFC rejected this suggestion and stated that the requirements are minimum requirements which all custodians should comply with and should not be difficult for existing trustees or custodians of SFC-authorized funds to comply with.

In response to queries regarding custody of digital assets, the SFC clarified that custodians should assess their expertise, competence and operational capabilities to ensure such assets are properly safeguarded. With regard to unlisted investments, the SFC stated that custodians should assess and understand the nature and custody risks of such investments by an OFC to ensure they are properly safeguarded.

The SFC further clarified a number of points in relation to requirements in Appendix A, including that:

- i) OFC assets may be held in omnibus accounts;
- ii) custodians must keep subscription money in a separate designated collection account pending allotment of the shares in the OFC and upon acceptance of the subscription for shares, the custodian should pay the relevant amount into the segregated bank account within one business day; and
- iii) in relation to standing authorities, whether circumstances render it “unconscionable” to deal in the OFC scheme property should be decided with reference to the factors outlined in section 6 of the Unconscionable Contracts Ordinance (UCO) (Cap. 458) as if the standing authority were a contract under the UCO.

d. Suggested Amendments to Chapter 7 of the OFC Code

A respondent suggested amending paragraph 7.3 of the OFC Code to allow custodians to disclaim their liabilities for assets which are non-custodial assets on the basis that, in their opinion, the private OFC or investment manager should be responsible for their safekeeping. The SFC responded that paragraph 7.3 (which requires a custodian to be able to exercise control over scheme property) reflects the general principle that the custodian, and not the investment manager or board of a private OFC, should determine whether particular scheme property can be held and how to hold it. The SFC also emphasised that the requirement is in line with section 112ZA of the SFO which requires a custodian to take reasonable care, skill and diligence to ensure the safe keeping of the scheme property of the OFC that is entrusted to it.

2. Expansion of Permitted Investments for Private OFCs

The SFC proposed in the Consultation Paper to expand the investment scope of private OFCs to include loans and shares and debentures of Hong Kong private companies. Generally, respondents found investment restrictions unnecessary and suggested there should be no investment restrictions for private OFCs given that no restrictions are placed on private funds in other legal forms in Hong Kong or on similar corporate funds in other jurisdictions such as the Republic of Ireland, the UK and Singapore.

The SFC agreed and all investment restrictions on private OFCs under the OFC Code have been removed, effective as of gazettal of the revised OFC Code on 11 September 2020. Please see Charltons’ January 2020 newsletter¹⁰ for a summary of the previous investment restrictions on OFCs.

The OFC Code has however been amended to require that:

- a) custodians and investment managers must have sufficient expertise and experience in managing and safekeeping asset classes in which the OFC invests;
- b) offering documents must contain clear disclosure of all material risks specific to the type and nature of assets in which an OFC may invest;
- c) proper records must be kept; and
- d) adequate internal controls and systems commensurate with the custodial risk specific to the type and nature of the assets in which the OFC invests must be in place.

Additionally, under the Fund Manager Code of Conduct, investment managers are required to ensure they have sufficient resources and experience for the proper performance of their duties considering the type and nature of assets they are managing and the markets in which the OFC invests.

In light of the removal of investment restrictions, the SFC emphasised that profits tax liability may arise where investments are made in certain situations under which the profits tax exemption under the unified profits tax regime for funds does not apply, such as the situations set out in section 20AS of the Inland Revenue Ordinance which sets out when an exemption under section 20AN does not apply to an OFC. These situations include, when a fund engages in direct trading or direct business undertaking in Hong Kong in assets of a non-Schedule 16C class or utilises assets of a non-Schedule 16C class to generate income.

3. Overseas Corporate Funds’ Redomiciliation as Hong Kong Open-ended Fund Companies

The SFC’s December 2019 consultation paper proposed a statutory re-domiciliation mechanism to allow overseas corporate funds to be re-domiciled in Hong Kong as OFCs

¹⁰ <https://www.charltonslaw.com/sfc-publishes-consultation-paper-on-amending-the-regime-for-open-ended-fund-companies/>

where the key requirements for the registration of a newly established OFCs under the SFO and OFC Rules are met. These include, for example, the appointment of an investment manager, custodian and directors who fulfil the eligibility requirements under the SFO, OFC Rules and OFC Code. Respondents were generally supportive of the proposal and the SFC will go ahead with the proposal by introducing new provisions to Part IVA of the SFO.

The SFC notes that any changes to the fund structure which do not affect the fund's ability to meet the requirements may be made after re-domiciliation.

With respect to unit trusts, the SFC notes that there is no restriction on the restructuring of unit trusts into OFCs provided that:

- a) the requirements for establishing an OFC under the SFO, OFC Rules and OFC Code are met; and
- b) the restructuring can be conducted in accordance with the unit trust's constitutive documents.

Where SFC-authorized funds in unit trust form are restructured into OFCs with a similar investment objective and management, information about their past performance and track records may continue to be used in the funds' advertisements.

Subsequent to re-domiciliation and if certain conditions are met, the OFC may be eligible for the profits tax exemption. As mentioned previously, profits tax may however arise if a private OFC makes investments in certain situations under which the profits tax exemption under the new unified profits tax regime for funds does not apply (i.e. the situations set out in section 20AS of the IRO, as detailed above).

No stamp duty will apply on re-domiciliation as there will be no change in the legal personality of the corporate fund and therefore no transfer of assets. This is however assuming that the statutory mechanism for re-domiciliation permits the continuity of the legal personality of the fund.

4. Further Consultation – Customer Due Diligence Requirements for OFCs

In the December 2019 Consultation Paper, the SFC proposed to impose requirements on OFCs to keep a register of beneficial shareholders under the OFC Rules to enhance AML/CFT measures. While a majority of respondents supported the proposal, concerns were raised about the practical difficulties

arising from the open-ended nature of OFCs whose investors change constantly and about imposing more onerous requirements on OFCs than on funds in the form of unit trusts.

The SFC is therefore conducting a further consultation on the customer due diligence obligations of OFCs. It proposes that OFCs should be required to appoint a responsible person to carry out AML/CFT functions as stipulated by Schedule 2 to the AMLO. For example, provisions governing when simplified customer due diligence can be carried out would apply. The requirements would be similar to those imposed on LPFs under the new Limited Partnership Fund Ordinance (**LPFO**) (Cap. 637), which came into operation on 31 August 2020. The SFC's proposal is aimed at alleviating the practical difficulties that may arise from the keeping of a significant controllers register and ensuring a level playing field for different fund vehicles.

If adopted, the latest proposal to require OFCs to appoint a responsible person to carry out AML/CFT functions will require legislative amendments, following which the SFC proposes a six-month transition period to allow the industry to prepare.

The cut-off date for submitting responses to the further consultation is 5 October 2020.

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