Charltons - Hong Kong Law Newsletter - 22 September 2011

[online version](http://www.charltonslaw.com/hkex-publishes-revised-guidance-for-chapter-21-companies-investment-companies/)

# HKEx Publishes Revised Guidance For Chapter 21 Companies (“Investment Companies”)

## Introduction

Chapter 21 (**Chapter 21**) of the Listing Rules (**Listing Rules**) of the Stock Exchange of Hong Kong Limited (the **Exchange**) sets out the specific requirements for the listing of securities by investment companies. Chapter 21 applies to unit trusts, mutual funds and other collective investment schemes not authorised by the Hong Kong Securities and Futures Commission (**SFC**). The separate requirements that apply to SFC authorised unit trusts, mutual funds and other collective investment schemes are set out in Chapter 20 of the Listing Rules. Chapter 20 listed funds remain subject to all of the investment, borrowing and other restrictions of the SFC's Code on Unit Trusts and Mutual Funds (the **Code**). As Chapter 21 listed funds are not authorised by the SFC they do not need to comply with the requirements and restrictions in the Code. However, in accordance with the Code, as Chapter 21 funds are not authorised by the SFC, their securities cannot be offered or marketed to the public in Hong Kong. There are currently twenty-five Chapter 21 investment companies listed on the Exchange. The listing of China New Economy Fund Limited in January 2011 was the first new listing of a Chapter 21 company in six years.

In September 2011 the Hong Kong Exchanges and Clearing Limited (**HKEx**) issued an update to its Guidance Letter for Chapter 21 companies first issued in May 2010. The original letter set out guidance on:-

* the minimum board lot and subscription size, market capitalisation, number of shareholders, and offering document in restricted marketing cases;
* considerations for listing investment companies;
* qualifications of directors, investment managers/investment advisers; and
* conflicts of interest where the investment company’s executive directors/investment managers/investment advisers also manage other third party funds.

## September 2011 Revisions

The September 2011 revisions apply inter alia to the registration of a prospectus by an investment company, qualifications of directors, investment managers/advisers, and conflicts of interest. The provisions relating to the minimum board lot and subscription size for investment companies has also been revised.

### Minimum Board Lot Size and Subscription Size

The Main Board and GEM Rules currently do not contain mandatory requirements on the minimum board lot size for listing applicants. Rule 21.14(5) provides that the Exchange reserves the right to impose a minimum investment and/or minimum board lot size if it deems it necessary by the nature of the investment company. The Exchange has a practice of requiring a minimum board lot size of HK$2,000 at the time of listing for general listing applicants.

Pursuant to the revised Guidance Letter, in the case of restricted marketing, to ensure that the securities of an investment company are not marketed to the public except to professional investors, the investment company must:-

1. generally have a board lot size and subscription size of at least HK$500,000 for its securities. The Exchange will consider individual circumstances and adjust the minimum board lot and subscription size as it sees appropriate.
2. demonstrate that the intermediaries involved in selling securities for and on their behalf should, as part of their “know your client” procedures under the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission, satisfy themselves that each placee is a professional investor as defined in Schedule 1 of the Securities and Futures Ordinance (cap. 571); and
3. demonstrate that other aspects of the offering structure are acceptable to the Exchange.

As regards the documentary evidence requirements under the Securities and Futures (Professional Investor) Rules (**Professional Investor Rules**) (referred to at (b) above), these apply to the categories of “high net worth” investors given “professional investor” status under the Professional Investor Rules. The Government has however recently gazetted amendments to the Professional Investor Rules, which are expected to come into force on 16 December 2011. Those amendments will allow intermediaries to adopt a principles-based approach in assessing an investor’s professional investor status. Intermediaries will be able to use the methods they deem appropriate to assess whether an investor meets the required assets or portfolio as an alternative to the existing methods prescribed by the Professional Investor Rules.

### Registration of a Prospectus by an Investment Company

Investment companies with restricted marketing under Rule 21.14 of the Listing Rules must not issue a listing document that constitutes an offer to the public. However, it may be marketed to professional investors. In such circumstances, the registration of a prospectus is not required. Investment companies engaging in restricted marketing and their sponsors should ensure that their offer does not amount to a public offer. In the event that the investment company requests the Exchange to register a prospectus, it must provide the Exchange with a submission from its sponsor and legal adviser as to why it considers that the offering document is a prospectus.

If an investment company intends to offer shares in connection with a collective investment scheme (**CIS**) to the public, both the CIS and the CIS listing document will be subject to SFC authorisation and the requirements under Chapter 20 of the Listing Rules.

### Other Considerations for Listing

The Exchange will consider the investment company’s:-

1. risk control and compliance measures to ensure compliance with its investment objective and policies as well as applicable laws, rules and regulations, and to review its investment portfolio and monitor its portfolio risk;
2. purpose in raising funds and rationale for listing; and
3. process (which must be clearly articulated) to identify and assess potential investments.

#### Qualifications of Directors, Investment Managers/Advisers

Rule 21.04(1) provides that the Exchange must be satisfied: -

* as to the character, experience and integrity of the directors of any investment company, its management company and/ or its investment adviser (if any) and the fitness and competence of each of them; and
* that the executive management committee has had satisfactory experience in the professional management of investments on behalf of third party investors.

There is no explicit standard for measuring the fitness and competence of any person who acts as an investment company’s director or investment manager/adviser. The Exchange ordinarily expects a high standard of integrity and competence from those who are responsible for giving investment advice to an investment company.

Information to facilitate the Exchange to assess whether Rule 21.04(1) is satisfied includes: -

1. their years of experience in professional management of investments on behalf of third party investors and/or providing investment advisory services to professional/institutional investors;
2. the types and geographical coverage of the investments they managed;
3. the fund sizes (including investment objectives and policies) and performance during the period under their management which should essentially be comparable to the proposed size of the investment company to enable the Exchange to appraise their experience in managing third party funds.  
     
   Performance indicators such as the net asset value of the managed funds, their absolute performance and their relative performance compared to that of other major managed funds and relevant indexes should be disclosed.  
     
   In one recent case, the Exchange did not consider the investment company’s executive directors and the investment manager’s directors suitable nominees for their posts where: -
   * the size of the portfolios previously under these persons’ management was much smaller than the company's;
   * some portfolios had a limited track record; and
   * the portfolios had generally recorded negative returns and underperformed compared to their respective benchmarks.
4. their roles and responsibilities in the present and past job positions, and how their work experience would help them perform their current roles in the investment company and/or its management company taking into consideration the performance of the funds managed;
5. details of their licences, academic and professional qualifications, including the year they were obtained and the granting institutions; and
6. any breaches of laws, rules and regulations in the relevant industry which have bearing on their integrity and/or competence.

The Exchange will examine the explanations given carefully for non-compliance. Inexperience will not be generally acceptable as an explanation for instances of integrity related non-compliance (e.g. market manipulation, failing to act in the best interest of clients on execution of orders).

The information referred to above must be disclosed in the listing document. The Exchange may not approve the persons taking up the relevant positions in the investment company if the information is not available.

The sponsor must confirm to the Exchange, with basis, the suitability of the persons proposed to be an investment company’s executive directors, investment managers/advisers.

### Conflicts of Interest

Potential conflicts of interest arise where an executive director is also a director/senior managing member of the investment manage,; or where an investment manager manages both the investment company’s funds and other funds. Under these circumstances, the investment company must demonstrate a satisfactory internal control mechanism to deal with conflict situations.

This includes: -

1. each executive director/investment manager/adviser must demonstrate that he is able to devote sufficient time and resources to look after the investment company’s affairs;
2. each conflicted person must maintain the confidentiality of the information of the investment company and other funds managed by him in accordance with the standards under any professional codes to which he is subject; and
3. the listing document must disclose a fair process for allocating investment opportunities between the investment company and the other funds managed by each conflicted person in a timely and equitable manner.

#### Where the Investment Manager Manages Funds other than the Investment Company’s

Where the investment manager also manages funds other than those of the investment company, the following internal control measures must be in place: -

1. the investment manager should have sufficient staff to serve the investment company and compliance officers to perform daily review of order allocation to ensure that all orders are allocated fairly under its internal control measures;
2. the investment manager must disclose to the investment company’s board of directors any potential investment opportunities and ensure that the investment company is given the opportunity to decide whether to participate in those investments before entering into those investments on behalf of other clients or on its own account; and
3. if the investment company and the investment manager’s other clients are interested to participate in the same investment and the available investment is insufficient to satisfy these demands, the investment company should allocate the investment to the investment company and other clients on a pro-rata basis depending on the respective subscription requests.

* When deciding the subscription size of any investment for the investment company and other clients, the investment manager/adviser must consider factors such as current weighting of assets, risk parameters, market outlook, constrains of investment exposure and the financial resources available to the investment and other clients.

#### Where an Investment Company’s Director also Manages other Third Party Funds

If any director(s) of the investment company are also involved in the management of other third party funds, the following measures must be in place: -

1. the number of conflicted directors must not be so excessive as to paralyse the decision making process of the investment company;
2. each conflicted director must before entering into any transaction disclose to the investment company’s board of directors the potential investment opportunities, and must abstain from voting on decisions on whether to invest in those transactions;
3. the independent non-executive directors (**INEDs**) must participate in the board meetings to assist the non-conflicted directors to make decisions in conflicted situations;
4. the INEDs must have sufficient expertise and knowledge in running an investment management business on behalf of third parties; and
5. the non-conflicted directors and the INEDs collectively must have sufficient experience and knowledge to ensure the proper function of the board of directors. They must be able to seek independent advice from external legal counsel or other professionals to assist them in arriving at investment decisions.

The sponsor must confirm to the Exchange that the potential conflicts of interest are satisfactorily managed to ensure the smooth running of the company’s affairs and that the interests of shareholders are not compromised as a result.

**This newsletter is for information purposes only.**

Its contents do not constitute legal advice and it should not be regarded as a substitute for detailed advice in individual cases.

Transmission of this information is not intended to create and receipt does not constitute a lawyer-client relationship between Charltons and the user or browser.

Charltons is not responsible for any third party content which can be accessed through the website.

If you do not wish to receive this newsletter please let us know by emailing us at [unsubscribe@charltonslaw.com](mailto:unsubscribe@charltonslaw.com?subject=unsubscribe%20-Hong%20Kong%20Law-)

**Charltons - Hong Kong Law Newsletter - Issue 135 - 22 September 2011**