Open-ended Fund Companies

Consultation Conclusions

Financial Services and the Treasury Bureau
www.fstb.gov.hk

January 2016

A. PURPOSE

1. This paper summarizes the submissions received from the consultation conducted in March 2014 on the proposed open-ended fund companies ("OFC") regime, and sets out the Government's responses, which will form the basis of the establishment, management and operation of OFCs and the regulation of such companies.

B. BACKGROUND

2. As noted in the consultation paper on OFCs ("Consultation Paper"), currently an open-ended investment fund may be established under the laws of Hong Kong in the form of a unit trust but not in corporate form due to various restrictions on capital reduction under the Companies Ordinance (Chapter 622) ("CO"). It is noted that the more popular fund structure from an international perspective is the corporate fund structure.

3. We propose that Hong Kong should introduce a new corporate structure for open-ended investment funds to provide a more flexible choice of investment vehicles. 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 vary its share capital in order to meet shareholder subscription and redemption requests. We hope that the additional option will diversify our fund domiciliation platform and be conducive to Hong Kong's further development as an international asset management centre.

4. The Government led an exercise to formulate a regime for the new OFC vehicle, with the participation of the Securities and Futures Commission ("SFC"), Companies Registry ("CR"), Inland Revenue Department ("IRD"), and Official Receiver's Office ("ORO"). In March 2014, the Government issued a consultation paper seeking views on proposals to introduce the OFC structure.

C. CONSULTATION FEEDBACK

5. A total of 27 written submissions were received. The respondents comprised various industry groups, professional bodies, fund operators, law firms, accounting and compliance firms, and other organizations and individuals. A list of the respondents is at **Annex**.

6. The respondents were generally supportive of the primary objective to introduce an OFC structure in Hong Kong. Some respondents sought clarifications or offered suggestions on some technical issues. We

have considered all responses and comments, and modified the proposals outlined in the Consultation Paper where appropriate.

7. Overall, comments received focused on four key issues, namely - (a) the investment scope of privately offered OFCs; (b) the requirement for a Hong Kong-incorporated custodian; (c) the requirement for at least one Hong Kong-resident OFC board member; and (d) the requirement for an investment manager licensed by or registered with the SFC. These issues are discussed in **Section D "Major Comments on Key Issues and Our Responses"**.

8. Other comments received in relation to specific questions raised in the Consultation Paper together with our responses are set out in **Section E "Specific Consultation Questions – Other Comments Received and Our Responses"**. Comments focusing on technical issues will be further considered when the SFC formulates the subsidiary legislation ("the OFC Rules") and the relevant code ("the OFC Code") to provide guidance on the incorporation, management, operation, administration, procedures and business of OFCs.

9. We have also received comments concerning issues not covered in the Consultation Paper. Such issues will not be addressed in this paper and will be considered separately where appropriate.

D. MAJOR COMMENTS ON KEY ISSUES AND OUR RESPONSES

(I) Investment scope of publicly and privately offered OFCs

10. As proposed in the Consultation Paper, OFCs would be established under the Securities and Futures Ordinance (Chapter 571) ("SFO") and primarily regulated by the SFC. In addition, the investment activities of OFCs would be required to be delegated to an investment manager licensed by or registered with the SFC.

11. Accordingly, it was proposed that the asset classes in which a Hong Kong OFC (be it a publicly or privately offered OFC) might invest should fall within the definition of securities, futures (and OTC derivative products once the relevant legislative amendments to the SFO have become effective) under the SFO within the scope of Type 9 regulated activity (asset management). The Consultation Paper highlighted that the primary purpose of a Hong Kong OFC would be to operate as an investment fund and the OFC was not designed to operate as a corporate entity for the purposes of general commercial business or trade.

12. The proposed investment scope aimed to ensure the current regulatory handle of the SFC in terms of licensing, supervision and enforcement would also apply to investment managers of OFCs. This would also

enable all existing fund managers licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity to manage OFCs without the need to apply for any new licences.

Respondents' views

13. A number of respondents considered that the proposed scope might be overly restrictive by precluding OFCs (whether publicly or privately offered) from investing in any other asset class, such as cash deposits, investments in shares of Hong Kong private companies, loan participations, real estate, films, insurance policies, wine, arts and other investments. They considered that such restriction would render OFCs less attractive as a Hong Kong-domiciled investment vehicle to fund managers.

14. A number of respondents held similar views that, for publicly offered OFCs, compliance with the same regulatory requirements applicable to the existing publicly offered funds (e.g. the Code on Unit Trusts and Mutual Funds ("UT Code") in the SFC Handbook on Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products ("SFC Handbook")) should be sufficient, while greater flexibility should be given to privately offered OFCs in respect of its investment scope and strategies.

15. Most of the respondents focused on privately offered OFCs. While one respondent agreed to the proposed scope of investment as private investors could invest in other asset classes via other investment products or through other forms of investment holdings, most of them expressed that privately offered funds were currently not subject to such regulatory constraints and such restriction would render OFCs less attractive as a Hong Kong-domiciled investment vehicle to fund managers. Some of them suggested that the investment scope of such OFCs be subject to the OFC's constitutional and/or offering documents only, while one suggested setting up a separate asset class "exclusion" list to limit the investment options. A few respondents suggested that the investments made by privately offered OFCs could align with the scope of "specified transactions" eligible for profits tax exemption under the regime for offshore funds.

Our response

General

16. As mentioned in paragraph 11 above, the primary purpose of a Hong Kong OFC will be to operate as an investment fund. The OFC is not designed to operate as a corporate entity for the purposes of general commercial business or trade.

17. Accordingly, while we have fine-tuned the permissible investment scope of OFCs as elaborated below, the asset classes in which a Hong

Kong OFC could invest should still fall predominantly within the definition of securities and futures (and OTC derivative products once the relevant legislative amendments to the SFO have become effective) under the SFO within the scope of Type 9 (asset management) regulated activity.

Investment scope of publicly offered OFCs

18. Having considered the comments received, we propose to allow publicly offered OFCs to invest in asset classes in accordance with the SFC's product code requirements and authorization conditions, i.e. mainly in securities, futures and OTC derivative products. This is on par with the existing regime for publicly offered SFC-authorized funds.

Investment scope of privately offered OFCs

19. As for privately offered OFCs, we consider that the proposed investment scope, i.e. to align with Type 9 (asset management) regulated activity, should be able to accommodate a very substantial part of the asset classes that privately offered OFCs normally invest in (e.g. cash, currency forwards, loans or distressed debt structured in the form of securities). We also note that the investment scope of those privately offered funds which seek to benefit from the existing profits tax exemption is already restricted in practice. While noting that there are no specified restrictions on permitted asset classes in some overseas jurisdictions, we are given to understand that in practice, not all asset classes may be accepted and may depend on various factors, such as whether the custodianship requirements can be satisfied.

20. Taking into account the comments received, we consider that the investment scope should still largely align with Type 9 (asset management) regulated activity, while proposing to introduce a degree of flexibility by allowing a 10% *de minimis* limit (i.e. a maximum of 10% of the total gross asset value of the fund) for investing in other asset classes.

21. For the avoidance of doubt, cash deposits and currencies, which are not inconsistent with Type 9 regulated activity, will be permissible asset classes not subject to the above 10% *de minimis* limit.

22. Should there be a passive breach of the *de minimis* limit due to market value fluctuations and redemptions by investors, similar to the requirement under UT Code, it is expected that the investment manager should take as a priority objective all steps as are necessary within a reasonable period of time to remedy the situation, taking due account of the interests of investors.

23. The SFC may, under the SFO, exercise its supervision powers in respect of the business conducted by the investment manager on behalf of the OFC to assess whether the investment manager is in

compliance with relevant regulatory requirements. The SFC may also investigate the affairs of OFCs if the SFC has reasonable suspicion of misconduct in connection with the management of the OFCs or the management or safe keeping of their scheme property. These will apply to all the functions and activities of the OFC (including investments in other asset classes).

24. As set out in the Consultation Paper, unlike publicly offered OFCs which are subject to the applicable restrictions in the SFC Handbook, investment managers of privately offered OFCs may have the flexibility to pursue their own investment strategies, provided that basic governance principles are complied with. These will include conduct and disclosure requirements, which are in line with international regulatory standards, as well as the investment scope proposed above.

(II) The requirement of appointing a Hong Kong-incorporated custodian

25. To strengthen investor protection and avoid potential conflicts of interest, we proposed in the Consultation Paper that the assets of the OFC must be segregated from that of the investment manager and entrusted to a separate, independent custodian for safe keeping. Given the significance of the role of the custodian, we proposed that the custodian must be incorporated in Hong Kong and acceptable to the SFC, and subject to similar basic eligibility requirements as required under the SFC Handbook. These proposed basic eligibility criteria, such as financial substantiality and independence requirements, are broadly in line with those in major overseas fund jurisdictions.

Respondents' views

26. Some respondents agreed to the requirement of appointing a Hong Kong-incorporated custodian. However, there was also substantive feedback from the respondents, suggesting that a non-Hong Kong-incorporated custodian should be allowed to hold assets of an OFC. In particular, the respondents noted that a substantial number of custodians and prime brokers (usually appointed in place of custodians for hedge funds) were based overseas instead of in Hong Kong. Some of them also commented that the custodian requirements for OFCs should be consistent with that afforded to authorized investment products under the UT Code, which do not require custodians to be incorporated in Hong Kong.

Our response

27. In the light of the comments received, we have reviewed the proposed requirement of appointing a Hong Kong-incorporated custodian. Given that Hong Kong is an open platform which is widely adopted by international investors to make global investments, many OFCs may

invest abroad regardless of the place of incorporation of the custodian. Having a Hong Kong incorporated custodian may not necessarily help in retrieving overseas assets.

28. As such, we propose to allow an overseas custodian provided that it meets the following requirements -

(a) satisfaction of eligibility requirements as generally referable to those applicable to custodians under the UT Code (including status as a bank entity or qualifying trust company, capital and independence requirements); and

(b) it has a place of business or a process agent in Hong Kong. This will ensure that there is an authorized local agent for the purpose of accepting the service of notices and legal documents in Hong Kong as the serving of court documents abroad can be lengthy and complicated.

(III) Requirement for at least one Hong Kong-resident OFC board member

29. We proposed in the Consultation Paper that, similar to the conventional company model, an OFC should be governed by a board of directors. At least one director of the OFC Board must be a Hong Kong resident. The arrangement aimed to ensure that there would be a local contact.

Respondents' views

30. Some respondents suggested removal of the requirement for at least one Hong Kong-resident OFC board member. They expressed that generally there were no similar requirements in other major overseas funds jurisdictions, except in Ireland. They also considered that the requirement might result in difficulties for an OFC to recruit Hong Kong personnel or to contend that its central management and control ("CMC") was not exercised in Hong Kong so as to enjoy profits tax exemption for offshore funds.

Our response

31. Taking into account the comments received, we propose to remove the requirement for at least one Hong Kong-resident OFC board member. Instead, we propose to require each of the non-resident directors of the OFC to appoint a process agent in Hong Kong to accept service of process.

32. In considering the revised approach, we have taken into consideration the comments received as well as the following -

(a) the SFC's major regulatory handle will be on the SFC-licensed or registered investment manager. Given that we will retain the requirement that the OFC investment manager must be SFC-licensed or registered (please refer to paragraph 36 below), we consider it acceptable to relax the requirement that at least one director of the OFC Board must be a Hong Kong resident; and

(b) this will generally be in line with other major overseas fund jurisdictions.

(IV) Requirement for an investment manager licensed by or registered with the SFC

33. In the Consultation Paper, we proposed that the investment management function of an OFC must be delegated to an investment manager who must be licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity under Part V of the SFO, given the OFC would be investing in securities and futures contracts (and OTC derivative products once the relevant legislative amendments to the SFO have become effective) which should fall within the remit of the SFO.

34. As licensed or registered persons of the SFC, investment managers of OFCs would be subject to the applicable requirements under the relevant legislation, regulations, codes and guidelines including the new OFC Code, as well as any other regulation applicable to such SFC-licensed or registered intermediaries. These requirements would apply to investment managers of both publicly offered and privately offered OFCs in Hong Kong.

Respondents' views

35. While some respondents agreed to the proposal that the investment management function of the OFC must be delegated to an investment manager who must be licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity, more respondents considered that, as an additional option, overseas management companies should be allowed to be appointed by the OFC. Reasons included -

(a) parity with the UT Code requirements which currently allowed overseas managers to manage publicly offered SFC-authorized funds provided that they were from an Acceptable Inspection Regime[1]; and

[1] Under the UT Code, the investment management operations of the scheme should be based in a jurisdiction with an inspection regime acceptable to the Commission, such jurisdictions being the "Acceptable Inspection Regime" (AIR). The list of AIRs is published on the SFC's website.

(b) potential difficulties for the OFC to contend that its CMC was abroad so as to enjoy the profits tax exemption under the offshore fund tax exemption regime, when its asset portfolios were managed by a SFC-licensed/registered investment manager.

Our response

36. While taking note of the respondents' comments, we maintain that the investment management functions of the OFC should be delegated to SFC-licensed or registered investment managers for the following reasons -

(a) we consider it important to build in a Hong Kong nexus as the policy objective of the OFC proposal is to attract more funds to domicile in Hong Kong and to build up Hong Kong's fund manufacturing capabilities to complement the existing fund distribution network and to develop Hong Kong into a full fund service centre;

(b) with the OFC being managed by a local investment manager, i.e. the high end of the value chain, it is more likely that the manager would hire local services along the service chain, including investment advising, custodian, business consulting, tax, accounting and legal services, etc.;

(c) from the recent data gathered by the SFC, an overwhelming majority of the Hong Kong-domiciled publicly offered funds are in fact managed by SFC-licensed investment managers. This indicates that Hong Kong-domiciled funds tend to be managed by SFC-licensed or registered investment managers in Hong Kong. The requirement should not have significant impact on OFCs' operations; and

(d) the requirement is important for investor protection purposes, given that the SFC-licensed or registered investment manager will be subject to the applicable requirements under the relevant legislation and codes.

E. SPECIFIC CONSULTATION QUESTIONS – OTHER COMMENTS RECEIVED AND OUR RESPONSES

Overarching principles in the development of OFCs

37. In the Consultation Paper, we set out a list of overarching principles which had been taken into account in developing the policy framework for OFCs and formulating the regulatory approach. While the

respondents generally agreed with the proposed overarching principles, some respondents submitted that fewer requirements should be imposed on privately offered OFCs, in particular as to investment scope, operational and filing requirements. These issues are discussed in other parts of this Paper.

Legislative framework and the OFC Code

38. In the Consultation Paper, the legal framework for OFCs was proposed to be provided for under the SFO, with the enabling provisions in the primary legislation and detailed operational and procedural matters in the OFC Rules. A new OFC Code to be issued by the SFC governing both privately and publicly offered OFCs was also proposed to supplement the legislation with more detailed and operational requirements. Key areas to be covered under the legislation and the OFC Code were set out in the Consultation Paper.

General

39. The respondents generally agreed with the proposed regulatory framework, while a few suggested the OFC vehicle be established under the CO instead.

40. Having regard to the general support received, we will proceed with the legislative process of amending the SFO through an Amendment Bill ("the Bill") to enable the OFC vehicle to be established under the SFO. The OFC Rules and the OFC Code will also be introduced accordingly after separate public consultation by the SFC.

OFC Code

41. The respondents generally agreed that the proposed scope of the code could adequately cater for the OFC regime. Of them, some suggested that the code should contain only core requirements. A few respondents suggested an amendment to the existing UT Code instead of introducing a new OFC Code.

42. We do not consider amending the existing UT Code for introducing the OFC appropriate. The OFC Code is intended to set out requirements specific to an OFC as a corporate vehicle, both publicly and privately offered. The contents dovetail the particular corporate features and intrinsic structural requirements unique to the OFC framework. The UT Code, on the other hand, applies to those unit trusts and mutual funds which are publicly offered and therefor serves different purposes.

Requirements applicable to privately offered OFCs

43. Some respondents suggested that the OFC Code should only apply to publicly offered OFCs and that there should be no or fewer regulatory

requirements applicable to privately offered OFCs. Some respondents suggested that privately offered OFCs should not be subject to the SFC's purview.

44. As to the requirements applicable to privately offered OFCs, it should be highlighted that the OFC Code is intended to lay down the same basic or minimum operational requirements applicable to all OFCs with reference to international regulatory practices and standards. Publicly offered OFCs would, in addition to the OFC Code, be subject to more extensive requirements under the UT Code, consistent with other SFC-authorized publicly offered funds.

45. Where the basic requirements in the OFC Code are met, other matters in respect of the operation of privately offered OFCs will remain largely governed by the OFCs' individual constitutive and offering documents. It should be noted that our imposition of certain essential regulatory requirements to a privately offered corporate fund is broadly in line with the approach in the UK, Ireland and Luxembourg.

46. In considering the regulatory framework for privately offered OFCs, we are minded to take a measured approach having regard to international regulatory practices and standards such as fundamental IOSCO principles, and the primary purpose of an OFC as an investment fund, rather than engaging in activities undertaken by conventional companies such as commercial trade and business.

Others

47. Some specific technical comments had been received regarding the OFC Code. These included for example, suggestions for inclusion of certain corporate governance requirements, risk management guidance, termination, directors' duty, documentation and reporting details. A respondent suggested that the OFC framework should be self-contained and comprehensive, and should avoid frequent cross-referencing to relevant provisions in the CO and the Companies (Winding Up and Miscellaneous Proceedings) Ordinance (Chapter 32) ("CWUMPO"). The SFC will take this into account in formulating the OFC Rules and the OFC Code.

48. A respondent commented that the SFC's regulatory requirements should prevail in case of discrepancy with the company law requirements. It should be noted that the OFC will be established under the SFO and its subsidiary legislation. It will therefore be the SFO and the OFC Rules which will be applicable to OFCs. Any referable company law requirements will be expressly incorporated into the legislative framework under the SFO as appropriate.

Roles and functions of regulators

49. We proposed in the Consultation Paper that the SFC would be the primary regulator of OFCs as OFCs were set up as an investment fund vehicle, while the CR would be responsible for their incorporation and statutory corporate filings.

50. In relation to streamlined termination of OFCs, this was proposed to be subject to the SFC's prior approval, while ORO would administer any court ordered winding up procedures similar to those applicable to conventional companies formed under the CO. The appropriate regulator was expected to administer the relevant process within their respective spheres.

General

51. While the respondents generally agreed with the proposed division of roles and functions of the SFC, CR and ORO, there were views that privately offered OFCs should not be regulated (please refer to paragraph 15 above).

Termination and winding up arrangements

52. The respondents generally agreed to the proposals regarding the termination and winding up of OFCs. A few respondents queried the need for the SFC's prior approval for a streamlined termination or for a winding up of OFCs, in particular privately offered OFCs.

53. In view of the support received, the legislative and regulatory framework will provide for the roles of the SFC and ORO as set out in the Consultation Paper. We note the respondents' comments regarding the need for the SFC's prior approval in the case of a streamlined termination and a winding up of an OFC. We maintain that the SFC's prior approval should be required in the case of a streamlined termination as the termination process will not follow those requirements and procedures for winding up of conventional companies, but will be carried out in a more streamlined manner. As for the case of a winding up of an OFC, the requirements and procedures are expected to follow closely those applicable to conventional companies in the CWUMPO as noted in the Consultation Paper. As such, additional approval from the SFC will not be required. The detailed provisions will be devised in the OFC Rules and will be subject to separate consultation.

54. As proposed in the Consultation Paper, a streamlined approval process would be provided where the termination is carried out pursuant to its constitutive and offer documents and upon satisfaction of stipulated procedures (for example, due liquidation of assets and distributions to investors). Please also refer to the discussions in paragraphs 146-149 below.

Essential features of an OFC

55. We proposed in the Consultation Paper certain essential features required of an OFC which would be registered with the SFC. These included - (a) having a set of articles of incorporation (now renamed as instrument of incorporation) complying with regulatory requirements; (b) having a Hong Kong registered office; (c) being governed by a board of directors who must at all times delegate the investment management function of the OFC to an investment manager licensed by or registered with the SFC under Part V of the SFO to carry out Type 9 (asset management) regulated activities; and (d) entrusting its scheme property to a Hong Kong incorporated custodian acceptable to the SFC.

56. The respondents generally supported the proposed structure of the OFCs, while some respondents suggested allowing a non-Hong Kong-incorporated custodian and the delegation of investment management function to offshore managers. As discussed in paragraphs 28 and 36 above, we agree to allow an overseas custodian but maintain that the investment management function should be delegated to SFC-licensed or registered managers. We will incorporate the proposed essential features into the regulatory framework accordingly.

Creation of different share classes

57. A few respondents suggested allowing for the creation of different share classes under an OFC. It is generally envisaged that there will be no prohibition on such share-class creation. This will however be subject to relevant OFC Code requirements, for example clear disclosure in the offer documents and in the case of a publicly offered OFC, observation of any applicable requirements in the SFC Handbook.

Appointment of third party service provider

58. A few respondents sought clarification as to whether appointment of administrators and other agents (for example valuation agents) would be regulated. Another respondent suggested allowing the board of directors to delegate valuation responsibilities to independent administrators or valuation agents.

59. Generally, it is envisaged that the appointment of third party service providers (including for example administrators or valuation agents) by the board of directors or by the investment manager, as the case may be, will be allowed subject to relevant OFC Code requirements. It should be noted however that the party making such appointment should remain responsible for overseeing the service provider appointed. This includes exercise of due care in the selection, appointment and ongoing monitoring process. The detailed technical suggestions received from respondents in relation to such delegation arrangement will be considered under the OFC Code.

Board of directors

60. Similar to a conventional company, we proposed in the Consultation Paper for an OFC to be governed by a board of directors who must meet certain basic eligibility requirements. Such requirements included that they must be natural persons who have attained the age of 18, of good repute, be appropriately qualified and experienced for the purpose of carrying out the business of the OFC. It was also proposed that the board be comprised at least two directors, with at least one Hong Kong resident and at least one director independent of the investment manager and the custodian. The directors were proposed to be subject to the same statutory and fiduciary duties owed to a conventional company by its directors under the law, including the duty to exercise reasonable care, skill and diligence. The board was proposed to be subject to corporate governance standards consistent with international standards for investment funds.

61. Except for some comments that the requirement to have at least one Hong Kong-resident board member should be removed (as discussed in paragraph 30 above), the respondents generally agreed to the proposal. This will form part of our regulatory requirements of OFCs.

Composition and eligibility of the board of directors

62. Some respondents opined that the eligibility requirements for the board might be too onerous. While one respondent commented that the board should consist of a minimum of three directors with a majority of independent directors, some other respondents considered the requirement of having at least one director that was independent of the investment manager not necessary. Some respondents considered that the appointment or removal of directors should not be subject to the SFC's approval. Some respondents sought clarification or commented on the criteria of an "independent director".

63. We maintain that the board of directors should be subject to basic eligibility and approval requirements. The requirements imposed have taken into account the fact that an OFC is fundamentally an investment fund which in nature differs from a conventional company. We have also considered relevant overseas practices.

64. With regard to the suggestion for removal of the independent director requirement, the board of directors is expected to provide an extra layer of oversight on the activities of the OFC for the shareholders. An independent director is essential for the purpose. As to the details on the requirements on "independent director", this will be set out in the OFC Code. Comparable overseas requirements will be taken into account in its formulation.

65. A few respondents inquired as to the proportion of independent and connected directors on the board. As proposed in the Consultation

Paper, a minimum of two directors will be required on the board with at least one independent director.

Duties on directors

66. Some respondents considered that common law duties would suffice for privately offered OFCs.

67. We maintain that having regard to investor interests, directors of OFCs should be subject to the relevant and applicable statutory and fiduciary duties owed by directors to a conventional company under the law, including the duty to exercise reasonable care, skill and diligence.

Delegation of investment management function to investment manager licensed or registered with the SFC to carry out Type 9 (asset management) regulated activity

68. Given that the OFC is an investment vehicle and having regard to the scope of investment of the OFC, we proposed in the Consultation Paper that the OFC board must delegate the investment management function of the OFC to an investment manager who is licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity.

69. Apart from the feedback suggesting allowing for an overseas investment manager as discussed in paragraph 35 above, the respondents' other comments mainly focused on the technical issues.

Definition of "day-to-day investment management" functions

70. One respondent sought clarification as to the role of the "investment manager" and definition of "day-to-day management" function to be delegated to the investment manager.

71. We expect that the board of directors will assume high-level oversight and legal responsibilities over the affairs of an OFC with the relevant and applicable statutory and fiduciary duties owed by directors of a company incorporated under the CO. However, given an OFC is an investment vehicle with investment management of its property entrusted to a SFC-licensed or registered investment manager, the role of the directors will be akin to that of non-executive directors of a company and they will owe similar statutory and fiduciary duties.

72. The board may on behalf of the OFC directly engage third party service providers to provide ancillary administrative services to the OFC. These may include for example, service agents to perform administration and valuation, filings, transfer agent services, etc.

73. On the other hand, the SFC-licensed or registered investment manager is responsible for the investment management of scheme property. In practice, the investment manager may also assist the board in its decision-making, for example by making recommendations on the above service providers.

74. More detailed provisions concerning the role, duties and functions of the investment manager in relation to the more routine operational and administrative matters of the OFC will be set out in the OFC Code.

Sub-delegation

75. Some respondents inquired if sub-delegation by the investment manager would be allowed (including sub-delegation to overseas managers). A respondent suggested allowing valuations to be conducted by an administrator who could rely on third party pricing services.

76. While no prohibition is expected in this regard, the investment manager will remain responsible notwithstanding such sub-delegation or appointment. This includes exercising due care in the selection, appointment, and ongoing monitoring of the performance by the delegate(s) and remaining fully liable in complying with regulatory requirements.

Appointment of multiple investment managers

77. A respondent proposed to allow for different investment managers to be appointed for different sub-funds.

78. While no prohibition is expected in this regard, we envisage that generally, an investment manager will be appointed for an OFC to ensure due compliance with investment management functions prescribed in the legislation and the OFC Code. The appointment of multiple investment managers for different sub-funds may be considered on a case-by-case basis.

79. The sub-delegation by the investment manager at the sub-fund level will be subject to requirements under the UT Code in the case of publicly offered OFCs and no restriction on such sub-delegation will be imposed in the case of privately offered OFCs. Notwithstanding such sub-delegation, the investment manager will remain responsible for all of its regulatory responsibilities. It should also be highlighted that investment managers will be expected to impose appropriate measures to oversee the selection, appointment and ongoing monitoring of their delegates.

Self-managed OFC

80. A few respondents proposed to allow OFCs to be self-managed. We consider that as the directors of an OFC are not subject to SFC licensing requirements, to ensure proper regulatory handle is in place, self-managed OFCs will not be appropriate.

Custodian

General

81. We proposed in the Consultation Paper that the assets of the OFC must be segregated from that of the investment manager and entrusted to a separate, independent custodian for safe keeping. We also proposed that the custodian must be incorporated in Hong Kong and acceptable to the SFC, and subject to the same basic eligibility requirements as required under the SFC Handbook. As discussed in paragraph 28 above, taking into account the views received, we agree to allow an overseas custodian.

82. Regarding the proposal for segregating the OFC's assets and mandating a custodian for safe keeping such assets, the respondents generally agreed to it. However, a few respondents proposed to remove or minimize the custodian requirement for privately offered OFCs. Some respondents commented that due to the diversity and size of assets under management, having one custodian to be in charge of all assets is impractical, costly and might present high levels of counterparty risk. They therefore recommended lifting or liberalizing the requirement for a custodian in respect of privately offered OFCs. One respondent also suggested that custodian requirements should not form part of the legislative requirements.

83. Having regard to the general support received and the IOSCO principles requiring segregation of assets which serve as an important safeguard to the assets of an OFC for investor protection, we will maintain the custodianship requirement in the legislation in respect of both publicly and privately offered OFCs.

Multiple custodians

84. A few respondents sought clarification on whether different custodians could be appointed in respect of different assets of an OFC. We generally expect that a custodian will be engaged who should be responsible for safe keeping all scheme assets and sub-custodianship may be provided for where appropriate and in compliance with the relevant requirements. On the other hand, for privately offered OFCs, the appointment of multiple custodians may be considered on a case-by-case basis by the SFC, having regard to the particular circumstances of the individual OFC.

Engagement of prime brokers and sub-custodians

85. Some respondents submitted that it was the business practice of privately offered funds to engage prime brokers to hold and administer fund assets, in particular for overseas prime brokers to be appointed for assets abroad. A respondent also inquired whether sub-custodianship would be permissible.

86. We expect that in the case of privately offered OFCs, where prime brokers are appointed to perform the function of a custodian, they should fulfill the eligibility requirements for custodians in the OFC Code. As to the appointment of overseas custodian, this will be allowed as discussed above. Separately, the appointment of sub-custodians is allowed, provided that the applicable requirements in the OFC Code are met. These will include that the custodian should carry out due oversight in the selection, appointment, and ongoing monitoring of the sub-delegates. Notwithstanding such sub-delegation, the custodian will remain responsible for all of its regulatory responsibilities. It should also be highlighted that custodians will be expected to put in place appropriate measures to ensure adequate risk management.

Others

87. A few respondents sought clarification or commented on the detailed responsibilities and liabilities of the custodian. Some respondents suggested an alignment of the requirements with those in the UT Code. Two respondents suggested that the role of custodian be considered having regard to the different types of assets that might be held by the OFC. One respondent proposed the same liabilities for custodians of both publicly and privately offered OFC.

88. Details on the requirements concerning the custodian will be set out in the OFC Code. These are expected to be broadly similar to those under the UT Code.

Incorporation of an OFC

General

89. It was proposed in the Consultation Paper that the applicant for an OFC should apply to the SFC for approval, and that the CR would incorporate the OFC upon receipt of specified documents and the issuance of an approval-in-principle for registration by the SFC. The Consultation Paper also set out what would be the effect of incorporation, the logistics of filing and requirements for maintenance of relevant registers.

90. The respondents generally supported the proposed arrangements in relation to the incorporation of OFC. Comments mainly suggested

better co-ordination and efficiency in the registration and incorporation process between the SFC and the CR.

91. We have taken into account the comments received and propose that "one-stop" service be provided for the registration, incorporation and business registration of an OFC. Broadly, the SFC will be the primary recipient of all application documents (including the documents required by the CR and IRD for incorporation and business registration respectively). Once the SFC is satisfied that the registration requirements are met, it will issue a notice of registration (instead of an approval-in-principle) to the CR. The SFC will forward relevant incorporation and business registration documents together with the notice of registration and the fees to the CR for the OFC's incorporation and business registration purposes. The CR will incorporate an OFC if it has received the notice of the registration and other relevant documents from the SFC and is satisfied that the requirements for incorporation have been met. The registration of the OFC will take effect only on the day of issue of the certificate of incorporation by the CR. Under the one-stop company incorporation and business registration regime, the CR will issue to the OFCs the first business registration certificate on behalf of the Commissioner of Inland Revenue simultaneously together with the certificate of incorporation. The registration and incorporation requirements will be set out in the legislation. Following the incorporation of the OFC, corporate filings are largely expected to be made solely with the CR by the applicant. The arrangement is expected to enhance efficiency and save costs.

92. A few respondents suggested that the SFC registration should be conducted more as a fulfillment of filing formality rather than a substantive pre-approval process. A respondent suggested waiving the requirement for filing by privately offered OFCs.

93. We note that in some of the overseas jurisdictions, for example the UK and Ireland, substantive regulatory requirements are maintained for the approval of the establishment of the investment vehicle. We also consider that relevant filing requirements for publicly and privately offered OFCs should be maintained for transparency purpose. Nonetheless, industry feedback will be taken into account when devising the OFC Rules and/or OFC Code concerning the filing requirements and arrangements in light of the nature of an OFC and whether it is publicly or privately offered.

Processing time

94. A few respondents suggested that an indicative approval timeframe should be provided for approval. The SFC and CR will publish the general processing time in handling relevant applications, which is expected to be broadly in line with existing practice.

Fees

95. A few respondents inquired as to the fees to be charged by the relevant regulatory authorities in respect of OFCs.

96. Subsequent corporate filing details will be considered by the CR and the SFC. The fees to be charged by the authorities are expected to be generally commensurate with existing fees for comparable activities. The fees chargeable by CR and SFC will be made by the Financial Secretary under the OFC Rules.

Liability for entering into contracts prior to incorporation of the OFC

97. One respondent had concerns as to the personal liability involved where a party entered into contracts (for example, to engage key operators) for an OFC which had yet to be incorporated.

98. As in the case of conventional companies, the Bill provides that a person entering into a contract on behalf of a proposed OFC before it is incorporated will be personally liable. The applicant should seek professional advice in this regard to ensure any agreement entered into in respect of an OFC will be appropriately arranged and will not constitute a contravention of the law as in the case of a person entering into a contract on behalf of a conventional company before it is incorporated.

Naming convention

99. We proposed in the Consultation Paper to introduce naming conventions for OFCs under the new legislation or the OFC Code to distinguish OFCs from companies formed under the CO, and require OFC names not to be misleading or undesirable. We also proposed that no person should use the title “open-ended fund company” or “OFC” without being registered with the SFC as an OFC.

100. The respondents generally considered the proposed naming convention as set out in the Consultation Paper provided sufficient level of clarity to investors. Two respondents sought further guidance on the naming convention, for example what may be “misleading” or “undesirable”.

101. The Bill specifies requirements for the name of an OFC to end with “open-ended fund company” or “OFC” and not to be misleading or otherwise undesirable. Further general principles in this connection will be set out in the OFC Rules and/or OFC Code which will be subject to public consultation.

102. A few respondents queried the necessity for the SFC's approval of the name of the OFC. One of them suggested applying only the existing requirements on names under the CO. However, having regard to investor interests and the fact that the OFC is an investment vehicle which differs from a conventional company, we maintain that the naming convention should be introduced and set out in the SFO and the OFC Rules and/or OFC Code accordingly. This is also in line with comparable overseas regimes.

Instrument of Incorporation (formerly named as Articles of Incorporation)[2]

General

103. The Consultation Paper proposed that an OFC should have an Instrument of Incorporation ("Instrument") and the basic mandatory content requirements (core provisions) would be set out in the regulations. The Instrument would be required for submission to the SFC as part of the registration process and also for approval upon subsequent material amendments prior to filing with the CR. It was also proposed that any change to the Instrument would be subject to shareholders' approval by way of a special resolution.

104. Feedback received generally agreed with the adequacy and features of the core provisions proposed. A few respondents suggested that the core provisions should not cover the investment scope or key operators of the OFC. A respondent suggested that the core provisions should be provided for voluntary adoption only.

105. We maintain that a set of basic content requirements in the Instrument should be mandated for OFCs. This is also the case in the UK. It should be noted that some of the regulatory requirements are expected to form part of the Instrument to ensure the OFC's compliance with legislative requirements. In considering applications for registration, the SFC will consider if the regulatory requirements will be met when reviewing the Instrument as a whole.

Approvals required in case of changes to the provisions of the Instrument of Incorporation

106. A few respondents proposed that in relation to privately offered OFCs, the SFC's approval should not be required in respect of changes to the provisions of their Instrument or where such changes had been approved by shareholders. Two respondents suggested that only material changes that might adversely affect shareholders should

[2] The proposed "Articles of Incorporation" is renamed as "Instrument of Incorporation" to avoid confusion with "Articles of Association" for conventional companies.

require shareholders' approval. One respondent suggested that changes to the provisions of the Instrument of a publicly offered OFC should be approved by the SFC.

107. Generally, for publicly offered OFCs, they should observe applicable requirements under the UT Code with regard to changes to their provisions of the Instrument and the relevant approvals required. For privately offered OFCs, taking into account the feedback received and overseas practices, immaterial changes to non-core provisions will not require shareholders' approval, provided that the relevant requirements to be set out in the OFC Code are satisfied. The approval threshold for changes to the provisions of the Instrument will be subject to separate consultation on the OFC Rules and OFC Code.

Others

108. One respondent inquired as to whether the OFC's Instrument might be automatically filed by the SFC with the CR upon the SFC's approval. As the Instrument will be included in the application to the SFC for registration, it will be sent to the CR by the SFC when the SFC issues notice of registration to the CR.

109. A few respondents made suggestions on what might be added to the core provisions of the Instrument. These include for example, details on share classes, share certificate, and meeting procedures. Substantive details of the Instrument will be subject to the separate consultation on the OFC Rules and OFC Code.

Offer of shares

General

110. We proposed in the Consultation Paper that OFC share offerings would be made under an offering document. Offering documents of publicly offered OFCs were proposed to be filed with the CR prior to issue after obtaining the SFC's authorization. To allow certain flexibility for privately offered OFCs, it was proposed that such OFCs would not be required to file their offering documents with the CR nor have their offering documents authorized by the SFC. Basic disclosure requirements were proposed to be set out in the new legislation and/or the OFC Code for the offering documents. The Consultation Paper also set out the principles and general expectations of the basic disclosure requirements.

111. The respondents generally agreed to the proposals for OFC share offerings to be made under an offering document and be subject to the basic disclosure requirements. A respondent suggested that for publicly offered OFCs, their offering documents should not require filing

with the CR. A few respondents suggested that privately offered OFCs should not be subject to filing requirement.

112. Taking into account the comments received, and noting that the offering documents of publicly offered OFCs will be published on the SFC's website, we agree not to require filings of the offering documents with the CR. In response to respondents' enquiries, the CR's consent will not be required for issuing the offering documents of an OFC. Further, as stated in the Consultation Paper, offering documents of privately offered OFCs will not be required to obtain the SFC's authorization.

113. A few respondents made suggestions as to the disclosure requirements to be imposed on OFCs' offering documents, mostly proposing to mirror those under the SFC Handbook. The requirements will be set out in the OFC Code. Preliminarily, it is envisaged that these will focus on basic requirements similar to the overarching principles section of the SFC Handbook. Publicly offered OFCs will, in addition, need to comply with the requirements set out in the UT Code.

Exemption for offers falling within Part 1 of Schedule 17 to CWUMPO

114. Under section 103(2)(ga) of the SFO, where an advertisement, invitation of document relates to an offer falling within paragraph (b)(ii) of the definition of "prospectus" under the CWUMPO, it will be exempted from SFC's authorization requirements. For parity with overseas corporate funds offered in Hong Kong, the Bill provides for an exemption if the relevant offer by the OFC falls within one of the exemptions equivalent to those set out in Part 1 of Schedule 17 to CWUMPO. These include, for example, where an offer is made to no more than 50 persons, with a minimum denomination of HKD 500,000 or a maximum size of HKD 5 million.

Corporate administration

115. In the Consultation Paper, proposals were made as to various aspects of corporate administration, including - (a) meetings; (b) reports and accounts; and (c) corporate filings.

116. The respondents generally supported the proposals. Comments were received on certain technical aspects of the proposals. The major comments were set out below. The SFC will take into account these comments in formulating the OFC Code.

Reporting standards and requirements for financial statements

117. A few respondents suggested allowing annual reports and accounts to be prepared in accordance with other international accounting

standards, in addition to the Hong Kong Financial Reporting Standards ("HKFRS").

118. We note that under the CO, it is prescribed that the HKFRS should be adopted for purpose of preparing accounts of private companies incorporated under the CO. However, taking into account the comments received and industry practices, we are amenable to accepting other accounting standards used by issuers to prepare financial statements which are of a high, robust and internationally acceptable quality in respect of OFCs.

119. In particular, we are prepared to accept the use of the International Financial Reporting Standards ("IFRS") in addition to the HKFRS, as we understand that the IFRS is a well-established and commonly recognized international accounting standard. For privately offered OFCs, the acceptance of accounting standards other than the HKFRS and IFRS will be considered on a case-by-case basis. In line with the IOSCO's guidelines, such other standards may be considered having regard to for example, the extent to which the standard is internationally recognized, whether the standard setting process is accountable and whether it has been subject to appropriate consultation. We will set out the acceptable accounting standards and factors taken into account when devising the OFC Code.

120. Separately, a respondent suggested that privately offered OFCs should not be required to prepare audited accounts, while another respondent suggested removing mandatory semi-annual reporting or providing for simplified reporting requirements. Given the majority support received in respect of the proposed reporting requirements and having regard to the importance of financial transparency to investors' decision, we will maintain the proposed requirements as set out in the Consultation Paper.

Extraordinary general meeting ("EGM")

121. One respondent suggested that investors of OFCs should have no voting rights and thus could not call an EGM. Separately, two respondents suggested that an extraordinary general meeting could be requisitioned by shareholders holding 10% voting rights (instead of 5% as proposed in the Consultation Paper) having regard to, among other things, current practice of unit trusts.

122. We maintain that, in line with market practice and the interests of the investors, investors of an OFC should generally be entitled to call an EGM. Taking into account the feedback received including parity with existing practice of unit trusts however, we will revise the requirement for requisitioning an EGM to 10% of voting rights held.

123. As to other technical input, for example different voting representations for different share classes, basic voting and meeting requirements, these will be considered for the purpose of devising the OFC Code. Generally, it is expected that the voting and meeting arrangements should largely be determined by the individual OFC in its Instrument.

Corporate filings

124. Comments concerning corporate filing requirements mainly suggested streamlining of the filing process, reduction in filing scope, and clear delineation of filings required with the respective authorities. A respondent suggested a dual filing regime.

125. Some respondents provided specific comments on the filings applicable to OFCs, such as no disclosure of list of members, change of directors and registered address.

126. In devising the detailed filing forms and procedures, the SFC and the CR will take into account the comments received and consider an appropriate approach. We generally maintain that the filings required should be similar to those applicable to conventional companies (for example, registered office address and change of directors) but the contents or scope of the filing will be streamlined having regard to the nature of OFCs and the comments received. Certain filings will not be applicable to OFCs, such as information on company secretary, list of members, changes in share capital, information on mortgages and charges. The requirement for an annual return will also be removed taking into account the comments received.

127. Some respondents queried the need for OFCs to seek the SFC's approval prior to making CR filings, noting that privately offered funds were currently not required to seek regulatory approval to scheme changes or to file annual reports for public viewing.

128. Under the current proposal, filings with the CR will not require any SFC approval. However, where the subject matter of that filing is subject to regulatory approval requirements specified by the SFC, such as a material change to the Instrument, or a change of directors, prior approval of the SFC should be obtained for that subject matter before the corresponding filing with the CR is made.

129. The detailed logistics on filings will be further published by the respective regulators upon the implementation of the OFC regime. The regulators will take into account the feedback received, existing practices on filings by conventional companies, as well as overseas practices on filings required for similar corporate investment vehicles when finalizing the filings required.

Operations of OFCs

130. The Consultation Paper set out our proposals on operations of OFCs, including share capital, valuation and pricing, issue and redemption of shares, and distributions.

131. The respondents generally supported the proposals. We will proceed to incorporate the requirements into the OFC Rules and OFC Code as proposed accordingly. Comments received on proposals concerning OFC operations largely focused on valuation and pricing.

Valuation and pricing

132. We proposed that the offer and redemption prices be calculated on the basis of the OFC's net asset value ("NAV") divided by the number of shares outstanding and that such prices might be adjusted by fees and charges to be disclosed in the offering document. Publicly offered OFCs should also comply with the SFC Handbook while valuation rules for all OFCs should be set out in the Instrument.

133. Two respondents suggested that valuation rules of privately offered funds should not be subject to regulation and be placed in the offering documents only instead of the Instrument. One of them made a similar suggestion in respect of pricing arrangements.

134. The proposed valuation and pricing arrangement as recapitulated above for OFC shares is considered fundamental and should be largely common between public and privately offered funds having regard to market and overseas practices as well as relevant IOSCO principles. Accordingly, we will maintain the proposed requirement. It is not envisaged that detailed rules in respect of valuation of individual asset classes held by privately offered OFCs will be prescribed, while the valuation rules for publicly offered OFCs will remain to be those set out in the SFC Handbook and the Fund Manager Code of Conduct.

Others

135. There were suggestions as to the technical operational details concerning suspension of dealings and deferrals of redemptions. These included, for example allowing deferral of redemptions to the next dealing day where redemption requests exceeded 10% of the total net assets (instead of the total shares) in the issue of a sub-fund. A suggestion was also received to allow, in connection with the suspension of dealings, fund managers to prohibit front-end subscriptions only without restricting redemptions.

136. These will be considered in the formulation of the OFC Code. Generally, it is expected that for publicly offered OFCs, the existing requirements under the SFC Handbook will apply.

137. A respondent sought clarification as to whether distribution out of capital for privately offered OFCs would be subject to the SFC's approval. It is expected that, subject to solvency and disclosure of such arrangement together with the risks involved in the offering documents, the SFC's approval will not be required.

Protected cells

General

138. We proposed in the Consultation Paper to introduce a protected cell regime for OFCs. It was proposed that the assets and liabilities of a sub-fund of an OFC be ring-fenced to that particular sub-fund, so as to limit the contagious effect of insolvency of a sub-fund within an umbrella fund. Where assets or liabilities were not attributable to any particular sub-fund, it was proposed that the OFC might allocate them in a manner which it considered to be fair to shareholders.

139. The respondents generally agreed to the proposed arrangements concerning a protected cell regime. A respondent noted the risk of unenforceability of the protected cell structure in overseas jurisdictions and suggested an "incorporated" protected cell as an alternative.

140. As set out in the Consultation Paper, it was uncertain whether foreign courts would uphold contract terms reflecting the protected cell regime. Accordingly, as proposed in the Consultation Paper, we would require the OFC offering documents to include a disclosure warning to highlight the risk involved to investors. Having regard to the general support received and in line with overseas practices, we maintain that it will be appropriate to introduce the protected cell regime.

Others

141. A few respondents inquired how to put in place the protected cell structure for particular types of funds and the resulting impact upon insolvency.

142. Given that individual OFCs may have different needs and be structured differently, applicants should seek professional advice on the detailed structure of their OFCs.

143. Further, a few respondents queried whether different share classes within a sub-fund would be subject to the protected cell regime. It should be noted that the mandatory protected cell regime is expected to be specified as applicable to sub-funds, rather than to share classes within a sub-fund. We also clarify that an umbrella fund which is a publicly offered OFC is not expected to have privately-offered sub-funds and vice versa, in line with overseas practices in the UK and Ireland.

144. In addition, one respondent noted that it was likely that some assets held by the OFCs were not directly attributable to its sub-funds, and there might be a need to "apportion" these common assets for the purpose of deciding the available assets of each sub-fund. It is envisaged that the regulations will enable an OFC to allocate between its sub-funds the assets or liabilities that (a) it receives or incurs on behalf of its sub-funds, or (b) in order to enable the operation of its sub-funds, provided that these are not attributable to any particular sub-fund and in a manner that it considers is fair to its shareholders. This approach is consistent with overseas practices for example that in the UK.

145. Separately, on the issue raised by a few respondents as to a sub-fund's ability to invest in other sub-funds within the same umbrella, it is expected that cross investments between sub-funds of the same umbrella will be permitted and that the relevant requirements will be set out in the OFC rules.

Streamlined termination

146. In the Consultation Paper, we proposed a streamlined termination process for a solvent OFC to be terminated in accordance with the specific provisions in the Instrument, provided that its solvency was certified by the OFC board and an independent and qualified auditor, and reasonable prior notice had been given to shareholders. In such a case, upon full distribution of assets to shareholders and settlement of liabilities, the OFC board could apply for de-registration with the SFC accompanied with relevant documents. The SFC would then notify the CR which would then update the OFC's status.

147. The respondents generally supported this streamlined termination proposal to provide an expedient way for terminating a solvent OFC. Comments focused mainly on reducing the processing time when implementing the relevant requirements. Some respondents submitted that the solvent termination of privately offered OFCs should be subject to post-dissolution filing only and not prior approval by the SFC. A respondent enquired if the streamlined termination process would be applicable to sub-funds of an OFC.

148. We maintain that prior approval by the SFC will be required for streamlined termination of both publicly and privately offered OFCs, having regard to the interests of investors. The detailed grounds of such termination will be formulated based on industry practices and be set out in the OFC Code. The streamlined termination process would be equally applicable to sub-funds of an OFC which are solvent.

149. As to individual suggestions on the details of the streamlined termination arrangements (including for example, method of handling distributions, right of the fund to provide redemptions in certain circumstances, and the manner of certifying the solvency an OFC), these will be taken into account when formulating the OFC Code, which will be subject to separate consultation.

Winding-up

General

150. It was proposed in the Consultation Paper the winding up processes under the CWUMPO would apply to OFCs as appropriate to ensure protection of shareholders and creditors. The respondents generally agreed with the proposal.

151. Suggestions were received from two respondents to dispense with the certificate of solvency which is currently applicable to conventional companies. A few respondents suggested removing the requirement for a liquidator. One respondent suggested that final accounts should be audited upon winding up. Another respondent suggested allowing for shareholders' voluntary winding up in accordance with the CWUMPO. A respondent expressed reservation on applicability of the insolvency regime in respect of OFCs.

152. We maintain that for consistency with the existing corporate winding up regime, and for protection of the interests of investors and creditors, the existing requirements under CWUMPO for winding up should generally be made applicable to OFCs. This will include the requirement for a solvency certificate and appointment of a liquidator and an auditor.

Parties entitled to petition for winding up

153. A respondent suggested removing the SFC's power to veto a compliance voluntary winding-up and asked for elaboration of the grounds on which the SFC could petition to the court for winding up. Another respondent inquired as to the requirement for SFC approval where an insolvent winding up process was invoked.

154. We note that the respondents generally agreed to the proposal to allow for the SFC and the custodian to petition to the court for the winding-up of an OFC. Having regard to the support received and the interests of investors, we will proceed to incorporate these requirements into the regulatory framework. It is expected that the SFC may petition for winding up in circumstances where it is in the interest of the investing public. As to the SFC's approval required in respect of winding-up, please refer to our discussion in paragraph 53 above.

155. The details of the winding-up regime for OFCs will be set out in the OFC Rules by incorporating the relevant provisions in the CWUMPO with appropriate modifications. Feedback received will be taken into account when formulating the requirements.

De-registration by the SFC

156. We proposed in the Consultation Paper that an OFC might be dissolved following de-registration, including being struck off the register by the SFC. A respondent inquired as to the circumstances for such de-registration initiated by the SFC.

157. We envisage that such de-registration by the SFC will be initiated where the registration requirements are contravened, or there is a breach of the law, or in other circumstances where the maintenance of registration is not in the interests of the investing public. Upon such de-registration, the SFC will notify the CR and the OFC respectively. Subject to the completion of the procedures as prescribed in the OFC Rules, the CR will remove the OFC from its register.

Supervisory, enforcement, civil and criminal powers

158. The Consultation Paper made various proposals concerning supervision, enforcement, civil and criminal powers in relation to OFCs.

159. In relation to supervision powers, it was proposed that the SFC-licensed or registered investment managers be subject to the existing Code of Conduct for Persons Licensed by or Registered with the SFC and Fund Manager Code of Conduct, together with the proposed OFC Code. An OFC seeking the SFC's registration and its key operators would be subject to the OFC legislation and OFC Code as well as post-registration requirements therein. Post-authorization requirements under the SFC Handbook would also be applicable to publicly offered OFCs.

160. With regard to enforcement powers, it was proposed that the SFC's investigatory powers under the SFO would be extended to apply in the case where the SFC had reasonable cause to suspect misconduct in connection with the management of an OFC so as to enable the SFC to investigate the OFC and the individual directors to safeguard investor interests. It was also proposed that the SFC would be equipped with certain intervention powers in respect of the management or business of an OFC in order to take effective action to protect the interests of investors.

161. On civil and criminal powers, the relevant existing provisions (sections 107, 108 and Parts XIII and XIV of the SFO) will apply to OFCs. We also proposed the provision of an appropriate coverage of sections 212,

213 and 214 of the SFO to OFCs in order to allow the SFC to seek relevant remedies for investor protection in certain circumstances such as where there has been misconduct in the affairs of an OFC or where business was carried out in an unfairly prejudicial or oppressive manner.

162. Most respondents agreed to the proposals. A few respondents suggested that privately offered OFCs should not be subject to ongoing compliance and monitoring. One respondent commented that the enforcement and investigatory powers should not be more onerous than those under the UT Code in the SFC Handbook.

163. In considering the relevant supervisory, enforcement, civil and criminal powers, we have considered regimes offering comparable corporate investment vehicles in overseas jurisdictions such as the UK, Ireland, Luxembourg and Cayman Islands. Having regard to the specific nature of OFCs and the general support received, we will proceed to adopt the proposals on the legislative and regulatory framework accordingly.

Profits tax exemption for OFCs

164. We proposed in the Consultation Paper that the existing profits tax exemption regime should apply to OFCs. Currently, profits tax exemption is given under section 26A of the Inland Revenue Ordinance (Chapter 112) ("IRO") to public funds, including mutual funds, unit trusts or similar collective investment schemes ("CISs") authorized by the SFC under section 104 of the SFO or similar bona fide widely held investment schemes which comply with the requirements of a supervisory authority within an acceptable regulatory regime. Profits tax exemption is also provided under section 20AC of the IRO to offshore funds, whether public or private, but the exemption is restricted to profits derived from specified transactions transacted through specified persons.

165. As for whether profits tax exemption should be applied to privately offered OFCs with CMC located onshore, we proposed in the Consultation Paper to consider carefully the exemption or the extent of exemption having regard to possible read-across implications.

<u>Respondents' views</u>

166. Whilst the respondents generally supported that the existing profits tax exemption regime should equally apply to OFCs, a number of respondents considered it important to extend the profits tax exemption to privately offered OFCs with CMC located in Hong Kong. Some respondents took the view that the existing profits tax exemption should be extended to cover all OFCs, whether publicly or privately offered. Their main reasons for the extension of the profits tax exemption to privately offered OFCs included – (a) the requirement that the CMC of

an OFC had to be exercised outside Hong Kong in order to qualify for profits tax exemption for offshore funds would create tax uncertainty for private funds and deter private funds from domiciling in Hong Kong through structuring as OFCs; (b) by giving tax exemption for asset management in Hong Kong, it is likely to result in no loss in tax revenue and would encourage growth in complementary and supporting industries such as the funds management, administration, legal and other industries; and (c) from an investor protection standpoint, it would be advantageous to encourage the board of directors of the OFC to be located in Hong Kong.

167. A few respondents expressed concern about the tainting provisions under section 20AC(3) of the IRO. They suggested that the sub-funds should not taint the tax exemption status of other sub-funds which are able to fulfil all the exemption conditions. They further proposed that in case a sub-fund invested in both "specified" and "non-specified" transactions, only the Hong Kong sourced profits from "non-specified" transactions should be subject to tax.

Our response

168. In view of supportive views received, we will proceed with the proposal that publicly offered OFCs, irrespective of the locality of their CMC, as well as privately offered OFCs with CMC located outside Hong Kong should be exempt from profits tax.

169. On par with the profits tax treatment for onshore privately offered funds under the existing tax exemption regime, onshore privately offered OFCs will be subject to profits tax. We nonetheless recognize that tax treatment is usually one of the main considerations influencing the decision of fund managers on the jurisdiction where the fund is domiciled and managed. On the other hand, we are aware that exempting onshore privately offered OFCs may give rise to concerns for tax avoidance, notwithstanding such OFCs will be domiciled in Hong Kong. We need to be mindful of possible adverse Base Erosion and Profits Shifting ("BEPS")[3] implications and the effectiveness of any safeguards to avoid such tax incentive being labelled as a harmful tax practice under the BEPS action plan. More time is needed for engagement with the industry and a critical review of the necessary safeguards to plug possible loopholes for abuse. As such, any necessary amendments for any further profits tax exemption will be taken forward in a separate exercise.

[3] BEPS refers to tax planning strategies that exploit the gaps and mismatches in tax rules (which may exist among economies) to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. The final BEPS package released by the Organisation for Economic Co-operation and Development in October 2015 seeks to ensure multinational corporations paying a fair share of taxes, realign taxation with economic activities, and standardize international tax rules to eliminate double non-taxation.

170. Regarding some respondents' concern about tainting provisions under section 20AC(3) of the IRO, we will consider carefully and thoroughly whether or not the requirements should be relaxed as there will be revenue implications.

Stamp duty treatment for OFCs

171. We proposed in the Consultation Paper that, for stamp duty purposes, allotment, transfers and surrenders of shares in OFCs or units in unit trusts might be treated in the same way, since shares in OFCs and units in unit trusts were similar in nature (they could be reissued after redemption or extinguishment).

Respondents' views

172. We have received divergent views on this proposal. Some respondents agreed that shares in OFCs and units under unit trust schemes should be treated alike for stamp duty purposes, whilst others proposed that transfers of shares in OFCs should be exempt from stamp duty in order to make the OFC regime more attractive.

173. One respondent asked whether the existing stamp duty treatments for a gift of Hong Kong stock or a transfer of such stock with no change of beneficial interest would apply to shares in OFCs. Another respondent commented that the stamp duty remission for the delivery of Hong Kong stocks as consideration for allotment and redemption of CIS should be available to the OFCs authorized under section 104 of the SFO.

Our response

174. Shares in OFCs fall within the definition of Hong Kong stock under section 2 of the Stamp Duty Ordinance (Chapter 117) ("SDO"). Thus in general, the existing stamp duty treatments for Hong Kong stock should apply to shares in OFCs.

175. OFC is to be introduced as a neutral platform for open-ended investment funds to complement the existing unit trust structure. Currently, transfers of units under exchange-traded funds or ETFs (being listed unit trust schemes) are not subject to stamp duty. For non-listed unit trust schemes, transfers of their units are usually effected by way of allotment and redemption, which are also exempt from stamp duty[4]. As such, we consider it not necessary to waive stamp duty for transfers of OFC shares. In view of the support

[4] Under sections 19(16) of the SDO, "sales or purchase" is defined to exclude allotment. By virtue of section 19(1A)(a) of the SDO, a sale or purchase of units under a unit trust scheme is exempt from stamp duty if the sale or purchase is effected by extinguishment.

received, we maintain our proposal that shares in OFCs should be accorded with the same stamp duty treatment as that for units under unit trust schemes.

176. Units or shares of CIS may be allotted or redeemed by means of in-kind allotment and redemption, i.e. transfers of underlying assets by investors to the CIS for an allotment of the CIS units or shares, and by the CIS to the investor for the redemption of such units or shares. Currently, the stamp duty payable on the aforesaid transfer of underlying assets (which are Hong Kong stocks) is remitted under section 52 of the SDO if the CIS is authorized by the SFC. As OFCs will be CISs, we agree that similar relief should be provided for the in-kind allotment and redemption of shares in OFCs.

Tax filing arrangement

177. We proposed in the Consultation Paper that since OFC was an investment fund vehicle taking a corporate form, OFCs should be required to register for business under the Business Registration Ordinance (Chapter 310) ("BRO") and complete tax returns to report income accrued to employees and profits whether fully or partially exempt from profits tax.

Respondents' views

178. A majority of the respondents did not object to the proposed tax filing arrangement and business registration requirement.

179. Those respondents who did not support the proposal took the view that the proposed tax filing arrangement would create additional administrative burden on the industry. They queried the need of tax filing by the OFC as unit trusts and offshore funds were not required to file tax returns. One respondent pointed out that Cayman Islands funds could apply for a tax exemption certificate from the Cayman Islands' government and were not required to file tax returns. Suggestions included an automatic exemption from filing profits tax returns by publicly offered OFCs and dispensing with annual tax filing by the OFCs which were fully exempted from Hong Kong profits tax without changing their taxation position in Hong Kong from year to year. A few respondents recommended that in the first year, a "nil" return should be filed with a simple declaration that the OFC satisfied the conditions for tax exemption; as well as an undertaking that the OFC would inform the IRD within 4 months of the end of a year of assessment if it did not subsequently meet the tax exemption conditions. In respect of a private OFC with umbrella fund structure, a few respondents suggested that each sub-fund should separately file a profits tax return.

180. One respondent who disagreed with the proposed business registration requirement took the view that an OFC as an investment fund vehicle was not designed to operate as a corporate entity for the purposes of general commercial business, trade or other uses. Another respondent considered that the requirement to register for business under the BRO was unduly burdensome, unless it would be an automatic application that was triggered at the time the OFC was incorporated.

Our response

181. We note that a majority of the respondents did not object to the proposal that OFCs should be required to register for business under the BRO and to complete tax returns with same obligations currently imposed on corporations, partnerships, trustees of trust estate and any other entities under the IRO.

182. To address a few respondents' concern about additional administrative burden on business registration, as mentioned in paragraph 91 above, we will extend the existing one-stop company incorporation and business registration regime to OFCs with a view to simplifying the registration process.

183. We wish to clarify that unit trusts chargeable to profits tax need to file tax returns each year. If an entity is exempt from profits tax or is in a loss position, the IRD may not require the entity to complete a tax return each year.

184. As mentioned in the Consultation Paper, an OFC may be created as an umbrella fund without having to register each of its sub-funds separately with the SFC. Under the proposal, an umbrella fund which is an OFC must register for business under the BRO, but each sub-fund is not required to obtain its own business registration. It will not be practical that each sub-fund separately files its profits tax return. For tax purpose, an umbrella fund needs to file profits tax returns to report consolidated profits of the whole fund.

F. Way Forward

185. Having regard to the general support received and taking into account the modifications as noted above, we aim to introduce into the Legislative Council a bill to amend the SFO in January 2016. We will continue to engage the relevant stakeholders in the process.

186. The SFC will conduct a separate public consultation on the draft OFC Rules and the OFC Code setting out more detailed operational requirements of the OFC regime.

187. We would like to take this opportunity to thank all respondents who sent in submissions for their time, effort and contribution.

Annex

List of Respondents

1. Alternative Investment Management Association
2. Ms Au Bo Shan, Jenny
3. Baker & McKenzie
4. Clifford Chance
5. CompliancePlus Consulting Limited
6. Deacons
7. Deloitte Touche Tohmatsu
8. Ernst & Young
9. Eversheds LLP
10. Hong Kong General Chamber of Commerce
11. Hong Kong Institute of Certified Public Accountants
12. Hong Kong Institute of Chartered Secretaries
13. Hong Kong Investment Funds Association
14. Hong Kong Securities Association
15. Hong Kong Trustees' Association
16. Hong Kong Venture Capital and Private Equity Association
17. International Chamber of Commerce
18. KPMG
19. Liberal Party
20. PricewaterhouseCoopers
21. State Street Trust (HK) Limited
22. The Hong Kong Association of Banks
23. The Hong Kong Institute of Directors
24. The Hong Kong Society of Financial Analysts
25. The Law Society of Hong Kong
26. Timothy Loh Solicitors
27. Vanguard Investments Hong Kong Limited