

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

Submission to the SFC Consultation Paper on the Securities and Futures (Open-ended Fund Companies) Rules and Code on Open-ended Fund Companies

Josephine Chung
Director, CompliancePlus Consulting Limited

August 2017

**For enquiries on this submission, please contact Josephine Chung at jchung@complianceplus.hk.
CompliancePlus Consulting Limited understands and agrees that our name and/ or submission may be published to the public.**

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

Introduction

This submission responds to the questions raised by the Consultation Paper (“the Consultation Paper”) issued by the Securities and Futures Commission on the rules and code governing open-ended fund companies (“OFC”).

Unless stated the otherwise, terms used in this submission are same as those terms as defined in the Consultation Paper.

Consultation Questions

- 1. Do you have any comments on the suggested one-stop process for the establishment of an OFC? Please explain your view.*

In general, we agree with the suggested one-stop process as it simplifies the procedure, hence increasing efficiency. Coordination problems and conflicting decisions between the SFC and CR may also be avoided. However, we are concerned about SFC’s resource availability. Therefore, we suggest that the SFC should carefully consider the amount of workload that would result from this arrangement.

We suggest the SFC to set a reasonable performance pledge and to align the process with the revamped fund authorization process as stated in the “Circular to management companies of SFC-authorized unit trusts and mutual funds - Launch of pilot revamped fund authorization process” dated 9th October 2015.

- 2. With regards to the suggested factors as to whether a proposed OFC name is “misleading or otherwise undesirable”, are there other factors which you think should be taken into account? Please explain your view.*

We think that the factor that restricts the similarity of the OFC names should be extended to include other types of institutions like banks and unit trust. Additionally, we suggest that the naming requirement, as stated in Para 7.24 of Code on Unit Trusts and Mutual Funds, to be applied to OFC as well.

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

This would give a concrete guideline when naming OFCs, where at least 70% of relevant assets should be invested according to its objective, geographic region or market as stated in the OFC name.

3. *Do you have any views on the proposals regarding the instrument of incorporation and the legal capacity of an OFC?*

We believe that codes on scheme changes, Chapter 12 of Code on Open-ended Fund Companies, should mirror Para 6.7 of Code on Unit Trusts and Mutual Funds. However, Para 6.7 of Code on Unit Trusts and Mutual Funds states that constitutive changes may be altered without consulting holders, whereas Para 12.4 of Code on Open-ended Fund Companies states that reasonable notification should be provided to shareholders, without clearly stating whether consulting them is obligatory.

In addition, Para 12.3 and 12.4 Code on Open-ended Fund Companies should be governed in accordance to the relevant requirements as stated in the memorandum and articles of association. We agree with the proposal that material changes need to be approved by shareholders.

4. *What are your views on the proposed General Principles in the draft OFC Code as outlined above? Are there any other areas which you think the General Principles should cover?*

We agree with the seven General Principles proposed.

5. *Do you have any comments on the proposed requirements as to the eligibility, appointment and removal, and duties of the key operators of an OFC? Please explain your view.*

We agree with the proposal regarding key operators of an OFC in general. However, 5.2 of the proposed OFC code requires at least one independent director for the OFC board whilst the Code on Unit Trusts and Mutual Funds does not require the same.

The definition of “independent director” that must not be a director or employee of

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

custodian may create confusion. The industry may be confused that whether director or employee of other service providers to the fund such as auditor or administrator should be approved or not. The SFC should consider not implementing this requirement till the SFC provides a clear and complete definition of “independent director” to the industry.

We also express our concerns regarding the filling process in the case of change of directors as stated in Para 52 in this consultation paper. Please refer to Question 8 for our comments.

6. *What are your views on the proposed persons and entities which may serve as the process agent of an overseas director and overseas custodian of an OFC?*

This increases the flexibility for an OFC to appoint overseas director and overseas custodian, which may increase Hong Kong’s competitiveness in the international asset management arena. We also agree with the proposed persons and entities which may serve as process agents.

7. *Do you have any views on the proposals concerning the shares, meetings and resolutions of an OFC discussed above?*

We agree with the proposal to a large extent. However, we do not agree that the annual general meeting would be optional. This would be inconsistent with the existing regime that it is compulsory for mutual funds and REITs to hold general meeting (see paragraph 9.9 of the Code on REITs and paragraph 6.15 of the Code on Unit Trusts and Mutual Funds).

8. *Do you agree with the proposed approach with regards to the filings with the CR? Please explain your view.*

Although we agree that the proposed one-stop approach can simplify the filing procedure, we are concerned about the confusion caused by arbitrarily dividing filings into two types.

For instance, it is palpable that while notice of appointment director has to be

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

submitted to the SFC, notice of cessation of director or change of particulars of directors is directly submitted to CR only. In case of termination of directors, SFC might need to raise questions as to the OFC's sustainability and any corporate governance issues of the OFC. We suggest that there should be dual filings for documents directly submitted to the CR and the SFC. In this way, SFC can keep record of all relevant matters.

9. *Do you have any views on the proposed eligibility, appointment and removal, and rights and powers of the auditors in the draft OFC Rules?*

We agree with the proposal.

10. *Do you agree with the proposed requirements regarding the financial reports of an OFC? Please explain your view.*

We agree with the proposal. Nevertheless, privately offered OFCs should not be subject to the requirement of preparing semi-annual or annual audited accounts, otherwise it would be inconsistent with the current regime (see paragraph 5.17 of the Code on Unit Trusts and Mutual Funds), where only publicly offered OFCs should be subject to the Code on Unit Trusts and Mutual Funds.

11. *Do you have any comments on the proposed provisions for the segregated liability of sub-funds and cross sub-fund investments? Please explain your view.*

We agree that the protected cell regime is important in limiting the potential contagion risk for investors by segregating the assets and liabilities of each sub-fund. However, it is uncertain whether foreign jurisdictions would recognize the legal enforcement of such segregation. The proposal has rightly required the offering documents of the OFC to include a warning to investors that the protected cells might not be recognized in foreign courts.

12. *Do you have any comments on the proposed draft OFC Rules regarding arrangements and compromises? Please explain your view.*

We agree with the proposal.

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

13. What are your views on the proposed requirements and steps for termination by application to the SFC?

The requirements and procedures have generally demonstrated adequate shareholders' protection. We agree with the proposal.

14. Do you agree with the proposed approach to applying the C(WUMP)O's winding up regime to OFCs and the modifications suggested in the draft OFC Rules when applying the winding-up regime? Are there any other modifications which you think should be included? Please explain your view.

The proposal adopted the C(WUMP)O on a wholesale basis. Under the current insolvency law regime under the C(WUMP)O, there is no formal procedures for corporate rescue and restructure. The public has been long awaiting an answer following FSTB's public consultation on the review of corporate rescue procedure legislative proposals in 2009.

http://www.fstb.gov.hk/fsb/ppr/consult/doc/review_crplp_conclusions_e.pdf.

Considering that winding up of OFCs would be a lose-lose situation for all stakeholders, including creditors, board of directors and shareholders, the SFC should consider this an opportunity to introduce formal corporate rescue procedures, including a statutory moratorium to provide OFCs a breathing space to come up with corporate rescue plans. We expect SFC to demonstrate more bravery and vision in the modifications to applying the winding-up regime.

Since that the nature and supervision of OFCs are fundamentally different from traditional limited companies, the SFC should take initiatives in formulating a formal corporate rescue regime for OFCs.

15. Do you have any comments on the wording in the proposed OFC Code in respect of the investment scope of private OFCs? Please explain your view.

We strongly disagree with the stringent restrictions on investment scope of private OFCs. Private funds have great flexibility and freedom in formulating their investment portfolio under the current regulatory framework. They are primarily subject to the

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

Fund Manager Code of Conduct and the Code of Conduct for Persons Licensed by or Registered with the SFC.

SFC's role is to monitor the regulated activities but not intervene in investment strategies. It is important to draw a distinction between privately offered OFCs and publicly offered OFCs. While publicly offered OFCs should comply with more stringent rules, private OFCs should have flexibility to pursue their investment strategies, which is recognized in the proposal itself. The requirement set out in para. 108(a) of the proposal is too restrictive that it will discourage establishing private OFCs in Hong Kong. This would also severely and unnecessarily limit the variety of products available to investors.

We suggest relaxing the current restriction by raising the de minimis limit from 10% to 30%. That means only 70% of the OFC's gross asset value should consist of asset types designated under para. 108(a). If this suggestion is accepted by the SFC, 11.2-11.4 of the proposed OFC Code should be amended accordingly. Otherwise, we can see no reason why a private fund would opt to domicile in Hong Kong and operate as an OFC.

16. Do you agree with the proposed approach and basic requirements concerning fund operations and disclosure by a private OFC? Do you think that there are other requirements that should be included in the proposed OFC Code? Please explain your view.

We agree with the proposed approach and requirements. We believe that the proposed requirements are sufficient for investors to understand the operation and particulars of the OFC, so no other additional requirements are needed.

17. Do you have any views on the proposed approach to the different types of scheme changes of a private OFC?

We disagree with the requirement of approval by SFC for the material scheme changes of a private OFC.

Scheme changes should not require SFC approval as it is company's internal affairs.

CompliancePlus Consulting

Compliance Consulting • Funds Consulting
Regulatory Consulting • Compliance Training

Insofar as shareholders' approval is obtained as per the procedures set out in the OFC's instrument of incorporation and in compliance with the laws and regulations applicable from time to time, the SFC should not intervene.

Notification for such material scheme changes would suffice for SFC to perform its role as a regulator. In any case, the investment managers of a private OFC must also comply with all relevant conduct requirements and the Fund Manager Code of Conduct as a Type 9 licensed corporation.

In addition, we take note of Para 114 of the Consultation Paper about the SFC streamlined approval approach for private OFC. We are, however, concerned that this streamlined approval approach is not stated or included in the Chapter 12 of the OFC Code that it should be included as a record.

Conclusion

Whilst noting that public OFC is required to comply with the Code on Unit Trusts and Mutual Trusts, we suggest that SFC should provide a comparison table regarding the difference between the OFC code and the Code on Unit Trusts and Mutual Funds so that interested parties can make an informed decision and the SFC can close any gaps in order to avoid the industry to engage in "regulatory arbitrage" on this area.

Also, in light of the complexity and novelty of OFCs, SFC should be prepared to provide more workshops and FAQ for applicants to decide they will opt for OFC structure.

Since the introduction of OFC and the proposed one-stop process will likely increase SFC's workload, we are concerned about the SFC's resources to handle fund authorization and registration given SFC's resource constraint. We suggest that SFC should make performance pledge as it is important for applicants to know in advance the processing time of application.

Last but not least, the consultation period is too short to collect feedback from the relevant industries. In consideration of summer holiday when many are out of town, the 2 months consultation period should at least be extended to 3 months.

-END-