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Submission to Open-Ended Fund Companies Consultation Paper issued by Financial Services and the Treasury Bureau

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Introduction

This submission responds to questions raised by the Consultation Paper ("the Consultation Paper") issued by the Financial Services and the Treasury Bureau (the Bureau) to introduce a new open-ended fund company ("OFC") structure to expand Hong Kong's legal structure for investment fund vehicles.

Scope of the Consultation Paper

Consultation Questions

Question 1: Do you agree with the overarching principles for OFCs?

We agree with the overarching principles suggested by the Bureau. In particular, we agree that a distinction must be drawn between publicly offered OFCs and privately offered OFCs. The Bureau has rightly suggested that the latter should be given more flexibility.

Nevertheless, we must point out that the introduction of OFCs in Hong Kong is long overdue and we urge the Bureau to be more proactive in creating an enabling business environment. This is especially so when the United Kingdom, the United States and the Cayman Islands have already introduced similar corporate structures before we do so.

Question 2: Do you consider it agreeable to set out the legislative framework for OFC in the SFO and the relevant subsidiary legislation in the proposed manner?

We agree with the proposal, since it is easier to amend the relevant subsidiary legislation should the need arise. We only wish to point out that in light of the existing section 399 of the SFO (which gives the SFC the power to issue codes and guidelines), it may not be necessary to specify the SFC's power to make OFC codes and guidelines in the amendment legislation.

Question 3: Do you think the proposed scope of the code and guidelines could adequately cater for the OFC regime? If not, what other essential features should the codes and guidelines include?

We agree with the proposed scope of the code and guidelines. We however stress that the core requirements should be specified in the amended SFO or the relevant subsidiary legislation rather than the guidelines. This is particularly so when the guidelines may not be directly applied by the courts in legal proceedings: see section 399(6) SFO.

We agree that publicly offered OFCs (but not privately offered OFCs) should be subject to the SFC Handbook. As paragraph 3.2 of the Code on Unit Trusts and Mutual Funds states:

> *""Collective investment scheme" or "scheme" means collective investment schemes commonly regarded as mutual funds (**whether they appear in the legal forms of contractual model, companies with variable capital or otherwise**) and unit trusts as are contemplated in this UT Code."* (Emphasis added)

For the avoidance of doubt, the Code on Unit Trusts and Mutual Funds should clearly states that publicly offered OFCs seeking authorization will also be covered by the Code.

Question 4: Do you agree with the proposal that the SFC should be the primary regulator of OFCs?

In principle we agree that the SFC should be the primary regulator, since OFCs are primarily used for investment purposes.

Nevertheless, we are concerned that the SFC may not have sufficient resources to regulate OFCs. As a matter of fact, the SFC has been criticized for its low response time.

The SFC's efficiency is the subject of criticism in the Process Review Panel for the SFC's 2012-2013 Annual Report. The report pointed out that it takes the SFC more than 1 year to authorize investment products. The SFC explained that longer time would be required for new or "one of the kind" products. We are concerned that in light of the complexity and novelty of OFCs, the SFC would need even more time to approve the establishment of OFCs.

The SFC should consider the recommendations provided by the Process Review Panel in the report (such as holding meetings with market practitioners so that the market will understand the SFC's expectation) and should have sufficient resources including staffing to handle related OFCs applications in the future.

Question 5: Do you agree with the proposed role and functions of CR in the OFC regime?

We agree with the proposal subject to the following two comments. Firstly, there should be closer communication and cooperation between the SFC and the CR in order to protect investors' interests effectively. Secondly, we note that the Bureau suggests that the CR should incorporate the OFCs once the SFC has given its approval-in-principle. There is not much discussion in the Consultation Paper on what "approval-in-principle" means. Please see our reply in Question 11 below about the potential uncertainty to investors that may arise from the approval process required from both the CR and the SFC.

Question 6: Do you agree with the proposed role of ORO and SFC in respect of proposed termination and winding up arrangements for OFCs?

There can be some overlap in the work of ORO and SFC. For example, what if in the course of liquidation the ORO discovers some misconduct on the part of the directors or managers, which may give rise to civil claims and regulatory enforcement actions (under the Bureau's proposal, the OFCs should be managed by SFC licensees, and the directors are subject to fiduciary duties)? Can the evidence obtained by the liquidators be used by the SFC in its enforcement actions? We note that extensive powers are given to the liquidators under the CO and the C(WUMP)O, and in the past difficult legal questions arose as to whether evidence obtained by the

liquidators is admissible (since the investigatory powers given to the liquidators can conflict with the directors' right against self-incrimination). We also note that the SFC's disciplinary action is not criminal in nature, adding to the complexity of this issue. The legislation should clearly specify whether the ORO can refer any alleged breach and the relevant evidence to the SFC.

Question 7: Do you think the proposed features comprise the essential features of an OFC? If not, what other essential features should an OFC possess?

We agree with the role of the Board of Directors and the need to appoint custodian. We also agree that the investment function can be delegated to the investment managers. We however disagree with the mandatory requirement that the managers must be SFC-licensed.

We believe that the investment function can be delegated to offshore managers. This is in line with the existing practice prescribed by the Code on Unit Trusts and Mutual Funds. Firstly, schemes authorized in recognized jurisdictions can be reviewed by the SFC on the basis that certain requirements are automatically satisfied by virtue of the overseas authorization: see paragraph 1.2 of the Code. More importantly, with regard to the appointment of a management company, the note to paragraph 5.1 reads:

> *"The investment management operations of a fund management company or those of the investment adviser (where the latter has been delegated the investment management function) should be based in a jurisdiction with an inspection regime acceptable to the Commission. A list of acceptable inspection regimes is published on the Commission's website. The Commission will consider other jurisdictions on their merits and may accept an undertaking from the management company that the books and records in relation to its management of a scheme will be made available for inspection by the Commission on request."*

Therefore, under the existing regime the management function can be delegated to overseas managers. We therefore take the view that OFCs should be allowed to do so too.

Question 8: Do you agree with the proposed features for the Board of Directors? Do you think the proposed structure of the Board and the proposed criteria of directors will be able to render adequate investor protection to those investing in OFCs? Or do you think the proposed structure is too onerous, and would hinder the development of OFCs in Hong Kong?

We agree with the proposal to a large extent. There are however two issues that require clarification.

The first is whether the manager (or members of the management company) can also be a director of the OFC.

The second is specific to privately offered funds such as hedge funds. It is very common for hedge funds to enter into "side letter" arrangement with important investors, pursuant to which the investors can invest in the funds on favorable terms. Hedge funds adopting the OFC vehicle will presumably allow such investors to subscribe to its shares at a cheaper price. Two issues arise. The first is whether such arrangement amounts to a breach of fiduciary duties (since arguably the existing shareholders' rights are diluted). Secondly, under sections 140 and 141 of the CO, such non-pro-rata allotment is impossible without the approval of the shareholders (by an ordinary resolution). To overcome this difficulty the SFC may consider allowing OFC to conduct non-pro-rata allotment without shareholders' approval.

Question 9: Do you agree that the OFC board must delegate the day-to-day management and investment functions 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?

As discussed above, we disagree with the suggestion that the functions can only be delegated to SFC licensees. We stress once again that under the existing regime prescribed by the Code on Unit Trusts and Mutual Funds, the collective investment schemes are entitled to appoint overseas management companies. We are of the view that an OFC should also be allowed to do so.

Question 10: Do you think the proposal to require a custodian in the OFC structure could foster the protection of investors in an OFC? Do you consider the proposed requirements and duties for a custodian adequate to meet this objective?

We agree with the proposal.

Question 11: Do you agree with the proposed arrangements in relation to the incorporation of OFC?

We believe that the proposed arrangements are impracticable on the following grounds.

Firstly, as discussed above the SFC's efficiency has been the subject of criticism. If it takes more than a year to authorize a product, it is likely that the SFC also has to spend considerable time to review an OFC application. Business efficiency will be greatly reduced.

Secondly, we have already examined the ambiguous term "approval-in-principle". We stress that the SFC must be able to give firm rather than conditional approval to applicants. Otherwise, the OFC has to be terminated upon non-fulfillment of the conditions. Considerable resources would also be wasted if the applicants are unable to secure firm approval. This will give rise to a business uncertainty that is not in the interest of Hong Kong to become a leading financial centre in the Region.

Lastly and most importantly, we have emphasized (in our answer to question 1) the importance of distinguishing privately offered OFC from public offered OFC. This distinction is accepted by the Bureau: the Bureau expressly states that more flexibility should be given to privately offered OFC. The Bureau is also right in recognizing that section 104 of the SFO and the SFC Handbook would not apply to privately offered OFC, since no authorization is required.

Unfortunately, the proposed arrangements fail to give weight to this principle, in that both publicly and privately offered OFCs have to be approved by the SFC. We

find this not in line with current practice that private hedge fund can complete incorporation process without the need to obtain prior approval from the SFC.

Under the existing regime privately offered funds (such as hedge funds) do not require SFC authorization. These funds are essentially given "a free hand" in their investment choices. In contrast, under the proposed regime privately offered OFCs have to be approved by the SFC. This means that privately offered OFCs suffer a disadvantage. Privately offered funds are in effect discouraged from adopting the OFC structure. We believe that the proposed arrangement defeats the legislative intention of the Bureau and must be rejected.

We hope the Bureau can clarify this point on the position about privately offered funds.

Question 12: Do you consider the proposed naming convention provides sufficient level of clarity to investors?

While we agree that non-OFC should not be allowed to mislead the public into thinking that it is an OFC, we do not think that the SFC should have the power to decide whether a company can use the term "OFC" as the term "OFC" is very common and can widely or easily be used in other industries such as catering and retail business.

We believe that the existing approach, pursuant to which the CR is given the power to reject undesirable names, is sufficient: see section 100 of the CO. We are of the view that section 100 allows the CR to reject the use of "OFC" if it gives the public the false impression that the applicant is an OFC. There is therefore no need to give SFC any additional power as this will cause unnecessary inconvenience to other industries in Hong Kong.

Question 13: Do you agree that the proposed Articles are adequate? What features should the Articles include?

We doubt if there is a need to specify the "investment scope" in the articles. We agree that OFCs should only invest in financial instruments (as opposed to real assets

such as real estates), but we do not think that the investment strategies have to be "set in stone". If the investment scope is specified in the articles it would be extremely difficult for the OFCs to adopt an alternative approach: it requires a 75% special resolution to amend the articles. We think that the proposal limits the investment choices of the OFCs.

Question 14: Do you consider the proposed investment scope and strategies could provide a competitive framework for OFCs in Hong Kong with sufficient safeguards for investor protection?

We strongly disagree with this proposal.

Firstly, we disagree with the suggestion that OFCs can only invest in securities and futures. Funds nowadays invest in a variety of asset classes. Indeed, the SFC recognizes this trend when it proposed to allow REITs to invest in the financial market earlier this year.

For publicly offered OFCs, we are of the view that compliance with Chapter 7 of the Code on Unit Trusts and Mutual Funds should be sufficient (and also Chapter 8 of the Code for specialized schemes). Otherwise, publicly offered OFCs would suffer a disadvantage in that they (unlike publicly offered unit trusts) have fewer investment choices. This again defeats the legislative purpose of encouraging the use of the OFC structure.

Secondly, for privately offered OFCs, once again we stress that a distinction must be drawn between privately offered OFCs and publicly offered OFCs. Privately offered funds require flexibility. If OFCs can only invest in the asset classes the Bureau mentions in the Consultation Paper, privately offered funds would probably avoid using the OFC structure.

The Bureau argues that the investment scope limitation facilitates the SFC to regulate the investment companies. This argument cannot bear close scrutiny. Under the existing regime privately offered funds require no SFC authorization, yet their managers are still SFC-regulated (via the Code of Conduct for Persons Licensed by or Registered with the SFC). The fact that the funds are not authorized does not

cause the SFC any difficulty in regulating the managers. We therefore urge the Bureau to abolish the investment scope limitation.

Question 15: Do you agree with the proposed arrangements in relation to the offer of OFC shares?

We agree that publicly offered OFCs must be SFC-approved under s.105 SFO and the SFC Handbook. We also agree that privately offered OFCs should not be required to have the private placement memorandum authorized. This is in line with the existing approach.

The Bureau should also clarify what "privately offered" actually means. Is the Bureau referring to the exception in section 103(3) of the SFO? Or is the Bureau having Schedule 17 of the old CO (Cap. 32) in mind?

Question 16: Do you agree with the proposed arrangements regarding corporate administration?

We disagree with the suggestion that the annual general meeting would be optional. This is inconsistent with the existing regime, pursuant to which mutual funds and REITs are required 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). The proposal is not in the interest of investors.

An alternative is to adopt section 613 of the new CO (i.e. Cap 622), pursuant to which the shareholders can dispense with annual general meeting by a unanimous resolution.

The Bureau also suggests that all (i.e. both publicly and privately offered) OFCs must prepare annual audited accounts. While authorized funds are required to prepare audited accounts (see paragraph 5.17 of the Code on Unit Trusts and Mutual Funds) under the existing regime, there is no such requirement for privately offered funds. Again, we urge the Bureau to respect the distinction between privately and publicly offered OFCs.

Question 17: Do you agree with the proposed arrangements in relation to fund operation? Are the proposed principles and arrangements adequate to cater for the practical operation for OFCs?

We agree with the proposal in principle. We note that the valuation method proposed by the Bureau is in line with the existing regime prescribed by paragraph 6.11 of the Code on Unit Trusts and Mutual Funds. We stress that the "open-endedness" of the OFCs must be clearly specified in the articles, and the legislation should ensure that the articles of the OFCs contain an article allowing shareholders to redeem their shares.

The offer documents should not contain onerous terms which practically deter shareholders from redeeming their shares. In fact, disclosure in the offer documents cannot absorb the OFCs from liabilities for breaches of the articles. This should be made clear by the legislation.

The SFC should issue guidelines on what amounts to onerous terms. For example, is it possible for privately offered funds to have fewer dealing days (compare the minimum "one day per month" requirement in paragraph 6.13 of the Code on Unit Trusts and Mutual Funds)? What is the acceptable time interval between a written request and payment (compare the one month requirement in paragraph 6.14 of the Code)? Since the "open-endedness" is the gist of an OFC, detailed guidance is required.

Question 18: Do you agree with the proposed arrangements in relation to protected cells?

We agree that the OFCs should be able to adopt the cell structure to segregate assets of one sub-fund from that of another. We suggest that the OFCs intending to adopt the cell structure should specify its intention in their articles. OFCs not specifying its intention in the articles should be able to adopt the cell structure if they amend the articles (via a 75% shareholders' special resolution).

Three issues deserve closer attention. The first issue relates to the OFC's ability to issue shares representing the different sub-funds. This means that an OFC

adopting the cell structure would probably have multiple share classes (for different sub-funds).

The second issue relates to "common assets". It is likely that some assets held by the OFCs are not directly attributable to its sub-funds, and there may be a need to "apportion" these common assets for the purpose of deciding the available assets of each sub-fund in case of the sub-funds' insolvency. To this end, the United Kingdom's Open-Ended Investment Companies (Amendment) Regulations 2011 inserts regulation 11A to the Open-Ended Investment Companies Regulations, which provides that:

> *(4) An umbrella company may allocate any assets or liabilities which —*
> *(a)it receives or incurs on behalf of its sub-funds or in order to enable the operation of the sub-funds; and .*
> *(b)are not attributable to any particular sub-fund, .*
> *between its sub-funds in a manner which it considers is fair to shareholders.*

The Bureau should clarify the treatment as to these common assets, and what treatment "is fair to shareholders".

The third issue is the sub-funds' ability to invest in other sub-funds within the same OFC. This is allowed under regulation 11B of the Open-Ended Investment Companies Regulations, inserted by the United Kingdom's Open-Ended Investment Companies (Amendment) Regulations 2011:

> *Notwithstanding section 658 of the Companies Act 2006(b) and any rule of law which prohibits or restricts a company from acquiring its own shares, an umbrella company may, for the account of any of its sub-funds, and in accordance with FSA rules, acquire by subscription or transfer for consideration, shares of any class or classes, however described, representing other sub-funds of the same umbrella company.*

The Bureau should also clarify this issue.

Question 19: Do you think the proposed termination procedures are adequate to provide an expedient way for terminating a solvent OFC?

Three issues arise. The first is whether the procedure applies to the sub-funds. In other words, is it legally possible to terminate a solvent sub-fund? Does the termination require SFC's approval?

We also question the need for SFC's approval. Termination is to a large extent a commercial decision. Moreover, creditors and shareholders will (presumably) look after their interests and irregularities (if any) would not escape their attention. Once again we refer to the SFC's lack of resources as discussed above.

Thirdly, what if, in the course of termination, it turns out that the OFC is insolvent? The Bureau should clarify whether the court or the creditors can take over the termination.

Question 20: Do you have any comments on the proposed termination, winding up and dissolution arrangements for OFCs, including the proposed power to be given to the custodian to petition to the court to wind up an OFC?

In respect of members' voluntary winding-up, once again we disagree with the requirement of SFC's approval. In voluntary winding-up the OFCs possess sufficient assets to pay off the creditors. If the shareholders decide to wind up the OFCs the SFC should not be given a de facto veto power.

While we agree that the SFC should be able to petition to the court to wind up the OFC, the Bureau should explain the grounds on which the SFC is able to do so. Those grounds should be clearly and narrowly defined.

We note that in the United Kingdom the depositary is given the power to petition to the court (by virtue of regulation 31(2) of the Open-Ended Investment Companies Regulations) and we agree with the Bureau's proposal.

Question 21: Do you consider the proposed powers are essential and proportionate?

We agree with the proposal save that once again we emphasize that OFCs should be allowed to delegate the investment and management functions to offshore managers.

Question 22: Do you think the existing profits tax exemption regimes for public funds authorized under section 104 of the SFO / bona fide widely held regulated funds and offshore funds are adequate to cater for OFCs?

We are of the view that the existing section 26A(1A) of the Inland Revenue Ordinance can cover the new OFCs.

The section covers "a mutual fund, unit trust or similar investment scheme that is authorized". This phrase has been interpreted by the Inland Revenue Department in its Department Interpretation and Practice Notes No.20 ("DIPN 20"). The DIPN refers to the definition of "mutual fund" in section 26A(2), which covers "any arrangement made for the purpose, or having the effect, of providing facilities for investment in shares in a corporation which is or hold itself out as being engaged primarily in the business of investing, reinvesting or trading in securities and which is offering for sale or has outstanding any redeemable shares of which it is the issuer". "Arrangement" is in turn defined in section 2 as:

> *arrangement (安排) includes-*
> *(a) any agreement, arrangement, understanding, promise or undertaking, whether express or implied, and whether or not enforceable or intended to be enforceable, by legal proceedings; and*
> *(b) any scheme, plan, proposal, action or course of action or course of conduct*

It seems that an OFC is an "arrangement" within the meaning of section 2.

In any event, the concept of "similar investment scheme" in section 26A can cover the OFC. DIPN 20 states:

> *The reference to "similar investment scheme" in section 26A(1A) is intended primarily to cater for investment arrangements established under civil law which are in substance the same as unit trusts or mutual funds which fall within the*

scope of section 26A(1A), but have a different legal form (e.g. a "Fond Commun D' Placement" which is essentially a contractual mutual fund, although not incorporated or established under trust). To be a qualified scheme, among others, the investors concerned should have no control over the management of the funds they have invested in the scheme (other than indirectly by being able to exercise voting rights in relation to the appointment of fund managers).

It seems that an OFC is a "similar investment scheme" since the investors have no control over the management of the funds. Thus, we are of the view that the exemption covers OFCs.

Question 23: Do you consider that the proposed stamp duty treatment on sale and transfer of shares in OFCs can cater for the market needs?

We will deal with the allotment, transfer and redemption of OFC shares respectively.

For allotment, we understand that an allotment is not a "sale and purchase" within the meaning of section 19(16) of the Stamp Duty Ordinance. Thus, allotment of shares or unit trusts is not subject to stamp duty. We agree that allotment of OFC shares should likewise be exempted.

For transfer, we understand that a transfer of shares for valuable consideration is subject to stamp duty. A contract note is required under section 19 and the contract note must be endorsed on the share transfer. We agree that this treatment should apply to OFC shares.

For redemption, we also agree that only a $5 fixed duty is chargeable.

We wish to raise two issues relating to voluntary disposition and nomination. Under the existing regime, a gift of shares is subject to stamp duty under section 27 (under head 2(3), amounting to 0.2% of the value of the shares plus $5). The Bureau should clarify if this applies to a gift of OFC shares.

For nomination, we understand that a declaration of trust is not a chargeable instrument. Section 27(5) also exempts transactions involving no change of beneficial ownership. In other words, if the owner sets up a nomination arrangement (transferring the legal title to the trustee but retaining the beneficial interest) or the trustee terminates the arrangement (transferring the legal title back to the beneficial owner), the transaction can be exempted. The Bureau should clarify if this applies to OFC shares.

Question 24: Do you consider the proposed tax filing arrangement agreeable?

Section 2 of the Business Registration Ordinance states:

(1A) For the purposes of this Ordinance-
(a) a company-
(i) that is incorporated in Hong Kong under the Companies Ordinance (Cap 622) or was incorporated under a former Companies Ordinance as defined by section 2(1) of the Companies Ordinance (Cap 622); and
(ii) that is not otherwise liable to be registered under this Ordinance; or
(b) a non-Hong Kong company as defined by section 2(1) of the Companies Ordinance (Cap 622) that is not otherwise liable to be registered under this Ordinance,
shall, notwithstanding any deemed cessation of business under section 6(4F) or any notification of cessation of business which may be furnished under section 8(2), be deemed to be a person carrying on business and shall be liable to be registered under this Ordinance.

It seems that under the Bureau's proposal, the OFCs will be incorporated under the SFO rather than the CO. Therefore, section 2 would not apply to the OFCs. Nevertheless, since both OFCs and other companies incorporated under the CO are limited companies, we agree with the Bureau's proposal relating to business registration and filing.

Conclusion

While we agree that the OFC should be introduced to Hong Kong, we urge the Bureau to respect the distinction between publicly offered and privately offered OFCs. In particular, we strongly disagree with the suggestion that privately offered OFCs can only invest in the designated asset classes and the requirement for SFC's approval in incorporating an OFC.

We are also concerned about the SFC's resources and effectiveness (or the lack thereof) given the Process Review Penal Report about the SFC's process in handling fund authorization and registration.

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