Press Release

LCQ20: The proposed new open-ended fund company structure

Wednesday, April 16, 2014

Following is a question by the Hon Kenneth Leung and a written reply by the Secretary for Financial Services and the Treasury, Professor K C Chan, in the Legislative Council today (April 16):

Question:

The Financial Services and the Treasury Bureau (FSTB) issued the Open-Ended Fund Companies Consultation Paper on March 20, 2014, which proposed to introduce a new open-ended fund company (OFC) structure to complement the existing unit trust structure. In this connection, will the Government inform this Council:

(1) whether the proposed OFC structure is comparable with or more competitive than that of the major asset management jurisdictions with similar collective investment scheme structures e.g. Luxembourg and Ireland, given that Hong Kong has lagged behind those countries in introducing the OFC structure;

(2) why FSTB proposes that OFC be allowed to invest its assets only in securities and futures contracts; whether, as proposed by FSTB, OFC will be allowed to invest in bonds, debts and distressed debts in general;

(3) of the policy considerations of FSTB for not proposing, apart from the profits tax exemption applicable to public funds and offshore funds, additional tax incentive for application to OFC, in particular, why (i) the central management and control of an OFC has to be located outside Hong Kong in order to qualify for the profits tax exemption for offshore funds and (ii) no ad valorem stamp duty exemption on transfers of shares in OFCs has been proposed; and

(4) as there are views that stamp duty on transfers of shares in OFCs can be avoided if such transfers are effected by simultaneously issuing and redeeming shares, whether it has assessed if there will be substantive loss in stamp duty revenue in this regard; if it has, of the assessment results?

Reply:

President,

(1) In developing the proposals for Hong Kong's Open-Ended Fund Companies (OFC), we have considered the legal framework and regulatory regimes of other major asset management jurisdictions, such as the United Kingdom (UK), Ireland, and Luxembourg, the relevant securities regulation principles published by the International Organisation of Securities Commissions (IOSCO) and the market landscape in Hong Kong, with the aim of striking a reasonable balance between facilitating market development, and protecting investors. We have also taken into account current practices adopted in these major asset management jurisdictions when formulating the proposals. Our proposed regime is broadly in line with their regulatory standards and practices.

(2) The proposed OFC regime aims to provide fund managers with more flexibility in the choice of fund legal structures by allowing investment funds to be set up in a corporate form. The primary purpose of an OFC is to operate as an investment fund. It is not designed to operate as a corporate entity for the purposes of general commercial business, trade or other uses. As such, the asset classes in which an OFC may invest are proposed to be broadly in line with a traditional investment fund, namely, securities and futures (Note 1) as defined under the Securities and Futures Ordinance (SFO).

The scope of securities and futures currently defined under Schedule 1 to the SFO is fairly broad. It covers, among other things, debentures, loan stocks, bonds or notes of, or issued by, a body, whether incorporated or unincorporated, or a government or municipal government authority unless such instruments fall within any of the specific exclusions set out in the definition.

The proposed investment scope of publicly offered OFCs is similar to public funds which are commonly approved by the regulators in the UK, Ireland, and Luxembourg under the European funds passport regime as Undertakings for Collective Investments in Transferable Securities (UCITS) pursuant to the European Directives. The permitted asset classes under UCITS are essentially transferable securities, money market instruments, collective investment schemes and financial derivative instruments. These are broadly similar to the instruments which are proposed for the investment scope for publicly offered OFCs.

Based on the understanding of the Securities and Futures Commission (SFC), the private OFCs equivalent in the abovementioned major asset management jurisdictions in practice largely invest in traditional securities and related financial instruments. It appears uncommon for private funds to conduct direct investment in alternative assets.

(3) and (4) The existing profits tax exemption to public funds authorised by the SFC under section 104 of the SFO or bona fide widely held regulated funds in an acceptable regime outside Hong Kong will equally be applicable to publicly offered OFCs. The offshore fund exemption regime was introduced to reinforce the status of Hong Kong as an international financial centre, attract new offshore funds to Hong Kong and further develop the fund management business in Hong Kong. If the central management and control (CMC) of an OFC, whether publicly or privately offered, is not exercised in Hong Kong, an OFC can qualify for the existing profits tax exemption for offshore funds in respect of profits derived from specified transactions carried out through or arranged by specified persons, notwithstanding that its asset portfolios are managed by a Hong Kong fund manager with full discretionary power.

We will consider carefully the exemption or the extent of exemption that should be applied to privately offered OFCs with CMC located onshore having regard to possible read-across implications.

For stamp duty purposes, shares in OFCs by definition are Hong Kong stocks. Their sale or purchase should be subject to stamp duty. At present, stamp duty is exempted if the sale or purchase of a unit in a unit trust scheme involves a redemption by way of extinguishing the unit; or if the manager of a unit trust scheme sells to a new unit-holder a unit which arises from a transfer of a unit to the manager within the preceding two months or the unit sold is a new unit. Instruments of transfer of units are also exempted from payment of the fixed stamp duty of $5 under specific situations. Shares in OFCs and units in unit trusts bear similarities since they can be reissued after redemption or extinguishment. As mentioned in the public consultation paper on OFC, we propose that allotments, transfers and surrenders of shares in OFCs or of units in unit trusts may be treated in the same way. We welcome public views in this. We do not have the assessment on tax revenue forgone in stamp duty as mentioned in the question.

The public consultation on the proposed OFCs commenced and will last until June 19. We welcome views and feedback on the proposals. We will carefully analyse comments received.

Note 1: And also over-the-counter (OTC) derivatives once the Securities and Futures (Amendment) Bill 2013 is commenced.

Ends