

Frequently asked questions: Open-ended Fund Companies (“OFCs”)

Q1 What is an open-ended fund company (“OFC”)?

- A1
- An OFC is an open-ended collective investment scheme which is structured in corporate form with limited liability and variable share capital. The main purpose of an OFC is to serve as an investment fund and manage investments for the benefit of its shareholders.
 - OFC shareholders do not have any day-to-day management rights or control over the underlying assets held by OFCs but they do have the right to participate in the income/profits arising from the management of and transactions in the fund property which is typically paid via distributions.
 - OFC shares are typically priced at net asset value which, broadly speaking, is the market value of the underlying assets divided by the number of shares issued less any costs.
 - OFCs could be set up as public or private funds.

Q2 What are the key benefits of the proposed OFC structure?

- A2
- The key benefits of the proposed OFC structure include -
 - Variable share capital to meet shareholder redemption requests
 - Corporate form with legal personality
 - Shareholder liability will be limited to their shares in OFCs
 - Streamlined procedures for termination

- Familiar structure to other fund jurisdictions, particularly those not familiar with trust law

Q3 How would the proposed OFC structure provide sufficient flexibility to cater for its open-ended nature?

- A3
- As it is proposed that OFCs will not be subject to any capital reduction restrictions, an OFC may create and redeem shares according to the investment demands of the market, subject only to the terms and conditions under its Articles of Incorporation (“Articles”).
 - As an OFC will be an open-ended fund, its shares should be redeemable at the request of shareholders on each dealing day subject to the terms and conditions set out in the offering document.

Q4 Why is there a need for Hong Kong to introduce OFCs as an additional option of investment fund vehicle? How would the new OFC regime attract funds to domicile in Hong Kong?

- A4
- As an international financial centre, Hong Kong could benefit from more choices on the legal forms of investment funds to fund managers worldwide.
 - While open-ended investment funds in unit trust form are widely understood and accepted in common law jurisdictions and have long existed in Hong Kong, which has well-established trust law, the more popular fund structure from an international perspective is the corporate fund structure. This structure is available in most major fund centres.
 - In the past couple of decades and since the introduction of Undertakings for Collective Investment in Transferable Securities (“UCITS”), we have observed that an increasing number of common law jurisdictions, which have traditionally

only offered unit trust funds, have expanded their legal framework and regulatory regimes to cater for the establishment of corporate fund vehicles. Ireland established investment companies with variable capital in 1990 and the UK introduced open-ended investment companies in 1997.

- The addition of a new OFC structure would provide an extra option for fund structure and create a more flexible business environment for fund managers to meet market demand, which in turn could attract more mutual funds and private funds choosing to domicile in Hong Kong.

Q5 Is the proposed OFC regime in Hong Kong comparable with the regimes adopted by other major asset management hubs?

- A5
- In developing the proposals for Hong Kong OFCs, we have considered the legal framework and regulatory regimes of other major asset management jurisdictions, the relevant securities regulation principles published by the International Organization of Securities Commissions (“IOSCO”) ¹ and the market landscape in Hong Kong, with the aim of reaching a balance between facilitating market development and maintaining Hong Kong’s competitiveness on one hand, and ensuring market integrity and protecting investors on the other.

Q6 Why are OFCs proposed to be governed under the Securities and Futures Ordinance (“SFO”)?

- A6
- Given that OFCs are set up to function as an investment fund vehicle, it is proposed that the Securities and Futures Commission (“SFC”) will be the primary regulator responsible for the registration and regulation of OFCs under the SFO.

¹ IOSCO Objectives and Principles of Securities Regulation (June 2010)

Q7 What is the proposed investment scope of OFCs?

- A7
- Considering that the investment activities will be required to be delegated to an investment manager licensed by or registered with the SFC, it is proposed that the investment scope of OFCs should align with those types of investment activities, which are subject to licensing and regulation by the SFC under the SFO, namely, securities, futures (and over-the-counter (“OTC”) derivatives once the relevant legislative amendments to the SFO have become effective) as defined under the SFO.
 - Being an investment vehicle, OFCs are not designed to engage in activities undertaken by conventional companies, such as commercial trade and business.

Q8 What are the requirements under the Companies Ordinance (“CO”) not applicable to OFCs to cater for their operational needs?

- A8
- The primary purpose of a Hong Kong OFC will be to operate as an investment fund. It is not designed to operate as a corporate entity for the purposes of general commercial business or trade. Therefore certain rules/requirements under the CO may not be applicable, in particular –
 - OFCs will not be bound by restrictions on the reduction of share capital applicable to companies formed under the CO, but will have the flexibility to vary its share capital in order to meet shareholder redemption requests;
 - OFCs will not be bound by restrictions on the distribution out of share capital applicable to companies formed under the CO, but may distribute out of share capital subject to solvency and disclosure requirements; and
 - certain corporate filings may not be applicable to OFCs or may be modified in view of the nature of OFCs as

investment funds. For example, forms for return of allotment, statement of particulars of charge and application for new share certificate may not be applicable; and while publicly offered SFC-authorized OFCs should file annual returns/accounts with the Companies Registry, the form could be simplified to exclude information relating to share capital and members.

Q9 Which parties under the OFC's structure will be subject to licensing by the SFC under the proposed OFC regime?

- A9
- Given the nature of OFCs as pure legal vehicle for investment, it is proposed that the day-to-day management and investment functions of OFCs must be delegated to an investment manager licensed or registered with the SFC to carry out Type 9 (asset management) regulated activity², and appointed by the OFC board.
 - As such, it is proposed that individual directors on the OFC board will not be required to be licensed under the SFO. The OFC board will nevertheless be legally responsible for all the affairs of the OFC and will provide an additional layer of oversight for shareholders. This is a common structure for corporate funds.
 - To strengthen investor protection and avoid potential conflicts of interest, we propose that the assets of OFCs must be segregated from that of the investment manager and entrusted to a separate, independent custodian for safekeeping. The custodian will be subject to the same minimum eligibility requirements as required under the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products including the Code on Unit Trusts and Mutual Funds ("SFC Handbook").

² Type 9 regulated activity is on asset management, including managing a portfolio of securities or futures contracts for clients on discretionary basis.

- While not subject to licensing requirements, directors of the OFC board will 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.

Q10 What are the proposed investor protection measures under the OFC regime?

- A10
- The key investor protection measures include –
 - mandatory delegation of day-to-day management and investment functions of OFCs to an investment manager licensed or registered with the SFC, subject to the oversight of the OFC board. This would help safeguard the interest of investors, as it separates the investment functions and day-to-day management from that of supervision;
 - basic eligibility criteria applicable to the OFC board, investment manager and custodian;
 - segregating assets of the OFC from that of the investment manager and entrusted to a separate, independent custodian for safekeeping. This aims to strengthen investor protection and avoid potential conflict of interest;
 - alignment of investment scope with those types of investment activities which are subject to licensing and regulation by the SFC under the SFO, namely securities, futures (and over-the-counter derivatives once the relevant proposed legislative amendments to the SFO have become effective);
 - proposed enforcement powers, including investigatory powers, powers of restriction and civil and criminal powers to properly oversee the OFC and its activities;

- like other SFC-authorized unit trusts and mutual funds, publicly offered OFCs required to seek SFC-authorization would also have to comply with the applicable requirements under the SFC Handbook, including disclosure requirements.

Q11 What is the respective role of the SFC and CR as OFCs' regulators?

- A11
- Given the function of OFCs as investment fund, the SFC will undertake the securities-related enforcement matters relating to OFCs. The proposal for the Companies Registry to administer the incorporation and relevant corporate filings functions and the securities regulator to administer the registration and securities regulation for OFC-like vehicles is largely in line with the model adopted in other comparable overseas fund jurisdictions.
 - Regarding the enforcement powers in relation to OFCs, it is proposed that the SFC should be vested with –
 - investigatory powers to investigate the affairs of OFCs and their directors as long as the SFC has reasonable suspicion of misconduct;
 - the power to intervene in the business and management of OFCs; and
 - criminal and civil powers.
 - As the OFC structure takes the corporate form, it is proposed that the CR, as the corporate registry of companies registered under the CO, will be responsible for the incorporation and relevant statutory corporate filings of OFCs. The CR will also administer statutory corporate filing breaches similar to its existing enforcement procedures.

Q12 What is the aim of the proposed protected cell regime?

- A12
- An OFC may be created as an umbrella fund meaning that the OFC could consist of a number of separately pooled sub-funds and each sub-fund would have a pool of assets that is managed in accordance with the investment objectives and policies for that particular sub-fund. Operationally, each sub-fund would also be distinct.
 - However, for example, if an umbrella fund has two sub-funds: a conservative bond fund only investing in high quality government bonds; and a highly leveraged emerging markets equity fund. The emerging markets equity fund collapses with liabilities exceeding its assets, without legal segregation of liabilities while the assets of the bond fund could be utilised to meet the claims of the collapsed equity fund.
 - A protected cell regime addresses this contagion risk by providing for a legally enforceable segregation of the assets and liabilities of each sub-fund. The concept of protected cells is adopted in a number of major fund centres.

Q13 What are the winding up and termination procedures for OFCs? Any difference as compared with those for conventional companies?

A13 Winding up an OFC (whether solvent or insolvent)

- Similar to conventional companies, it is proposed that winding up of OFCs (whether solvent or insolvent) would be in accordance with the requirements and procedures set out in the Companies (Winding Up and Miscellaneous Provisions) Ordinance.

Termination of an OFC – a streamlined procedure (for solvent OFCs)

- Given the nature of OFCs as investment funds, which are often terminated for commercial reasons (such as changes in the market conditions resulting in the investment strategy becoming unviable; the size of the fund dropping below a certain level; or

changing investment trends, etc.), it is proposed that OFCs could be terminated under the new legislation (subject to SFC's prior approval) in a more straight-forward and cost efficient manner, and without compromising investor protection, where –

- the OFC is to be terminated in accordance with the specific provisions in the OFC Articles;
- the OFC is solvent as certified by the OFC board and an independent and qualified auditor; and
- reasonable prior notice has been given to shareholders.

Q14 What is the proposed tax treatment for OFCs?

- A14
- The existing profits tax exemption for public funds will apply to publicly offered OFCs.
 - For privately offered OFCs, profits tax exemption will be available under the existing regime for offshore funds with its central management and control (“CMC”) located outside Hong Kong.
 - 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.