Open-ended Fund Company: A new initiative for HK to attract funds to domicile

The Mainland-Hong Kong Mutual Recognition of Funds (MRF) scheme was launched in May 2015, and since the first funds were approved late 2015, to-date, more than 20 Mainland funds have been approved and authorized by the Hong Kong Securities and Futures Commission (SFC) to be offered in Hong Kong. At the same time, 3 Hong Kong-domiciled funds have so far gained approval in the Mainland for cross-border distribution. On both fronts, the number of funds to be approved are expected to continue to increase.

The MRF arrangement has made the establishment of Hong Kong-domiciled funds attractive and enhanced Hong Kong's position as an asset management centre. The next step forward for Hong Kong to further develop into a global cross-border fund hub is, as most industry participants believe, to enhance its attractiveness as a fund domicile by introducing an open-ended fund company (OFC) structure.

We may soon see the adoption of the OFC regime in Hong Kong towards meeting its long-standing aspiration of becoming a global cross-border fund centre.

Securities and Futures (Amendment) Bill 2016

On 15 January 2016, the proposed Securities and Futures (Amendment) Bill 2016 was gazetted to be put before the Hong Kong Legislative Council, with the intention to introduce the legal, regulatory and tax framework for Hong Kong's OFC regime.

The proposals put forward are the result of more than two years of design and industry consultations on the framework. The Hong Kong Financial Services and Treasury Bureau (FSTB), the SFC and other relevant authorities have coordinated and developed the details of the proposed framework which was first announced in early 2014. A consultation paper was published in March 2014, and the consultation conclusions were published earlier this month by FSTB. The consultation conclusions culminated in the release of the detailed proposed legal and regulatory frameworks in respect of the OFC regime.

In particular, the proposed Bill shall introduce a new Part IVA to the Securities and Futures Ordinance (Cap. 571) (SFO) on OFC, containing provisions on the incorporation, registration, capacity and specific requirements on the establishment and operations of OFC (including on the directors, investment manager, custodian, sub-custodian and auditor of an OFC).

The Bill also outlines the powers of the SFC who shall be the primary regulator of OFCs, including for the SFC to make further rules on the regulation of OFCs. It is expected that the SFC will also issue a new OFC Code detailing the operational requirements to supplement the legislation.

The Companies Registry (CR) shall be responsible for the incorporation and administration of statutory corporate filings of OFCs, alongside such role of the CR with respect to Hong Kong companies in general.

Fund market landscape in Hong Kong

As at the end of September 2015, among the 2,090 SFC authorized unit trusts and mutual funds in Hong Kong, there were only 628 domiciled in Hong Kong, with the rest mainly in Luxembourg (1,010), Ireland (281) and the Cayman Islands (92), according to the latest available data of Securities and Futures Commission (SFC). The current fund market in Hong Kong is overwhelmingly dominated by Luxembourg or Irish Undertakings for Collective Investment in Transferable Securities (UCITS).

While the number of Hong Kong-domiciled funds increased by around 54% from 386 in March 2012 to 594 in March 2015, according to FSTB, creating the OFC structure will provide asset managers with an additional option and flexibility for Hong Kong to be more attractive as a fund domicile.

Corporate structure a more popular form of investment fund

The OFC is seen as an increasingly popular fund vehicle in the industry globally, in particular for cross-border funds, and is available in most major fund centers such as Luxembourg, Ireland, Cayman Islands and United States.

At the moment, an open-ended investment fund established in Hong Kong can only take the form of a unit trust. Due to various restrictions on capital reduction under the Hong Kong Companies Ordinance, and lack of flexibility to vary its capital in order to meet investors' subscriptions and redemptions, open-ended funds cannot be established as a Hong Kong company.

The unit trust structure has been described as "inflexible" once it is established and "not particularly suitable" for some investment strategies currently used by both public and private funds. Onerous trustee provisions in trust deeds may deter asset managers from structuring their funds as a unit trust or render some trustees unwilling to accept appointment for funds of certain investment strategies.

Further, unit trust is not a familiar structure to asset managers in jurisdictions which do not have well-established trust law, such as in the Mainland. From this perspective, there may indeed be attractiveness in a Hong Kong OFC structure for funds that may seek to be authorized by the SFC for public offer and eventually to apply for approval by the Mainland securities regulator for distribution in the Mainland.

Proposed Hong Kong OFC structure

Flexible capital structure

Under the proposals, the new OFC vehicle will be structured as a corporation with limited liability and variable share capital, aiming to serve as an investment fund vehicle and manage investments for the benefit of its shareholders. The proposed OFC will not be bound by restrictions on reduction of share capital nor restrictions on distribution out of share capital under the CO. Instead, it can vary its share capital to meet shareholder redemption requests, and make distribution out of share capital subject to solvency and disclosure requirements.

Governance

The OFC will be a body corporate with a legal personality and governed by a board of directors. Directors of an OFC are not required to be Hong Kong residents, however non-resident directors shall appoint a process agent in Hong Kong.

Investment management

The management and investment functions of an OFC must be delegated to an investment manager licensed by or registered with the SFC to carry out Type 9 regulated activity (i.e. asset management), subject to the oversight of the OFC board. This requirement applies equally to public and private funds, although private unit trusts now do not have such restriction. The individual directors, however, are not required to be licensed by the SFC but are subject to statutory and fiduciary duties.

Custody of assets

The assets of the OFC must be segregated from that of the investment manager and held by an independent custodian acceptable to the SFC. An OFC may appoint an overseas custodian, subject again to the requirements for the non-resident custodian to appoint a Hong Kong process agent.

Investment scope

The asset classes in which an OFC (whether public or private) could invest include securities, futures (and OTC derivatives once the relevant proposed legislative amendments to the SFO become effective) within the scope of Type 9 regulated activity under the SFO. For privately offered OFC, the government proposes to add some flexibility by allowing a 10% upper limit (i.e. 10% of total asset value of fund) for other asset classes.

Umbrella fund structure

The Bill also include provisions that allow an OFC to be established as an umbrella fund consisting of a number of separate sub-funds, for legislation to prescribe segregation of assets and liabilities between sub-funds. This follows similar protected cell mechanism in other jurisdictions such as the segregated portfolio company in the Cayman Islands.

Registration and authorization

An OFC may be set up as a public or private fund. As a legal vehicle, the OFC itself will not be required to be licensed as a licensed corporation under the SFO. However, the OFC will need to be registered with the SFC under the new legislation, and the incorporation of an OFC by the Companies Registry and registration of its constitutive document, ie. its instrument of incorporation, shall only be possible following approval of registration by the SFC. If shares of the OFC are to be offered to the public, it must also be authorized by the SFC under section 104 of the SFO, as similarly applicable to other publicly offered unit trusts and mutual funds in Hong Kong. The application for authorization can be processed concurrently with the application for registration as an OFC.

Tax and stamp duty

Related proposals to amend the Inland Revenue Ordinance and Stamp Duty Ordinance have also been put forward to the Legislative Council. The existing profits tax exemption to public funds will be made available to publicly offered OFCs, while privately offered OFCs with central management and control located outside Hong Kong will also benefit from the profits tax exemption offered to offshore funds, subject to meeting relevant conditions. However, for privately offered OFCs where the central management and control is in Hong Kong, there is concern that allowing profits tax exemption may have negative implications.

While shares in OFCs by definition are Hong Kong stocks, transfer of shares in OFCs would be subject to a stamp duty, but the allotment and cancellation of shares will not be subject to stamp duty.

Legislative Time-table

According to the Hong Kong legislative process, the First Reading of the Bill is scheduled 27 January 2016, as well as the commencement of the Second Reading debate. The timing for the continuation of the Second Reading debate is still to be fixed. The Bill shall be under scrutiny of the House Committee of the Legislative Council. Following review of the Legislative Council, debate and, upon support of the Legislative Council of the Third Reading, the Bill may then be enacted into law.

Although it remains uncertain when the OFC framework could be finally introduced, following years of fund industry lobbying and study, the prospect of the Hong Kong corporate structure open-ended investment fund may be getting quite close and real.

Contact Details

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