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SYNOPSIS SERIES

Offering Hong Kong Retail Funds

This Publication aims to provide an overview of the Hong Kong regulatory approach and requirements for establishment funds and collective investment schemes that may be offered to the public in Hong Kong.

Regulatory Framework for Funds and Requirements for Authorization by SFC

The main legislation governing funds and collective investment schemes in Hong Kong is the **Securities and Futures Ordinance** (Chapter 571) (**SFO**), first promulgated in 2002 and as amended. The **Securities and Futures Commission** (**SFC**) is the regulatory body with such regulatory objectives, functions, powers and duties given under the SFO to administer the SFO.

Under Part IV of the SFO, it is an offence to issue advertisements, invitation or document containing invitation to the public to invest or participate in a collective investment scheme, unless authorized by the SFC. According to Section 104 of the SFO, the SFC may, where it considers appropriate, authorize any collective investment scheme, subject to conditions it considers appropriate, and that an application for authorization shall be accompanied by such information and documents as the SFC requires.

Besides the SFO, the SFC issues codes, guidelines and circulars which contain principles and guidance relating to the standards and practices which the SFC apply in administering the regulations and requirements under the SFO. Compliance with codes or guidelines issued by the SFC is expected, although the codes, guidelines and circulars are not subsidiary legislation to the SFO and do not carry the status or force of law, and failure to comply with them does not itself render a person liable to any judicial or other proceedings.

Exemption for Funds for Professional Investors Only

An exemption from the requirements of Part IV of the SFO that apply to funds for public offer is available to funds or collective investment schemes that are offered to professional investors only. Other than complying with the relevant provisions of the SFO on offers to professional investors, for such funds that are not offered to the public but are for professional investors only, there is no specific legislation or regulatory requirements governing the establishment, offer, structure or investments of such products.

Codes and Guidelines

The key set of codes and guidelines that applies to funds and collective investments schemes that seek authorization or are authorized by the SFC for public offer is the **Code of Units Trusts and Mutual Funds** ("**UT Code**"), issued within the **SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products**, the latest edition published by the SFC on 30 January 2015 and as updated from time to time by the SFC. The SFC Handbook contains the UT Code, together with the Code on Investment-Linked Assurance Schemes and the Code on Unlisted

Structured Investment Products, as well as a section on the overarching principles and general requirements that the SFC applies in authorizing investment products whether unit trusts and mutual funds, investment-linked assurance schemes or unlisted structured investment products.

Funds seeking authorization by the SFC to be offered for retail sale in Hong Kong are required to comply with the applicable requirements of the UT Code. The UT Code includes:

- requirements on the trustee/custodian of the fund or collective investment scheme;
- requirements on the management company and auditor of the fund or collective investment scheme;
- product operational requirements;
- investment requirements and limits;
- requirements on the contents of the offering document;
- requirements on the contents of the constitutive documents;
- requirements on the contents of financial reports and auditors' reports;
- post-authorization ongoing requirements and reporting requirements.

While the SFC expects compliance with those requirements, the SFC does not prescribe or limit the specific form or structure for funds. Structures adopted are usually open-ended investment company structures or unit trust funds. The SFC also does not specify or restrict the place of domicile or jurisdiction of funds that may be authorized. Therefore, funds applying for authorization by the SFC may be established in Hong Kong or elsewhere. Further, schemes that are already authorized in certain jurisdictions within a list of recognized jurisdictions published by the SFC could be accepted by the SFC as already complying in substance with the UT Code, although the SFC may still expect a scheme to comply in all material respects with the UT Code.

Types of Permissible Retail Funds

Retail fund products for public offer need to comply with the requirements set out in the UT Code in order to be approved and authorized by the SFC. The UT Code sets out general requirements as well as specific requirements for specialized funds, as outlined in section 4 below.

Currently, the SFC has issued codes, guidelines and circulars that govern the following types of investment products (which are funds or collective investment schemes):

1. Closed-end funds
2. Exchange-traded funds
3. Investment-Linked Assurance Schemes (ILAS)
4. Mandatory Provident Funds
5. Paper Gold Schemes
6. Pooled Retirement Funds
7. Real Estate Investment Trusts

Did you know?

Most SFC authorized funds are domiciled elsewhere, including quite often European Undertakings for Collective Investment in Transferable Securities (UCITS), most commonly domiciled in Luxembourg or Ireland, and there are also funds domiciled in other jurisdictions including Cayman funds. However, there has in recent years been an increase in the use of Hong Kong domiciled unit trust funds that seek SFC authorization, potentially to take advantage of mutual recognition arrangements between Hong Kong and Mainland China (see below, under "The China Angle"). Most recently, Hong Kong and Switzerland entered into a similar mutual recognition arrangement, while there are limited mutual recognition arrangement with jurisdictions such as Australia, Malaysia and Taiwan. The Hong Kong Government has also gazetted the amendment ordinance for open-ended fund company regime in HK in June 2016.

8. Structured Investment Products
9. Unit Trusts & Mutual Funds

Under the UT Code, there are specific provisions for the authorization of the following types of specialized schemes:

i. unit portfolio management funds
ii. money market/cash management funds
iii. warrant funds
iv. futures and options funds
v. guaranteed funds
vi. index funds
vii. hedge funds
viii. structured funds
ix. funds that invest in financial derivative instruments

Any proposed new and innovative product development would still need to comply with the applicable requirements in the UT Code, having to meet and fit within the existing requirements, unless an application is made to and approved by the SFC for waiver or exemption from specific requirements.

However, the SFC may from time to time issue new guidelines, circulars or even codes to provide for new or innovative products or address new issues or requirements that relate to such products.

Permitted Investments

The general investment requirements are in Chapter 7 of the UT Code, which are the core but general requirements on the investment limitations and prohibitions that apply to funds, unless otherwise applicable for a specialized scheme.
Chapter 8 of the UT Code contains specific requirements that apply to the different types of specialized funds.

A fund may invest in new or innovative financial instruments or investment products provided it is within the permitted investment parameters and requirements set out in the UT Code, either the general requirements or the specific requirements for specialized scheme, as applicable and as authorized by the SFC.
In addition, investment in such new financial instrument or investment product must be within the investment objective, policies and restrictions as stated and disclosed to investors in the offering document of the fund.

Liquidity

The UT Code requires funds to have at least one regular dealing day per month, and the maximum interval between a properly documented redemption request and the payment of redemption money may not exceed one calendar month. However, the UT Code allows the period to be extended where the market(s) in which a substantial portion of investments of the fund is made is subject to legal or regulatory requirements (such as foreign currency controls) that render the payment of redemption money within one calendar month to be not practicable.

Valuation and Pricing

The UT Code does not prescribe the specific frequency for valuation and pricing, and requires that the offer and redemption prices of a fund are required to be calculated on the basis of the fund's net asset value divided by the number of outstanding units/shares of the fund.

Manager/Sub-advisor

A management company of retail funds to be offered to the public in Hong Kong is subject to approval by the SFC as part of the authorization process. For funds that are managed in Hong Kong, the fund manager carrying out asset management in Hong Kong is engaging in a regulatory activity and is required to be licensed by the SFC subject to such licensing requirements and conditions under the SFO. However, having an asset management license is not sufficient, as the management company must also satisfy the SFC that it complies with the requirements in the UT Code including having sufficient human and technical resources, with investment personnel with sufficient and relevant investment management experience that meet SFC requirements.

It is possible for the management company to be domiciled outside Hong Kong, or for the management to be delegated to sub-advisors based elsewhere. In particular, the SFC published a list of acceptable inspection regimes (AIR) where the SFC accepts that manager or sub-advisor may be based. Delegation to sub-advisors in non-AIR jurisdictions is subject to conditions and case-by-case approval by the SFC.

Approved Person & Hong Kong Representative

Each authorized fund is required to appoint an individual ordinarily resident in Hong Kong to be the "Approved Person", who is the appointed person to be served with notices or decisions of the SFC in relation to the fund. For non-Hong Kong based funds, a Hong Kong representative must be appointed.

Regulatory approaches

As the main regulator of funds and collective investment schemes in Hong Kong, the SFC adopts both principles-based approach as well as disclosure-based approach.

- ***Principles***

Under the Overarching Principles set out in the SFC Handbook, the SFC stipulates the following general principles that the SFC believes to be fundamental for the regulation of products generally offered to the public, and further stipulates that product providers shall comply with the spirit of these principles in administering, managing or dealing with any matters relating to the issue, advertising and operation of products.

The general principles in Chapter 3, Section 1 of the SFC Handbook are:

GP1: Acting fairly – Product providers shall act honestly, fairly and professionally.

GP2: Disclosure – Disclosure shall be complete, accurate and fair, and be written and presented in a clear, concise and effective manner and in such manner as to be readily understood by the investing public. Information provided shall not be false or misleading nor be presented in a deceptive or unfair manner. Where ongoing disclosure is required, the relevant information shall be disseminated in a timely and efficient manner.

GP3: Proper protection of assets – Where assets are specifically required by the applicable product code to be held for the benefit of investors, all such assets shall be properly protected.

GP4: <u>Avoidance of conflicts of interest</u> – Product Providers, counterparties and service providers shall avoid being placed in a conflicts of interest position that may undermine the interests of the investors of the relevant product.

GP5: <u>Regulatory compliance</u> – Product Providers shall ensure that all applicable legal and regulatory requirements are complied with and shall respond to requests and enquiries from the regulators in an open and co-operative manner.

GP6: <u>Diligence</u> – Products Providers shall discharge their functions with due skill, care and diligence.

GP7: <u>Marketing</u> – Advertisements for a product shall be clear, fair and present a balanced picture with adequate and prominent risk disclosures in compliance with all applicable regulations. Advertisements shall not be false, biased, misleading or deceptive.

The SFC will have regard to both the spirit as well as the letter of these general principles in considering product authorization applications and whether products should remain authorized.

- ***Disclosure***

As stipulated in general principles 2 above, product providers are required to ensure disclosure shall be complete, accurate and fair, and be written and presented in a clear, concise and effective manner and in such manner as to be readily understood by the investing public. Information provided shall not be false or misleading nor be presented in a deceptive or unfair manner. Where ongoing disclosure is required, the relevant information shall be disseminated in a timely and efficient manner.

Chapter 6 of Section 1 of the SFC Handbook contains further disclosure requirements, including specific requirements for the offering documents and product key facts statements of investment products. Offering documents are required to contain the information necessary for investors to make an informed judgment of the investment and meet the disclosure requirements of the applicable product code. All key features and risks of the product shall be highlighted for investors prominently in a succinct manner. Product key facts statements are product summaries that shall highlight key information in respect of the investment product in a clear, concise and effective manner, be fairly presented and not contain any false or misleading information. All authorized funds to be offered to the public in Hong Kong are required to issue product key facts statements.

In authorizing investment products, the SFC will consider whether the offering documents and product key facts statement of the investment product meet these general requirements as well as specific requirements set out in the SFC Handbook.

- ***Protecting the investing public***

Further, one of the main regulatory objectives of the SFC is to provide protection for members of the public investing in or holding financial products. Accordingly, under section 104 of the SFO, it is stated that "without limiting any other ground on which the Commission may refuse to authorize any collective investment scheme..., the Commission may refuse to do so where it is not satisfied that the authorization is in the interest of the investing public".

Product Authorization Process

The Investment Products division of the SFC conducts the authorization of investment products for offer to the public in Hong Kong.

The SFC Investment Products division:
- develops and implements codes and guidelines for authorization of investment products so as to facilitate market growth and product innovation;
- regulates and authorizes investment products offered to the public;
- monitors disclosures and continuing compliance of authorized investment products.

Applications for authorization of investment products are first handled and reviewed by case officers, under the supervision of managers or senior managers, who in turn report to directors of the Investment Products division. The officers of the Investment Products division may have diverse background or experience, with those having audit, accounting or legal background being more common, as well as officers with industry experience or experience from other financial markets or jurisdictions.

The SFC has made performance pledges for the processing of applications for authorization of investment products. Under a revamped fund authorization process which is formally adopted to take effect from 9 May 2016, all fund applications that are in order shall be taken up within 5 business days of the receipt of the application. Authorization with conditions, or requisitions to applicants will be made within 14 business days of take-up, and may be processed according to a standard, fast-tracked application process or under an enhanced process for non-standard applications.

If the application involves a complicated structure or substantial deviations from the Code requirements, the SFC may seek more detailed information from the applicant in its requisitions, and may at times require a meeting with the solicitors and/or applicant where necessary.

It is important to note that the authorization time for applications is largely dependent on the complexity of the case, the quality of submissions to the SFC and the response lead time. For example, for an application which involves a new management company or that falls within the specialized fund types under Chapter 8 of the UT Code or with uncommon structures, raising policy issues or seeking waivers without precedents, the time taken will be much longer.

For new or innovative products that seek exemption from certain provisions of the UT Code, the application may be subject to further review and approval of a Products Advisory Committee. The Products Advisory Committee is a special committee established by the SFC for the purpose of consultation and advising the SFC on matters relating to the authorizing of investment products, on overall market environment and industry practices, and on novel product features.

The SFC does not apply different standards or requirements to "mature" or "innovative" products. All fund products seeking authorization are required to comply with the applicable requirements in the UT Code. New or innovative products will still need to meet and fit within the existing requirements, unless an application is made to and approved by the SFC for waiver or exemption from specific requirements.

The Products Advisory Committee of the SFC may consider applications for waiver or exemption from certain requirements of the UT Code or may consider issuing new guidelines or circulars in order to permit or provide for the development of certain new or innovative products or product features. Generally, the SFC would take into its regulatory objectives and general principles for regulating investment products including whether allowing such new or innovative products or product features is in the interest of the investing public.

The Products Advisory Committee comprises of certain senior officers of the Investment Products division for the time being appointed to be a member of the Products Advisory Committee, industry representatives, professional consultants or academia. Each term of the Products Advisory Committee serves a two-year period.

Each fund that is offered to the public is required to seek authorization by the SFC, and each fund seeking authorization is required to submit its application together with its offering document and constitutive documents that comply with the requirements of the UT Code.

The SFC conducts careful and detailed review of each fund application, although the SFC clearly stipulates in the UT Code that the SFC does not take any responsibility for contents of any offering documents authorized by it, authorization is not a recommendation or endorsement of a product by the SFC, and that SFC authorization does not imply that the fund has complied with the SFO or other legal or regulatory requirements.

Currently, under SFC's "application lapse policy", a fund authorization process is required to be completed within 6 months, otherwise the application will lapse and will need to be re-submitted. In October 2015, the SFC announced the introduction of a streamlined authorization process, under which there is a stronger emphasis on submission of quality application documents that meet SFC requirements, and also on prompt turnaround by fund applicants, with the aim that application process and timeline could be significantly shortened to 1 – 2 months for standard applications or 2 – 3 months for non-standard applications. It is intended that the time to market for fund products would be shorter, and could thereby enhance Hong Kong as an asset

The China Angle

As part of the stated objective of the Investment Products division of the SFC, it "promotes product diversification and facilitates the Mainland's capital-raising initiatives offshore".

On 22 May 2015, the "Mainland-Hong Kong Mutual Recognition of Funds" (MRF) initiative was formally agreed between and jointly announced by the China Securities Regulatory Commission (CSRC) and the Hong Kong SFC. This initiative came into effect 1 July 2015, under which Mainland and Hong Kong funds that meet the relevant eligibility requirements may apply for approval and authorization for offering to retail investors in each other's market.

Qualified Mainland funds may now apply to the SFC for authorization pursuant to the MRF arrangement, to be distributed to Hong Kong public. On the other hand, qualified SFC authorized funds (and domiciled in Hong Kong) may apply to CSRC to be approved for distribution in Mainland China.

For further information on MRF, please refer to our publication on the topic (also available online: http://www.vteu.co/2015/06/02/mutual-recognition-south-bound-requirements/)

management center, without compromising investor protection. MRF applications (see table on page), are also included under the streamlined process.

When the SFC has authorized a fund, the fund needs to comply with ongoing compliance and reporting requirements under the UT Code. SFC authorization is perpetual and not subject to any specific time limit, although the SFC reserves its right to withdrawal authorization of a fund as it deems fit.

Post-authorization Ongoing Requirements

Authorized funds are required to seek the prior approval of the SFC for the following proposed changes:

(i) changes to constitutive documents;
(ii) changes to key operators (including the trustee/custodian, management company and its delegates, and Hong Kong representative of funds established outside Hong Kong);
(iii) changes in investment objectives, policies and restrictions of the fund (including the purpose or extent of use of derivatives), fee structure and dealing and pricing arrangements;
(iv) any other changes that may materially prejudice holders' rights or interests;
(v) merger or termination of a fund.

For other changes that do not require the prior approval of the SFC, the investors holding interests in the fund should be informed as soon as reasonably practicable of the changes as necessary to enable holders to appraise the position of the scheme. The offering document of the fund may be updated to incorporate such changes and reissued without further authorization provided the content and format of such document remains fundamentally the same as the version previously authorized, and the revised offering document must be filed with the SFC within one week from the date of issuance.

Authorized funds must publish at least two financial reports each financial year, being the annual reports and accounts published and distributed to holders within four months of the end of the fund's financial year, and the interim reports within two months of the period they cover. All financial reports of a scheme must be filed with the SFC within the same time frame respectively. Upon the SFC's request, all information relevant to the fund's financial reports and accounts must be supplied to the SFC.

In addition, the management company (or the Hong Kong representative of a fund established outside Hong Kong) must notify the SFC as soon as possible of any change to the information provided in the application form submitted when seeking authorization by the SFC.

With a well-established framework for regulatory approval and oversight on investment funds and collective investment schemes for public offer, clear regulatory objectives to be market friendly without compromising investor protection, and uniquely positioned to take advantage of the growth and liberalization of China financial market, Hong Kong is set to continue to develop and enhance its position as an asset management center.

Specific Requirements on China-theme Funds

Hong Kong has been playing a key role in giving investors access to China investment opportunities, having approved China-focused retail funds that invest in the China domestic stock markets well ahead of other major asset management centers. The first SFC-authorized "QFII" fund – a fund that invests at least 70% of its assets in Mainland China stock markets under the "Qualified Foreign Institutional Investor" scheme – was approved in 2007. Since then, there have been numerous SFC approved QFII funds, and subsequently further expanded to the approval of the RMB-equivalent, the RQFII funds and RQFII exchange-traded funds. Hong Kong was also the first to approve Renminbi (RMB) "dim sum" bond funds and also RMB-denominated funds. Following the roll-out of the Hong Kong-Shanghai Stock Connect in 2014, under which investors may invest in certain stocks listed on the Shanghai Stock Exchange through the Hong Kong Exchange, and vice versa, many SFC authorized funds are now also able to access the Mainland domestic stock market under Stock Connect.

Funds with investment or exposure to QFII/RQFII or RMB are required to meet certain specific requirements. QFII/RQFII funds will need to have in place appropriate custody arrangement for safe custody and segregation of fund assets, and will need to satisfy the SFC requirements on custody of assets in this regard besides complying with the PRC regulatory custodian requirements. QFII/RQFII funds are also subject to specific disclosure requirements on A-Share market risks, particular risks relating to domestic securities, liquidity and repatriation risks, foreign exchange and tax risks. Other funds that may have substantial exposure to domestic securities, RMB dim sum bonds, investing in China through Stock Connect or the China Interbank Bond Market initiative, are also required to include relevant risk disclosures in the fund offering documents.

Contact Details

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