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LEGAL UPDATE

Open-ended Fund Company:

An alternative fund vehicle for Hong Kong domiciled funds

Pursuant to the Gazette published on 27 July 2018, the Securities and Futures (Amendment) Ordinance 2016 enacted to amend the Securities and Futures Ordinance (**SFO**) comes into effect on 30 July 2018, along with subsidiary legislations[1] issued in May 2018 including the Securities and Futures (Open-ended Fund Companies) Rules (**OFC Rules**), and also the non-statutory Code on Open-ended Fund Companies (**OFC Code**) promulgated by the Securities and Futures Commission (**SFC**) along with its consultation conclusions on the OFC Rules.

The legal framework has now been finally and fully put in place to offer the open-ended fund company (**OFC**) as an alternative fund vehicle for Hong Kong domiciled funds, with the policy objective to bolster Hong Kong as a full-service asset management hub.

Market landscape in Hong Kong: Public and private funds

The retail funds market in Hong Kong has for a long time been dominated by Undertakings for Collective Investment in Transferable Securities (**UCITS**) domiciled in Luxembourg, Ireland and to a lesser extent the United Kingdom, authorized by the SFC for offer to the public in Hong Kong. Hong Kong domiciled unit trusts, among other structures including those of other jurisdictions, make up the rest of the authorized funds. Hong Kong domiciled unit trusts are especially more frequently adopted in recent years by Hong Kong fund managers for structuring retail funds, spurred by mutual recognition of funds (**MRF**) arrangements with certain jurisdictions namely Mainland China, France and Switzerland under which Hong Kong funds may be registered in such host jurisdictions while their foreign funds may in turn be authorised in Hong Kong.

In the private funds space, despite the availability of Hong Kong domiciled unit trust structure, the offshore vehicles in the form of exempted limited liability company or limited partnership, typically domiciled in the Cayman Islands, have tended to be the preferred structures for Hong Kong managers. There is an expectation that the launch of the OFC structure in Hong Kong as an onshore corporate fund vehicle may be more welcomed and impact the public funds sector more than it would do in the private funds space, although it is nevertheless a positive development to have an additional choice of structure that private fund managers may now also consider, with potential benefits as we briefly outlined below.

Hong Kong OFCs vs. Hong Kong unit trusts

As noted in our firm's previous publication in January 2016 regarding the OFC, the Hong Kong domiciled unit trust structure has been seen as inflexible once established and not particularly suitable for some investment strategies adopted by both public and private funds. Furthermore, onerous trustee provisions in trust deeds may deter managers from structuring their funds as a unit trust or render trustees unwilling to accept appointment for funds of certain investment strategies. Besides, the OFC

[1] (i) the Securities and Futures (Amendment) Ordinance 2016 (Commencement) Notice (the Commencement Notice); (ii) the Securities and Futures (Open-ended Fund Companies) Rules (the OFC Rules); and (iii) the Securities and Futures (Open-ended Fund Companies) (Fees) Regulation (the Fees Regulation).

structure may be attractive to managers in jurisdictions not having well-established trust law and who are hence unfamiliar with the unit trust structure and trust concepts, and who would have a clear preference for the OFC structure to establish funds for public offer. The OFC structure may also be better received by investors in a host jurisdiction under the MRF, such as in the Mainland China, France or Switzerland, where trust concepts are not well established or well recognized by the investors or legal systems there.

Hong Kong OFCs vs. Cayman structures

Hong Kong domiciled OFC structure, if adopted by Hong Kong managers for their private funds, would allow them to simplify the fund formation process as well as ongoing operational compliance requirements, by having to deal with the requirements in a single jurisdiction instead of two which would be the case for funds using Cayman structures, no matter in respect of the regulator, the regulatory regime and requirements or with the service providers.

By using the Hong Kong OFC structure, Hong Kong managers would need to deal with only the Hong Kong regulator, primarily the SFC, and comply with the Hong Kong regulatory and compliance requirements, instead of having to also have regard to or comply with regulatory requirements or reporting to the Cayman regulator i.e. the Cayman Islands Monetary Authority (**CIMA**) in addition to the SFC, in the case of Cayman mutual funds. Using the Hong Kong OFC would also obviate the need of liaising with an additional layer of service providers for the Cayman structure, such as the Cayman auditors, legal and corporate services.

However, it remains to be seen whether these shall be reasons for Hong Kong managers to prefer establishing private funds in the form of Hong Kong OFCs, as it has generally been considered relatively easy to establish Cayman structures, well supported by many Cayman service providers of high level of expertise and quality. On the other hand, as the establishment of the Hong Kong OFCs structure would be subject to prior approval by the SFC, there may be a wait-and-see until there is better visibility as to how the process would pan out.
There may also be other reasons where a Hong Kong manager may still adopt Cayman structures, such as for offers to international investors that may be more familiar with investing in Cayman funds over Hong Kong domiciled funds. Investors' familiarity with Hong Kong OFCs and in turn its use and popularity may only develop over time.

While the introduction of the Hong Kong OFC structure may be more welcomed by some over others, it is a key development that has the potential of changing the market landscape significantly if it becomes more widely adopted. We believe it is certainly a structure that would, going forward, be considered as an option by Hong Kong managers or others seeking to establish or offer an investment fund in Hong Kong.

We highlight below some of the key requirements on the Hong Kong OFC.

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Hong Kong OFC regime: Key requirements

Registration and incorporation

An OFC is established by obtaining an approval of registration from the SFC and a certificate of incorporation from the Companies Registry (**CR**), which can be achieved via a one-stop process whereby the applicant would only need to deal with the SFC who in turn will deal with the CR for the certificate of incorporation and the Inland Revenue Department (**IRD**) for the business registration certificate. For a public OFC, the SFC will process the registration and authorization in tandem with the processing time expected to be the same as that for other public funds, generally ranging between one and three months from the take-up date of the application depending on whether it is a "standard" or "non-standard" application[2].

Instrument of incorporation

An OFC's constitutional document will be an instrument of incorporation containing certain mandatory provisions prescribed by the SFO. Considering the nature of a private OFC and its need to customize investment policy and operations from time to time to meet the demands of private investors, the SFC has provided in the OFC Rules and OFC Code such that material changes to the instrument of incorporation (including material changes to the OFC's investment objectives and policy or other changes which may materially prejudice shareholders' rights) would only require shareholders' approval and post-change filing rather than requiring pre-approval from the SFC. Under the OFC Code, scheme changes may be effected in accordance with the offering documents and/or the instrument of incorporation, while reasonable prior notice should be provided to shareholders for material scheme changes. For an immaterial scheme change to a private OFC, the board of directors should certify that it is an immaterial change and obtain the custodian's confirmation that it has no objection.

Name of OFC

The name of an OFC must end with "Open-ended Fund Company" or "OFC" (and this naming requirement would apply to even closed-ended funds – an OFC may have variable capital and is not precluded from imposing redemption restrictions as long as this is clearly disclosed in its offering documents) and must not, in the opinion of the SFC, be misleading or otherwise undesirable, and must not bear the same name of another existing OFC. Any change of name of an OFC will be subject to the SFC's approval.

Directors

An OFC must have at least two individual directors including at least one independent director (i.e. independent of the custodian, but not of the investment manager). Each of the directors must be of good repute, appropriately qualified and experienced. The appointment of directors is subject to the SFC's approval. In contrast, while CIMA requires directors of Cayman funds to register, it does not "approve" the appointments nor impose any requirements as to qualifications, experience or independence.

Directors of Hong Kong OFCs are subject to fiduciary duties and the duty to exercise reasonable care, skill and diligence, and they have an overall duty in overseeing the operations of the OFC, including a general duty of oversight over the investment manager and the custodian. In regards to the removal of directors, the OFC Rules provides that no share may carry a greater number of votes than it would carry in relation to the generality matters to be voted on at a general meeting of the OFC, therefore prohibiting such structures whereby one class of shares has the right to vote on the appointment and removal of directors while the other classes have the right to vote on all matters other than the appointment and removal of directors.

[2] Please refer to the SFC's "Circular to management companies of SFC-authorized unit trusts and mutual funds – Launch of pilot revamped fund authorization process" dated 9 October 2015.

Investment manager

The OFC structure requires that an investment manager licensed by or registered with the SFC for Type 9 (asset management) regulated activity must be appointed and the appointment is subject to the SFC's approval. The investment manager must be and remain fit and proper at and after the time of registration of the OFC. The investment management functions to be delegated to the investment manager should include valuation and pricing of the property, which can be contrasted with the case of Cayman funds for which valuation and pricing is the remit of the board of directors and is typically delegated to the administrator. The investment manager may have its delegates and the appointment of which is not subject to the SFC's approval, although the key operators have to exercise due care in the selection, appointment, and ongoing monitoring of the performance of the delegate and remain fully liable for complying with the applicable regulatory requirements.

Custodian

An OFC must appoint a custodian and the appointment of the custodian is subject to the SFC's approval. The custodian of an OFC should meet the same eligibility requirements as set out in the Code on Unit Trusts and Mutual Funds (**UT Code**) for SFC-authorised funds, even where the OFC is one for private placement only. It is noteworthy that in the context of hedge funds, while the SFC considers that custodians' eligibility requirements are essential baseline requirements for the protection of scheme property of an OFC, many hedge funds appointed prime brokers who act as custodians may not meet such eligibility requirements and may not agree to accept more onerous responsibility than they would take for Cayman funds. With regard to the sub-custody arrangement, the OFC Rules provides that a sub-custodian must take reasonable care, skill and diligence to ensure the safekeeping of the scheme property that is entrusted to it.

Investment scope

The OFC Code expressly states that a private OFC must not be a business undertaking for general commercial or industrial purpose. The investment scope of a private OFC may include asset types which fall under a Type 9 (asset management) regulated activity (including securities and futures contracts (plus OTC derivatives once the new Hong Kong licensing regime for OTC derivatives comes into effect)), and cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts, with a maximum of 10% of gross asset value of the OFC in other asset classes (**10% de minimis limit**). In the case of an umbrella OFC, the 10% de minimis limit applies to the gross asset value of each sub-fund as well as to the gross asset value of the umbrella OFC as a whole. With such restriction imposed, the OFC structure will likely not be suitable for private equity funds (as shares in private companies are not included in the definition of "securities" under the SFO), real estate funds, infrastructure funds etc., although it may be considered as an option for equity or hedge fund managers.

Process agent

A non-resident director and an overseas custodian of an OFC must have a process agent for the purpose of accepting the service of notices and documents in Hong Kong. Under the OFC Rules and the OFC Code, the following persons/ entities may act as a process agent: (a) an individual whose usual residential address is in Hong Kong, (b) a company formed and registered under the Companies Ordinance (**CO**) in Hong Kong, or (c) a firm of solicitors or certified public accountants in Hong Kong. The SFC has clarified that the requirement to appoint a process agent is imposed on the custodian and not on the sub-custodian.

Tax implications

While Hong Kong has a profits tax exemption framework for offshore private funds whose central management and control is located outside Hong Kong, and public funds authorised by the SFC under Section 104 of the SFO, the Hong Kong Government gazetted the Inland Revenue (Amendment) (No.2) Ordinance 2018 on 29 March 2018 to offer the profits tax exemption to onshore private OFCs as well (**OFC Tax Exemption**), subject to certain qualifying conditions such as the requirement that an OFC be "not closely held"[3]. With respect to stamp duty, however, transfers of OFC shares will be subject to Hong Kong stamp duty, and this is seen as a disadvantage to Cayman funds, as the transfer of shares of Cayman funds that maintain their register of shareholders outside Hong Kong will not be chargeable with Hong Kong stamp duty.

Segregated liability regime

In the case of an umbrella OFC, the OFC Code requires that the risks be highlighted in the offering documents of the OFC in relation to segregated liability between sub-funds, being that foreign courts may not enforce such segregated liability provision. The OFC Code also includes a disclosure requirement for cross sub-fund investments in OFCs' annual reports.

As noted above, although it may be an alternative fund structuring option more immediately for Hong Kong domiciled SFC-authorised funds, and may strengthen Hong Kong's position as a preferred fund domicile, the Hong Kong OFC structure may potentially face challenges when attracting the interest of private fund managers. We expect to see that the preferred fund vehicle for private fund managers based in the region may possibly remain the Cayman structures which are more flexible, simply-established, less burdensome and more lightly-regulated.

Contact Details

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[3] To meet the "not closely held" requirement, among other conditions, an onshore private OFC with at least one qualified investor (i.e. a large institutional investor investing more than HK$200 million each) must have a minimum of five investors (including the qualified investor, and not including the originator and its associates), whereas an onshore private OFC without such qualified investors must have at least ten investors.