



Open-ended Fund Companies Regime in Hong Kong

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Equipped with an established and mature asset management platform, Hong Kong has been a popular location for asset management activities. The open-ended fund company (“OFC”) regime was launched in 30 July 2018 after four years of market consultation and legislation to further enhance and diversify Hong Kong’s fund platform. This article provides an overview on the OFC regime in Hong Kong and outlines recent regulatory enhancement that aims to amplify the regulatory environment for OFC.

Features of OFC

Traditionally, an open-ended investment fund which proposed to domicile in Hong Kong was established in the form of a unit trust, instead of a company limited by shares. Following the introduction of the OFC regime in July 2018, fund managers can now establish an open-ended investment fund in the form of a limited liability company, which has key features similar to a conventional limited company. The key features include the followings:

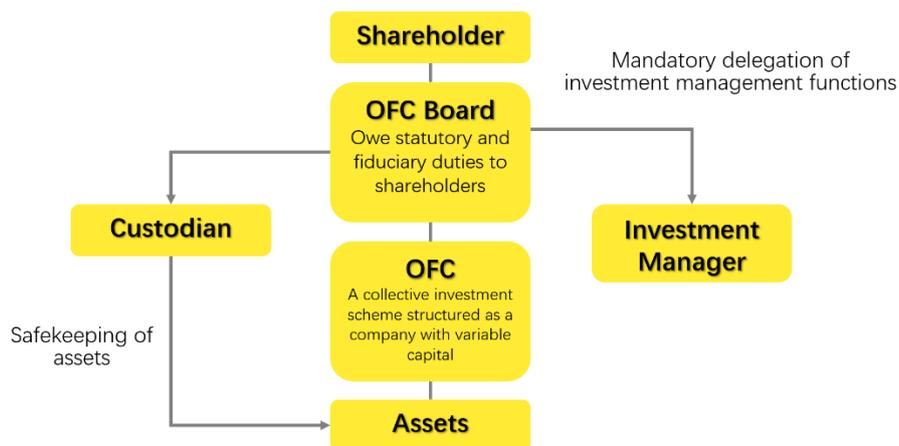
- having a corporate structure and legal personality;

- being governed by a board of natural person directors; and
- limiting the liability of its shareholder to the amount unpaid on their shares in the company.

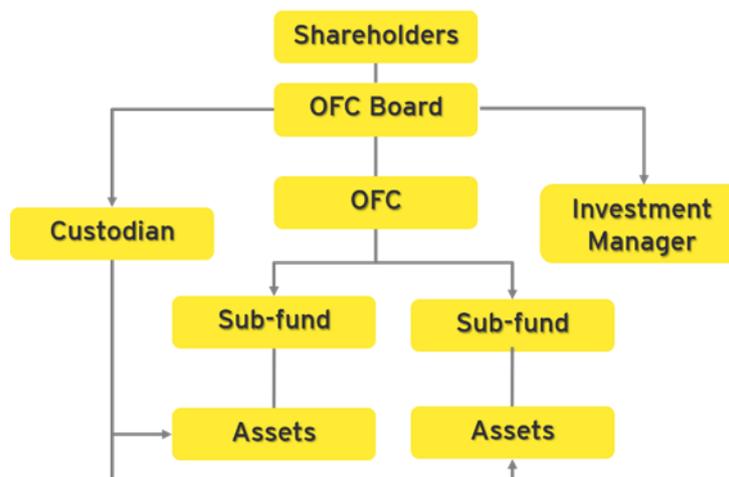
In addition, as an investment vehicle, an OFC also has the following features that allow more flexibility than conventional companies:

- variable capital structure with the flexibility to create and cancel shares for investors to subscribe and redeem the funds;
- distribution of assets out of share capital subject to solvency and disclosure requirements;
- allowing for the establishment in the form of umbrella fund; and
- could be publicly (subject to prior authorisation of the Securities and Futures Commission (the “SFC”)) or privately offered.

Structure of an OFC



The activities of an OFC will reflect a traditional investment funds whereby the board will delegate investment management functions to a professional investment manager and the assets of the OFC will be held by an independent custodian.



OFC can also be established in an umbrella and sub-fund structure to divide the scheme property into separate parts and segregate the liability of sub-funds. The assets of a sub-fund belong exclusively to the sub-fund and must not be used to discharge the liabilities of, or the claims against, any other person, including the OFC itself and any other sub-fund under the OFC. Section 158 of the Securities and Futures (Open-ended Fund Companies) Rules (Cap. 571AQ) (the “**OFC Rules**”) provides for terms that will be implied

in an umbrella OFC’s contracts and transactions:

- a contracting party with the OFC agrees not to seek to have recourse to any assets belonging to other sub funds in the discharge of liability that was not incurred on behalf of that sub-fund;
- if such party succeeded in having recourse to such assets, he is liable to the OFC to pay a sum that equals to the value

of the benefit that the party obtained as a result; and

- the asset seized will be held on trust by such party and he will be obliged to keep the assets /proceeds of sale of the assets separate and identifiable as trust property.

- OFC Rules; and
- The Code on Open-Ended Fund Companies (“**OFC Code**”), being a non-statutory code published by the SFC in July 2018.

These rules and regulations have laid down requirements on the three main personnel of an OFC, namely the (1) directors; (2) custodian; and (3) investment manager. Appointment and replacement of these key personnel require prior approval of the SFC. Table below sets out the eligibility requirements of these key personnel.

Requirements on the key personnel

The legal framework of the OFC regime consists of three main pieces of legislation:

- the Securities and Futures (Amendment) 2016 Ordinance;

	Directors	Investment manager	Custodian
Eligibility	<ul style="list-style-type: none"> • Two directors (natural persons over 18 years old) • Not an undischarged bankrupt • One independent director who is not a director or employee of the custodian • Have technical knowledge, ability to perform their duties and satisfactory expertise in relevant business 	<ul style="list-style-type: none"> • Must be registered or licensed for Type 9 (asset management) regulated activity • Must remain fit and proper, at and after registration of the OFC 	<ul style="list-style-type: none"> • Apart from custodians that satisfy the requirement under the Unit Trust Code, for private OFCs, as expanded in September 2020, the custodian can also be a corporation licenced for Type 1(Dealing in securities) regulated activity which meets the following requirements: <ul style="list-style-type: none"> • its licence does not restrict holding client assets; • it must at all times maintain paid-up share capital of not less than HK\$10 million and liquid capital of not less than HK\$3 million; • the OFC must at all times be a client of such licensed corporation or registered institution in respect of its business in Type 1 (Dealing in securities) regulated activity; • have at least one responsible officer or

	Directors	Investment manager	Custodian
			<p>executive officer responsible for the overall management and supervision of its custodial function; and</p> <ul style="list-style-type: none"> • be independent of the investment manager.
Duties	<ul style="list-style-type: none"> • Fiduciary duties and the duty to exercise reasonable care, skill and diligence • Must delegate investment manager functions to the investment manager by an investment management agreement 	<ul style="list-style-type: none"> • Carry out investment management functions of the OFC in accordance with the instrument of incorporation and investment management agreement 	<ul style="list-style-type: none"> • Safe-keeping investment scheme property and segregation of trust account for scheme money • Delegation is permissible so long there is proper oversight and a written internal control policy for selection and ongoing monitoring sub-custodian and addressing conflict of interest
Overseas candidate	<p>Overseas directors must appoint a process agent, who may be: (a) an individual whose usual residential address is in Hong Kong; (b) a company formed and registered under the Companies Ordinance (Cap. 612) ("CO") in Hong Kong; or (c) a firm of solicitors or certified public accountants in Hong Kong.</p>	<ul style="list-style-type: none"> • Overseas management companies are not allowed to be an investment manager for OFCs. 	<ul style="list-style-type: none"> • Overseas custodian must appoint a process agent unless it is a registered non-Hong Kong company under Part 16 of the CO.

Regulatory enhancement - Investment scope

Initially, substantial investments of a private OFC must consist of such assets the management of which constitutes Type 9 regulated activity. Private OFCs are subject to a 10% de minimis limit, which expressly provides that the total value of an OFC's investment in other asset classes (other than those the management of which would

constitutes a Type 9 regulated activity, cash, bank deposits, certificate deposit, foreign currencies and foreign exchange contracts) shall not exceed 10% of the gross asset value of that OFC. For an umbrella OFC, this limit applies to each sub-fund as well as to the umbrella OFC as a whole.

This limit has been lifted in September 2020 and the SFC has removed all investment restrictions on private OFCs under the OFC

Code such that private OFCs are allowed to invest in all asset classes without having to confine substantial amount of its investment in regulated activity. This enhancement is driven by the intention of placing private OFCs on a level playing field with other overseas corporate fund structures. Without the investment restrictions, OFC can now be adopted for investments other than securities or futures, such as investments in private companies, real estate, credit or other assets not previously eligible.

New requirements will be introduced requiring (i) investment managers and custodians to have sufficient expertise and experience in managing and safekeeping the asset classes in which an OFC invests, (ii) enhanced risk disclosure in the offering documents, and (iii) maintenance of proper records.

In terms of enhanced risk disclosure, this includes ensuring offering documents contain clear disclosures on all material risks specific to the type and nature of assets in which the OFC invests, in particular where the OFC invests 10% or more of the gross asset value of the OFC in non-financial or other less common asset class(es).

Regulatory enhancement - Significant controller register

The SFC suggested to require private OFCs to keep a significant controller register similar to the requirement for companies under the CO so as to enhance the transparency of corporate beneficial ownership of OFCs in its public consultation on enhancing OFC regime in 2019. However, such proposal met with a lot of criticisms, for reason of impracticability of such requirement, having considered the open-ended nature of OFC. This is because investors in a private OFC are constantly changing due to the feature of frequent subscription and redemption of shares of the funds.

The SFC has therefore proposed and conducted further consultation in September 2020 to require the OFC to appoint a responsible person to perform AML/CFT functions as stipulated under Schedule 2 to the Anti-Money Laundering and Counter Terrorist Financing Ordinance (Cap. 615). This is similar to the requirements imposed on limited partnership funds in an effort to harmonise AML/CFT requirements across different investment vehicles.

Such responsible person must be (a) an authorised institution (i.e., a bank, a restricted license bank, or a deposit-taking company under the Banking Ordinance (Cap. 155)), (b) a licensed corporation (i.e. a corporation that is licensed to carry on regulated activities under the Securities Futures Ordinance (Cap. 571)), (c) an accounting professional or (d) a legal professional. The appointment of a responsible person should be made by the board of directors of an OFC, as the board is legally responsible for all of the OFC's affairs.

Regulatory enhancement - Re-domiciliation

When the OFC regime was first introduced, there was no mechanism for re-domiciliation. Funds that were established in other jurisdictions may only transfer the assets and the investors to a new vehicle in Hong Kong through restructuring by way of, among others, asset transfer or share swap.

The re-domiciliation proposal has been introduced by the Financial Services and the Treasury Bureau (the "Bureau") in February 2021. The core requirements under the proposal is that the migrating offshore fund must meet the same set of eligibility requirements of an OFC.

The application process requires a single submission of the application documents and

application fee to the SFC to register a non-Hong Kong fund as an OFC and the SFC would process the application and notify the Companies Registry upon completion for issuance of the certificate of registration/re-domiciliation. In terms of the application, the application for re-domiciliation should include:

- confirmation that the proposed re-domiciliation and de-registration of the offshore fund are not prohibited by its constitutive documents, contracts and laws of its place of establishment;
- a certificate issued by the directors to confirm the solvency of the fund and each sub-fund, the absence of any petition of winding-up, liquidation, receivership or arrangement or compromise arrangement; and
- notice of the proposed re-domiciliation served to creditors.

Once registered, the offshore fund will then have to de-register in its original place of establishment within 60 days of issuance of the certificate of registration, failure of which would lead to its registration being cancelled.

Upon re-domiciliation, the fund's identity will be preserved and remains as the same legal entity. Re-domiciliation to Hong Kong does not intend to prejudice or affect the identity of the fund as previously incorporated or registered. This translates into numerous benefits:

- any contract made or resolution passed will remain intact;
- all rights, functions, liabilities or obligations, and property of the fund before its registration in Hong Kong, will be preserved;

- previous legal proceedings by or against the fund will not be rendered defective; and
- the re-domiciliation does not amount to a transfer of assets or a change in beneficial ownership, hence no stamp duty implications.

The Bureau targets to introduce the bill to effect the re-domiciliation proposal into the Legislative Counsel for first and second reading in the second quarter of 2021.

What's next?

The OFC regime and the reforms aim to enhance the competitiveness of both the OFC regime and Hong Kong's fund industry, making it an attractive alternative to comparable structures available in other developed jurisdictions.

Government dedication in boosting the use of OFCs can also be seen in the 2021-22 Budget Speech, in which additional measures were announced to include an intention to provide subsidies to cover 70% of the expenses paid to local professional service providers for OFCs set up in or re-domiciled to HK in the coming three years, subject to a cap of HK\$1 million per OFC.

However, while these measures and regulatory enhancements are expected to significantly enhance the utility and competitiveness of the OFC regime, it is yet to be seen whether OFCs will become a trend in Hong Kong in light of the introduction of the limited partnership funds which is subject to less scrutiny with more freedom in governing the funds.

Nevertheless, given the introduction of economic substance law in Cayman Islands, Cayman funds are now subject to more stringent regulatory scrutiny and these reforms pose uncertainties as to the fund

formation environment within Cayman Islands. The absence of clarity and market consensus around the economic and practical impact of these changes presents opportunity for Hong Kong to become the next alternative jurisdiction for investment funds and solidify its position as the asset management hub in the region and also to develop a robust domestic private fund industry. Hong Kong has always been a

logical choice for fund managers given its strong community of investors and professional service providers, the proximity to Mainland China and the active initial public offering market for conducting fundraising, deal sourcing and investment management activities. It is expected to witness a growing trend of funds domiciled in Hong Kong in the future.

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