Hong Kong Institute of
Certified Public Accountants
香港會計師公會

By email < ofc@fstb.gov.hk > and by post

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Consultation on Open-ended Fund Companies
Financial Services Branch
Financial Services and the Treasury Bureau
24/F Central Government Offices
2 Tim Mei Avenue, Tamar, Hong Kong

Dear Sirs,

Open-ended Fund Companies Consultation Paper

The Corporate Finance Committee of the Hong Kong Institute of Certified Public Accountants ("the Institute") has considered the above consultation paper, which seeks views and comments on the proposals to enhance Hong Kong's legal infrastructure for investment fund vehicles, by introducing a new open-ended fund company ("OFC") structure to complement the existing unit trust structure.

Broadly speaking, we believe that Hong Kong would benefit by extending the options of legal forms that may be adopted as a vehicle for investment funds. In principle, this should help to attract more funds to domicile here and assist in Hong Kong's development as an international asset management centre. Given also that the OFC structure is already quite well established in some financial markets, we support the proposal to allow for the adoption of OFCs as an additional legal structure for investment funds in Hong Kong.

However, given that an OFC will be an investment vehicle and not a fund as such, consideration should be given to using terminology that more accurately reflects an OFC's function, such as an "open-ended fund investment company".

We note that this consultation focuses on the proposed policy framework, operation and regulatory structure and principles for OFCs, while more specific details regarding the proposals will be developed, taking into account comments received from this consultation. Some of the issues to be considered later will be important, such as the new OFC legislation and the OFC code and guidelines to be issued by the Securities and Futures Commission ("SFC") which will set out, amongst other things, the key functions and duties of directors and other key operators of OFCs. Other important matters will include the practicalities of the interface between the OFC framework and the Companies Ordinance (Chapter 622) ("CO"), on statutory corporate filings and registration of company documents, and the Companies Ordinance/ Companies (Winding Up and Miscellaneous Provisions) Ordinance (Chapter 32)("Cap. 32"), on the winding up of OFCs. Given that these details are not clear at this stage, it is difficult to take a definitive view of the proposed OFC framework.

Our comments on the principles and the proposed framework for OFCs set out in the consultation paper are provided below.

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Sections A and B: Overarching principles and proposed framework for OFCs

We agree with the overarching principles for OFCs set out in paragraph 10 of the consultation paper. In particular, we agree that a distinction should be drawn between publicly offered and privately offered OFCs. For the sake of clarity and certainty, the meaning of "privately offered", including the eligibility to invest in privately offered funds, should be further explained.

We also agree that detailed regulation of OFCs should be set out in subsidiary legislation to facilitate future modifications.

As regards key areas proposed to be covered in the new legislation (paragraph 19 of the consultation paper), we note that some of these, including corporate requirements and the termination and winding up requirements, appear to overlap with the CO and Cap. 32, which contain their own enforcement provisions. As indicated above, the practical interface between these different legislative regimes will need to be made clear.

Section C: Regulators

We agree that the SFC should be the primary regulator of OFCs, since OFCs are primarily vehicles for investment funds. We would suggest that consideration be given to introduce a form of dual filing arrangement for OFCs, under which OFCs would be required to file also with the SFC corporate documents that are required to be filed or registered with the Companies Registry ("CR"), so that the SFC could provide a "one stop shop" for filing information about OFCs and to facilitate its enforcement role as the primary regulator.

As details of the interface between the OFC framework and the CO, on statutory corporate filings and registering of company documents, and with Cap. 32, on the winding up of OFCs, are not clear at this stage, it is difficult to provide any specific views on the proposed role and functions of the CR in the OFC regime and the proposed role of the Official Receiver's Office ("ORO") in relation to termination and winding up arrangements for OFCs.

Nevertheless, we would emphasise the importance of providing a clear segregation of roles between the regulators, so as to avoid any regulatory gaps, on the one hand, and overlapping regulatory functions on the other. For example, it should be clearly stipulated, under the OFC regulatory framework, which agency will be the enforcement agent (whether the SFC or the CR) in relation to directors' fiduciary duties owed to the OFC, including the duty to exercise reasonable care, skill and diligence, under the CO.

In addition, we should like to clarify whether, in the OFC legislation and the OFC Code, cross-references would be made to relevant provisions of the CO and Cap. 32. We are of the view that a reasonably self contained, comprehensive legal framework for OFCs, avoiding the need for frequent cross-referencing to other legislation, would be helpful and would enable stakeholders to know more readily where they stand.

Section D: Legal structure

As regards the proposed OFC structure, we have reservations about the requirements that the investment manager must be licensed by, or registered with, the SFC to carry out Type 9 (asset management) regulated activity, under Part V of the Securities and Futures Ordinance ("SFO"), and that the custodian must be incorporated in Hong Kong.

It is noted that under the Code on Unit Trusts and Mutual Funds ("UT Code"), paragraph 1.2 states that schemes authorised in recognised jurisdictions will be accepted. In relation to applications for authorisation of recognised jurisdiction schemes, the SFC will generally review the scheme's structural and operational requirements, and core investment restrictions, to see whether they already comply in substance with the UT Code.

As regards appointment of the management company, note to paragraph 5.1 of the UT Code states: "*The investment management operations of a fund management company or those of the investment adviser (where the latter has been delegated the investment management function) should be based in a jurisdiction with an inspection regime acceptable to the Commission. A list of acceptable inspection regimes is published on the Commission's website. The Commission will consider other jurisdictions on their merits and may accept an undertaking from the management company that the books and records in relation to its management of a scheme will be made available for inspection by the Commission on request.*"

Since, under the existing unit trust regime, the investment functions can be delegated to overseas managers based in an acceptable inspection regime, we consider that similar flexibility should also be provided in the OFC regime. This would be in keeping with the objective of introducing OFCs, so as to provide more flexibility in establishing and operating funds in Hong Kong and attract more funds to domicile in Hong Kong.

The UT Code accepts a trustee/ custodian which is " … *a banking institution or trust company incorporated outside Hong Kong which is acceptable to the Commission*." (paragraph 4.2 (d)). Following the same line of thought in relation to the requirement for investment manager discussed above, we consider that the appointment of a Hong Kong-incorporated custodian should not be imposed as a mandatory requirement under the OFC regime.

We generally agree with the proposed features for the board of directors of an OFC and with the proposal that the OFC board should be subject to corporate governance standards consistent with international standards for investment funds. High standards of corporate governance and transparency will be important in providing protection to investors. In this regard, it is not clear whether it is intended that there would be any difference in the minimum requirements applicable to publicly offered and privately offered funds. This should be clarified.

It is noted that the consultation document does not indicate, under what situations the investment manager, the custodian, or a director of an OFC could be removed or replaced. We envisage that this matter would be set out in the OFC Code to be issued by the SFC. We recommend that an OFC should be able to remove or replace the investment manager, the custodian, or a director by a simple majority of

shareholders, subject to the SFC's approval of the qualifications of the replacement investment manager, custodian or director. This would be in line with the UT Code, which provides, in the case of a unit trust, that the management company can be removed where, inter alia, holders representing at least 50% in value of the units outstanding (excluding those held or deemed to be held by the management company), deliver to the trustee a written request to dismiss the management company (paragraph 5.11(c)).

Section E: Formation and incorporation

It is noted that, in order to set up an OFC, the applicant should apply to the SFC for approval. Upon the CR's receipt of specified documents and the SFC's issuance of an "approval-in-principle" for registration, the CR would incorporate and register the OFC.

In order to avoid any doubts and uncertainties, we recommend that the ambiguous term, "approval-in-principle", be more clearly defined. Is it, for example, meant to signify a conditional approval, such that an applicant that failed to fulfil the conditions would be deemed to be unsuitable for registration, or would approval-in-principle be given by the SFC only when the SFC was satisfied that all relevant legislative and regulatory requirements had been met by the applicant? If it is the former, would the applicant need to seek subsequent clearance from the SFC on its fulfilment of the conditions?

We have some doubts about the proposal for both the SFC and the CR to maintain lists of OFCs (paragraph 58 of the consultation paper). Which list would be regarded at the definitive list, in the event of any discrepancies between them? It is unclear why the CR would need to maintain a separate list of OFCs, given that the CR's role in relation to OFCs appears to be concerned purely with their legal status as companies under the CO.

Regarding the naming conventions for OFCs, consideration should also be given to distinguishing between public and private OFCs. It is not clear how the SFC's proposed power to vet the acceptability of OFCs' names (paragraph 63 of the consultation paper), which would presumably include the power to reject names, would sit with the CR's powers in relation to company names.

While we would have no objection, in principle, to imposing the proposed restrictions on the investment scope of publicly offered OFCs, i.e., that they may invest only in securities and futures (and over-the counter derivatives, once the relevant proposed legislative amendments have become effective), as defined in the SFO, we would have reservations about imposing the same restrictions on private OFCs. Imposing such a limitation on the investment scope of private OFCs may deter them from establishing in Hong Kong.

Private OFCs should be able to invest in other asset classes that may constitute an investment fund, subject to any self-imposed restrictions in their constitutional documents. This would be consistent with the overarching principles in the development of OFCs in Hong Kong, which include the proposal that privately offered funds be given some flexibility to pursue their investment strategies (paragraph 10(b) of the consultation paper).

Section F: Administration and operation

As regards corporate filing requirements, it is noted that the SFC and the CR will conduct a further review so as to formulate the detailed corporate filing requirements for OFCs. As indicated above, it will be important that there is maximum clarity and certainty regarding the respective roles of the SFC and the CR. For example, we question, in section E, above, the need and desirability for two separate lists of OFCs to be maintained.

In section C, above, we also suggest that consideration be given to introducing a form of dual filing requirements for OFCs. We believe that this should not be a significant administrative burden on OFCs, since they would have to seek the SFC's approval-in-principle, prior to filing relevant documents with the CR, including, e.g., appointments and/ or replacements of directors and any notifications to commence winding-up.

Section G: Protected cells

Where an OFC consists of a number of separately pooled sub-funds, we should like to seek clarification on whether there would be any restrictions, under the OFC regulatory regime, on the ability of a sub-fund to invest in another sub-fund within the same OFC, or whether this would be left to be determined by the OFC's constitutional documents.

Section H: Termination and winding up

Paragraph 107 of the consultation paper deals with the winding up of solvent OFCs. To facilitate the termination of a solvent OFC in a more straight-forward and cost efficient manner, where an OFC is to be terminated in accordance with the specific provisions in its Articles, we would suggest that prior approval from the SFC should not be necessary and that notification to the SFC should be sufficient. Given that the Articles of OFCs should be submitted to the SFC for review during the registration process, and any subsequent changes would be subject to shareholders' approval, and that material amendments must be approved by the SFC, there should already be adequate safeguards to prevent any abuses.

Paragraph 108 of the consultation document proposes that, in cases where an OFC is insolvent, winding-up would be in accordance with the requirements and procedures set out in Cap. 32. We have some reservations about OFCs being able to make use of the procedure under section 228A of Cap. 32, which is a special procedure initiated by the directors, where the majority of directors have formed the view that the company cannot by reason of its liabilities continue in business, and it is not reasonably practicable for the winding up to be commenced under another section of the ordinance. Under section 228A, the directors can appoint a provisional liquidator, who, although he or she has limited powers to sell assets, is empowered to sell property that "is of a perishable nature or likely to deteriorate if kept". There may be a case for limiting insolvent liquidations of OFCs to those conducted by the court, but this needs to be considered in more detail.

Additionally, paragraph 110 refers to the possible dissolution of OFCs by their being struck off the register by the SFC, because they are defunct or in other circumstances specified under the new law. However, there is also a procedure for striking off

defunct companies from the register under the CO and, again, the interface between the two procedures needs to be made clear.

It is noted that this section covers termination of OFCs. What would be the principles and procedures for the termination of sub-funds? Would this also be subject to the SFC's prior approval?

Section I: Regulatory regime

We should like to reiterate our suggestions, set out in section D above, that, in line with the existing unit trust regime, the investment functions of OFCs should be permitted to be delegated by the board to overseas managers based in jurisdictions with an acceptable inspection regime, and that the trustees/ custodians should be permitted to be banking institutions or trust companies incorporated outside Hong Kong and acceptable to the SFC.

Section J: Tax and other issues

We consider that tax will be an important issue for the new OFC regime.

We support the proposal that the profits tax exemption regimes provided under sections 26A and 20AC of the Inland Revenue Ordinance should also be applicable to publicly offered OFCs authorised by the SFC, or offshore funds with their central management and control located outside Hong Kong.

While offering a more favourable tax treatment for private OFCs with their central management and control located onshore may help to attract more Hong Kong domiciled OFCs, this should be considered in tandem with the proposed new rules on offshore fund exemptions, announced by the financial secretary in the budget, which are currently being drawn up by the government.

The above comments and observations reflect our views on the proposed principles and framework for OFCs to be introduced in Hong Kong. Our apologies for this delayed response but, nevertheless, we hope that you will be able to take our views into account.

If you have any questions on this submission or wish to discuss it further, please contact me at the Institute on 2287 7084 or at peter@hkicpa.org.hk.

Yours faithfully,

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