



**CONSULTATION PAPER
OPEN-ENDED FUND COMPANIES**

The Law Society's Submissions

Question 1: Do you agree with the overarching principles for OFCs?

Law Society's response:

Yes.

Question 2: Do you consider it agreeable to set out the legislative framework for OFC in the SFO and the relevant subsidiary legislation in the proposed manner?

Law Society's response:

Yes.

Question 3: Do you think the proposed scope of the code and guidelines could adequately cater for the OFC regime? If not, what other essential features should the codes and guidelines include?

Law Society's response:

We suggest a light touch approach to the OFC Code. The OFC platform can largely be supported by the existing regulatory framework, supplemented by the OFC documentation (Articles and Offering Document). The manager of a publicly offered OFC will be subject to the requirements of the Code on Unit Trusts and Mutual Funds ("UT Code") and, all OFCs will have managers subject to the SFC Code of Conduct, the Fund Manager Code of Conduct and the other conduct requirements of the SFC.

Question 4: Do you agree with the proposal that the SFC should be the primary regulator of OFCs?

Law Society's response:

Yes. For privately offered OFCs, we suggest clarifying that the SFC's power to intervene in the running of the affairs of the privately offered OFC arise on specified triggers (such as insolvency, or the OFC carrying on its business in a manner prejudicial to its investors) rather than granting the SFC a general supervisory mandate.

Question 5: Do you agree with the proposed role and functions of CR in the OFC regime?

Law Society's response:

Yes.

Question 6: Do you agree with the proposed role of ORO and SFC in respect of proposed termination and winding up arrangements for OFCs?

Law Society's response:

The termination and winding up arrangements should not interfere with an OFC's right to effect the return of funds by way of redemptions.

If an OFC board of directors decide to effect a voluntary winding up (perhaps due to below average performance over the recent past), that decision should not require regulatory approval.

If an insolvent winding up process is invoked, that decision also should not require regulatory approval. The determination of when the commencement of a winding-up takes place impacts upon insolvency claw-backs. We query why the SFC should put itself in a position where it holds up the commencement of an insolvent liquidation process.

In light of the above, we do not think a further layer of supervision – being SFC prior approval – should be introduced for termination and winding up.

We agree with the proposed role of the ORO.

Question 7: Do you think the proposed features comprise the essential features of an OFC? If not, what other essential features should an OFC possess?

Law Society's response:

Agreed.

Question 8: Do you agree with the proposed features for the Board of Directors? Do you think the proposed structure of the Board and the proposed criteria of directors will be able to render adequate investor protection to those investing in OFCs? Or do you think

the proposed structure is too onerous, and would hinder the development of OFCs in Hong Kong?

Law Society's response:

We consider the existing common law framework of directors' duties provides ample protection for investors of a privately offered OFC. We suggest using the OFC Code to provide a light touch layer of further granularity to directors' duties in the context of publicly offered OFCs.

We query the need for one director to be a Hong Kong resident, mindful of the intended proposed profit exemption for OFCs if "central management and control" of an OFC is not in Hong Kong¹ and given the fact that other jurisdictions (such as the Cayman Islands) do not have this requirement. We note that in any event the day-to-day management of the OFC will be carried out by the investment manager, not the directors.

Question 9: Do you agree that the OFC board must delegate the day-to-day management and investment functions of the OFC to an investment manager who is licensed by or registered with the SFC to carry out Type 9 (asset management) regulated activity?

Law Society's response:

Agreed.

Question 10: Do you think the proposal to require a custodian in the OFC structure could foster the protection of investors in an OFC? Do you consider the proposed requirements and duties for a custodian adequate to meet this objective?

Law Society's response:

The separation of the functions of a custodian from those of an investment manager will offer useful protection.

We suggest that the government should not seek to adopt custody requirements specific to OFCs. For publicly offered OFCs, the eligibility requirements for and responsibilities of a custodian under the UT Code provides a framework of protection for investors. For all OFCs, the investment manager will be subject to the Fund Manager Code of Conduct which requires investment managers to ensure proper custody of assets. We also note that the market norm for hedge funds is to appoint a prime broker, who carries out an extensive range of functions (including that of custodian and of credit provider). The credit risk of a hedge fund to its prime broker depends on the terms of the prime brokerage arrangements (including in particular any rehypothecation (prime broker borrowing) limits – which typically impact upon pricing for prime brokerage services). We expect that an attempt to legislate for custody requirements will have a substantial negative impact upon the attraction of OFCs for funds with strategies that utilise prime brokerage arrangements.

¹ The introduction of a requirement of a Hong Kong resident director opens up a possible argument as to whether "central management and control" is in Hong Kong due to that director's residence in Hong Kong.

In order to make an OFC a more attractive vehicle, we suggest permitting the use of custodians in jurisdictions other than Hong Kong, rather than requiring each custodian to be Hong Kong incorporated. If Hong Kong becomes a favoured location for OFC incorporations, there will be a tendency for custodians to wish to set up establishments in Hong Kong.

Question 11: Do you agree with the proposed arrangements in relation to the incorporation of OFC?

Law Society's response:

We recommend that the SFC registration process consist of a filing rather than a detailed pre-approval process. We note that a publicly offered OFC will be subject to a detailed review by the SFC at the authorisation stage.

Question 12: Do you consider the proposed naming convention provides sufficient level of clarity to investors?

Law Society's response:

Whilst we agree that a fund's name should not be misleading, we query the need for the SFC to vet acceptability at the registration stage. We suggest that any name vetting by the SFC may take place as a post-registration item.

Question 13: Do you agree that the proposed Articles are adequate? What features should the Articles include?

Law Society's response:

Yes.

We see no need to include further statutory requirements for the features of the Articles. Instead, OFCs should tailor the Articles on a case-by-case basis, including for example the ability to move FATCA non-compliant investors to other share classes and to draft tailored conflicts and voting provisions depending upon the circumstances of the OFC board of directors.

As the details of an OFC's investment scope sit better in the Offering Document, we suggest that the description of the investment scope that is included in the Articles be drafted as broadly as possible, to permit all investments that may be made under the OFC regulatory regime. If a particular OFC wishes to include further limitations in the Articles, it is free to do so. Most OFCs will then include further (limiting) detail on investment scope in their Offering Documents.

For privately offered OFCs, material amendments such as a change of investment strategy

should be permitted without requiring the SFC's prior approval. Professional and institutional investors in privately offered OFCs are sufficiently sophisticated to make their own decisions on the suitability of proposed changes.

Question 14: Do you consider the proposed investment scope and strategies could provide a competitive framework for OFCs in Hong Kong with sufficient safeguards for investor protection?

Law Society's response:

Our preference is not to prescribe an investment scope in the OFC regime. We do not expect the scope of abuse to be a significant risk because the day-to-day management of OFCs is carried out by Type 9 asset managers. By not prescribing the investment scope, the OFC platform will be more attractive and competitive.

Particular causes of concern with the current proposed limited scope are that the OFC (via its licensed Type 9 asset manager) may be unable to:

- invest in shares of private companies – which fall outside of the SFO definition of 'securities'
- carry out investment activities that fall within the scope of leveraged foreign exchange trading
- make cash deposits (including with foreign banks that are not Hong Kong authorized institutions)

We note that the Type 9 licensing framework does not restrict a licence-holder to undertake only regulated activities under the SFO.

We note that for publicly offered OFCs, the UT Code provides an effective framework for investment scope and restrictions. Such restrictions are not required for privately offered OFCs which serve professional and institutional investors.

We also suggest the legislation should state that the OFC's responsibility for investment scope and strategies is limited to (i) instructing an asset manager licensed for Type 9 regulated activity and (ii) carrying out its investment scope and strategy in accordance with its Articles and (possibly) its Offering Document. The legislation should deem OFCs not to be in breach of any Part V/ Schedule 5 SFO licensing and registration requirements if they act in accordance with (i) and (ii) above.

Question 15: Do you agree with the proposed arrangements in relation to the offer of OFC shares?

Law Society's response:

Agreed.

Question 16: Do you agree with the proposed arrangements regarding corporate administration?

Law Society's response:

There are no disclosure requirements in respect of investors' holdings in public unit trusts. We therefore suggest that the OFC disclosure requirements should not extend to disclosing each shareholder's holding in the OFC.

The above is premised on our expectation that shareholder powers over the OFC will be limited (in particular given the regulatory oversight of the OFC).

We query the need for the OFC Code to require SFC approval prior to making corporate filings with the CR. We note that any material matters for a publicly offered OFC will need SFC approval or notification under the UT Code. We suggest a light touch approach be applied here to avoid over-regulation.

Question 17: Do you agree with the proposed arrangements in relation to fund operation? Are the proposed principles and arrangements adequate to cater for the practical operation for OFCs?

Law Society's response:

Agreed.

Question 18: Do you agree with the proposed arrangements in relation to protected cells?

Law Society's response:

Agreed.

Question 19: Do you think the proposed termination procedures are adequate to provide an expedient way for terminating a solvent OFC?

Law Society's response:

Termination / closure of a publicly offered OFC will already be supervised by the SFC under the UT Code. For privately offered OFCs, we regard a post-dissolution filing with the SFC to be sufficient.

Please see the response to Question 6.

Question 20: Do you have any comments on the proposed termination, winding up and

dissolution arrangements for OFCs, including the proposed power to be given to the custodian to petition to the court to wind up an OFC?

Law Society's response:

No.

Question 21: *Do you consider the proposed powers are essential and proportionate?*

Law Society's response:

Provided that the triggers to the use of the powers are clear, we have no objection to the scope of the proposed powers. The legislation should take a light touch to the triggers for bringing monitoring and enforcement action against the OFCs in light of the SFC's powers against the manager of the OFC (being the Type 9 asset manager).

Question 22: *Do you think the existing profits tax exemption regimes for public funds authorized under section 104 of the SFO / bona fide widely held regulated funds and offshore funds are adequate to cater for OFCs?*

Law Society's response:

Section 26A Inland Revenue Ordinance

We suggest including both exemptions under s26A of the Inland Revenue Ordinance, namely:

- exemption for OFCs authorized under s104 SFO; and
- exemption for OFCs bona fide widely held which comply with the requirements of a statutory authority within an acceptable regime.

The second exemption would be useful to OFCs whose investor base is largely located outside of Hong Kong (and who have, say, less than fifty Hong Kong investors).

For an OFC to be able to fall within the second exemption, corresponding amendments need to be made to the current concept of 'a supervisory authority within an acceptable regime' so that Hong Kong OFCs fall within this term.

Section 20AC Inland Revenue Ordinance

The purpose of the introduction of OFCs is to encourage both publicly offered and privately offered OFCs.

To encourage privately offered OFCs, the OFC itself must not attract tax, so that the use of an OFC is tax neutral to investors.

We suggest amending s20AC of the Inland Revenue Ordinance in the context of OFCs as follows:

- permit the exemption to apply to Hong Kong resident funds
 - the exemption encourages board meetings of OFCs to be held outside of Hong

Kong and for the majority of OFC directors to be non-Hong Kong resident. Subject to the issue of “central management and control” and the intended proposed profit tax exemption identified in the response to Question 8 above, we see no strong reason for seeking to limit the appointment of Hong Kong resident directors to the boards of OFCs; and

- extend the scope of the specified types of transaction
 - please see response to Question 14.

The current anti-avoidance round-tripping provisions should be retained so that no Hong Kong-resident investor may benefit from the exemption if the investor has a beneficial interest of 30 per cent. or more (either alone or jointly with the investor’s associates) in the OFC, subject to the current carve-outs.

Question 23: Do you consider that the proposed stamp duty treatment on sale and transfer of shares in OFCs can cater for the market needs?

Law Society’s response:

Although the vast majority of fund flows into and out of OFCs will be subscriptions and redemptions (which do not attract stamp duty), investors in funds do from time to time request transfers (often, transferring intra-group).

We suggest excluding the sale and transfer of shares in OFCs from being subject to stamp duty, as this will enhance the attractiveness of OFCs.

Question 24: Do you consider the proposed tax filing arrangement agreeable?

Law Society’s response:

We have no concerns with the proposed tax filing arrangement.

**The Law Society of Hong Kong
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