



Consultation Paper on the Securities and Futures (Open-ended Fund Companies) Rules and Code on Open-ended Fund Companies

The Law Society's Submissions

The Securities and Futures Commission (“SFC”) in June 2017 launched a consultation on the detailed legal and regulatory requirements applicable to the new open-ended fund company structure. In response thereto, the Law Society provides the following submissions on the consultation questions posed.

Overall comment

The Law Society fully supports the introduction of open-ended fund companies to the Hong Kong regime. This will be a welcome development in terms of Hong Kong's position as a full-service international asset management centre and preferred fund domicile, subject to the comments and responses below.

Consultation Questions

***Question 1:** Do you have any comments on the suggested one-stop process for the establishment of an open-ended fund company (“OFC”)? Please explain your view.*

Law Society's response:

This is an essential feature of the new regime, ensuring as far as possible a seamless method of setting up an OFC without duplication of effort by market participants or potential inconsistencies in their treatment under the incoming rules. Easy access for market participants to using the new structure will be vital to ensure as far as possible a good take-up. In the same vein, the one-stop approach concerning changes of name is similarly essential.

Question 2: With regards to the suggested factors as to whether a proposed OFC name is “misleading or otherwise undesirable”, are there other factors which you think should be taken into account? Please explain your view.

Law Society’s response:

We have the following comments on the suggested factors.

We would have expected the collective provisions to be more in alignment with Cap. 622, the Companies Ordinance:

Section 100

(1) A company must not be registered by—

- (a) a name that is the same as a name appearing in the Index of Company Names;
- (b) a name that is the same as a name of a body corporate incorporated or established under an Ordinance;
- (c) a name the use of which by the company would, in the Registrar’s opinion, constitute a criminal offence; or
- (d) a name that, in the Registrar’s opinion, is offensive or otherwise contrary to the public interest.

(2) Except with the Registrar’s prior approval, a company must not be registered by—

- (a) a name that, in the Registrar’s opinion, would be likely to give the impression that the company is connected in any way with—
 - (i) the Central People’s Government;
 - (ii) the Government; or
 - (iii) any department or agency of the Central People’s Government or the Government;
- (b) a name that contains any word or expression for the time being specified in an order under section 101; or
- (c) a name that is the same as a name for which a direction has been given under—
 - (i) section 108, 109 or 771; or
 - (ii) section 22 or 22A of the predecessor Ordinance on or after 10 December 2010.

The wording in red and underlined could easily and appropriately be adopted in the OFC Rules, as a result harmonizing the companies legislation and the OFC Rules to a reasonable degree.

Similarly:

Section 780

Registrar may serve notice to regulate use of corporate names or approved names

(1) The Registrar may serve a notice on a registered non-Hong Kong company if satisfied that a corporate name or approved name of the company—

(a) is the same as or is too like –

(i) a name that appears, or should have appeared, in the index of names kept under section 22C of the predecessor Ordinance or in the Index of Company Names on the material date; or

(ii) the name of a body corporate incorporated or established under an Ordinance before the material date; or

(b) gives so misleading an indication of the nature of the company's activities in Hong Kong as to be likely to cause harm to the public.

The above wording in red and underlined chimes with that in section 100(1)(d).

The additional restrictions would provide a more level playing field across the various types of entity operating in Hong Kong, in terms of funds and other corporate entities.

We appreciate that the Code on Unit Trusts and Mutual Funds (“Unit Trust Code”) and related guidance cover advertising issues for funds covered by that Code, but we consider it appropriate to ensure that the regime deals with this type of issue as seamlessly and comprehensively as possible.

In principle, the OFC Code wording as regards *misleading or undesirable* is appropriate across the board.

The Consultation Paper states *(emphasis supplied)*:

The proposed OFC Code...provides guidance on the factors which would be considered by the SFC in determining whether a proposed OFC name would be regarded as “misleading or otherwise undesirable”. For example, whether the proposed name (a) is inconsistent with the nature, investment objectives or policy of the OFC, (b) is substantially similar to the name of another OFC, (c) would give investors a sense of assurance or security not justified by the underlying features of the OFC, or (d) might lead investors into inferring or might otherwise create the impression, that the directors

are not responsible for the OFC.

It would in our view be appropriate for fuller guidance to be developed to flesh out the meaning of the wording in red and underlined. Our point above regarding seamless regulation across the funds piece equally applies here.

The Law Society notes that the name of an OFC will need to end with “open-ended fund company” or OFC. It may be appropriate, given the clear distinction between public and private OFCs to require the name to end with “private open-ended fund company” or PrivateOFC, or “public open-ended fund company” or PublicOFC, to ensure the clear differentiation between the two types of OFC under the new regime. That would ensure that investors are put on immediate notice as to the nature of the OFC and its regulatory treatment.

This issue is in the context of the nature of the OFC as a Hong Kong-incorporated entity, and is consistent with the concept under the Companies Ordinance of tagging a Hong Kong company as to whether it is a public or a private company.

***Question 3:** Do you have any views on the proposals regarding the instrument of incorporation and the legal capacity of an OFC?*

Law Society’s response:

In a case where the OFC acts outside its instrument of incorporation, the third party (regardless of notice) would be treated as having entered into an invalid transaction with the OFC. While that is helpful, it needs to be recognized that the remedies available to ensure that the underlying investors’ position is made whole seem to be potentially insufficient here: since the shareholders’ power is restricted to pre-emptive action to head off a transaction; where the third party, in the light of the invalid transaction, may be unable to reverse the transaction; where the directors are unable to fund any shortfall themselves. There would be no satisfactory redress for the investors from the OFC, for obvious reasons. The underlying shareholders would accordingly suffer.

***Question 4:** What are your views on the proposed General Principles in the draft OFC Code as outlined above? Are there any other areas which you think the General Principles should cover?*

Law Society’s response:

We have no comments on the proposed General Principles.

Question 5: Do you have any comments on the proposed requirements as to the eligibility, appointment and removal, and duties of the key operators of an OFC? Please explain your view.

Law Society's response:

Directors – Overall, we agree with the proposed requirements. We welcome the application of the Companies (Winding-up and Miscellaneous Provisions) Ordinance (Cap.32) regime on disqualification of directors to OFCs. We consider the modifications appropriate.

An issue of concern is in **paragraph 5.1 of the OFC Code** (*emphasis supplied*):

Each of the directors of an OFC must be of good repute, appropriately qualified, experienced and proper for the purpose of carrying out the business of the OFC.

Note:

In determining whether a person satisfies 5.1, the Commission may have regard factors including but not limited to the following:

*(a) whether the person has relevant industry qualifications and/ or experience; and
(b) whether the person, or any business with which the person has been involved, has been held by any court or competent authority to have breached any company, securities or financial markets laws and regulations, have been held for fraud or other misfeasance; or has been disciplined by, or disqualified from, any professional body.*

We presume that this provision has been worded in this way to align it closely with the SFC's discretion to approve directors of, for example, a licensed corporation, while retaining the overall substance of a company. We would suggest introducing at least an element of materiality to the concept of breaches of relevant laws and regulations, particularly in the context of a competent authority. Court findings would be less of an issue. That would incorporate a degree of proportionality into the ineligibility of an OFC director.

Investment manager and custodian – No comments.

Question 6: What are your views on the proposed persons and entities which may serve as the process agent of an overseas director and overseas custodian of an OFC?

Law Society's response:

We regard the proposals as appropriate to take into account offshore directors and custodians in the context of an OFC.

Question 7: *Do you have any views on the proposals concerning the shares, meetings and resolutions of an OFC discussed above?*

Law Society's response:

No comments.

Question 8: *Do you agree with the proposed approach with regard to the filings with the Companies Registry ("CR")? Please explain your view.*

Law Society's response:

We consider the proposals appropriate. We welcome the one-stop approach to be followed in relation to OFCs.

In that regard, for the sake of simplicity, it may be preferable for OFCs to file all documentation directly with the SFC to avoid confusion over which document should be filed where.

By way of illustration:

Notice of removal/ resignation of auditor
SFC - N/A
CR – Yes

We would have expected the SFC to have been the appropriate first port of call for the OFC in relation to this type of filing, not least given the regulatory implications.

Question 9: *Do you have any views on the proposed eligibility, appointment and removal, and rights and powers of the auditors in the draft OFC Rules?*

Law Society's response:

No comments.

Question 10: *Do you agree with the proposed requirements regarding the financial reports of an OFC? Please explain your view.*

Law Society's response:

No comments.

Question 11: *Do you have any comments on the proposed provisions for the segregated liability of sub-funds and cross sub-fund investments? Please explain your view.*

Law Society's response:

Implied contractual terms are less robust than wholesale structural legislative change, but we understand the reasons for the approach taken. The flaws in the approach include – in 158(b) of the Securities and Futures (Open-ended Fund Companies) Rules 2017 - the difficulties created where a third party succeeds in having recourse to a sub-fund's assets in respect of liabilities not incurred by the sub-fund, and then the assets are immediately dissipated. Where the third party is unable to meet a claim in respect of the protected cell, the aims of the legislation would have been defeated.

We welcome the inclusion of provisions catering for cross sub-fund investments, duly monitored, which will provide welcome flexibility for asset managers.

We have no additional comments.

Question 12: *Do you have any comments on the proposed draft OFC Rules regarding arrangements and compromises? Please explain your view.*

Law Society's response:

No comments.

Question 13: *What are your views on the proposed requirements and steps for termination by application to the SFC?*

Law Society's response:

No comments.

Question 14: *Do you agree with the proposed approach to applying the Companies (Winding Up and Miscellaneous Provisions) Ordinance ("C(WUMP)O")'s winding-up regime to OFCs and the modifications suggested in the draft OFC Rules when applying the winding-up regime? Are there any other modifications which you think should be included? Please explain your view.*

Law Society's response:

No comments.

***Question 15:** Do you have any comments on the wording in the proposed OFC Code in respect of the investment scope of private OFCs? Please explain your view.*

Law Society's response:

We regard this issue for the most part to be one of proper disclosure / fair treatment in the offering documentation and surrounding selling activity, given the nature of private funds.

There is scope for an OFC not being viewed as becoming in regulatory breach of the investment restrictions where it is clear that there will be such a breach and the investment manager sought prior blessing from the SFC in appropriate cases. This would normally be where there will be, for whatever reason, an unavoidable issue arising in the short term which cannot be resolved before the limit is crossed. This would allow the manager / ODC to avoid a "breach", having demonstrated a proactive approach to a looming problem. Although, naturally, the SFC would need to be cautious before giving any such "approval" - to avoid any gaming of the provisions or to avoid giving unwarranted relief to investment managers for unsuitable forward planning.

***Question 16:** Do you agree with the proposed approach and basic requirements concerning fund operations and disclosure by a private OFC? Do you think that there are other requirements that should be included in the proposed OFC Code? Please explain your view.*

Law Society's response:

We agree overall with the approach taken. It is important for OFCs to be viewed as flexible vehicles for the enhancement of the Hong Kong fund management industry, albeit within appropriate regulatory restrictions. Particularly important is the need for OFCs not to be viewed as an overly restrictive alternative to unit trust structures, to allow OFCs to have a reasonable opportunity to flourish.

***Question 17:** Do you have any views on the proposed approach to the different types of scheme changes of a private OFC?*

Law Society's response:

We regard these provisions as appropriate, subject to the general observations made in our response to Question 16.

**The Law Society of Hong Kong
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