

Oversight

Overhaul of the private OFC regime

February 2020

Introduction

The open-ended fund company (OFC) regime came into effect on 30 July 2018. Although this Firm acted on the first public OFC platform (the Global X Exchange Traded Funds Series OFC with three listed funds) there have only been, to date, two private OFCs registered in Hong Kong.

The slow take-up is perhaps surprising given that the Securities and Futures Commission (SFC) published its consultation conclusions in respect of the proposed rules and code for the new OFCs back in May 2018. The consultation itself had commenced in June 2017. The launch of OFCs had been preceded on 23 June 2017 by the publication of the Inland Revenue (Amendment) (No.4) Bill 2017 which amended the Inland Revenue Ordinance (IRO) to provide for a profits tax exemption in respect of certain privately offered OFCs. Earlier still saw the enactment of the Securities and Futures (Amendment) Ordinance (Amendment Ordinance) in 2016 which amended the Securities and Futures Ordinance (SFO) to establish the legal framework for the incorporation of OFCs. The OFC regime was in fact the culmination of many years' lobbying by the fund industry of the Hong Kong Government. Impetus was given by the recommendations in November 2013 of the Financial Services Development Council and the Financial Services and Treasury Bureau set out in a consultation paper of March 2014.

Whilst a major criticism of the OFC regime had related to the limited and complex exemption from taxation for private OFCs, this was addressed more recently with further revisions to the IRO. These in effect extend the tax exemption for funds to those domiciled in Hong Kong and remove any advantage previously enjoyed by overseas-domiciled funds. The changes to the IRO took effect in April 2019. Accordingly the lack of interest in OFC-structured funds has caused the SFC to look further at enhancements to the regime. With this in mind the SFC published its Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies Regime (Consultation) at the end of last year (December 2019). The SFC has requested feedback by no later than 20 February 2020.

This *Oversight* recaps the key features of OFCs and examines the SFC's proposed changes.

Overview of the OFC Regime

OFCs are a form of open-ended body corporate under Hong Kong law. OFCs issue shares and have boards of directors. OFCs are not, however, ordinary companies subject to the complex requirements of the Companies Ordinance. OFCs issue redeemable shares and have a variable capital. They are designed to be mutual fund corporations incorporated in Hong Kong. As such OFCs constitute collective investment schemes as defined in the SFO. OFCs can be structured as single funds or umbrella funds (with statutory ring fencing for sub-funds).

Prior to the creation of OFCs Hong Kong-domiciled open-ended funds could not be established in corporate form due to the restrictions under the Companies Ordinance (CO) relating to capital reductions and distributions out of capital. These restrictions limited the choice of Hong Kong domiciled vehicles for fund formation, particularly when compared to other jurisdictions, such as the Cayman Islands or Delaware. Most developed jurisdictions offer corporate mutual funds or equivalent as well as “protected cell” corporate umbrella funds. Luxembourg’s société d’investissement à capital variable (SICAV) is well known in the Hong Kong retail funds market, and the United Kingdom has long had open-ended investment companies (OEICs). Singapore has also launched the Singapore variable capital company (VCC) in January 2020.

Unlike, say, the Cayman Islands – where the Cayman Islands Monetary Authority (CIMA) has limited (although increasing) input or oversight of private or non-retail mutual fund corporations, under the OFC regime all OFCs, whether to be offered on a private or retail basis, must be approved by and established through the SFC, under a new Part IVA into the SFO. Consistent with the role of the SFC, OFCs are required to be registered by the SFC under that Part.

Beneath Part IVA of the SFO, sit the Securities and Futures (Open-ended Fund Companies) Rules (OFC Rules). The OFC Rules are subsidiary legislation which provide more detail as regards the requirements of Part IVA. Beneath the OFC Rules, the SFC has issued the Code on Open-ended Fund Companies (OFC Code). Like other codes and guidelines issued by the SFC, the OFC Code is promulgated under the SFO but is not statute – rather a set of non-legally binding requirements failure to comply with which may lead to disciplinary action. As with the Code on Unit Trusts and Mutual Funds (UT Code), this enables the SFC to revise the requirements without changing legislation. Indeed the OFC Code format follows the UT Code. The SFC promulgated frequently asked questions (FAQs) on OFCs on 27 July 2018. As the SFC does with the FAQs relating to the UT Code these FAQs clarify its expectations in respect of the OFC Code and are updated and revised from time to time.

Utility and Establishment

OFCs can be structured as either “public OFCs” or “private OFCs”. Neither Part IVA of the SFO nor the OFC Rules differentiate between “public OFCs” and “private OFCs”. An SFC authorised umbrella OFC can, like other types of SFC authorised fund, have private sub-funds as well as public sub-funds. However a public SFC authorised sub-fund must be a sub-fund of a public OFC umbrella.

Because OFCs are collective investment schemes, the general prohibition in Section 103(1) of the SFO on advertisements issued to the public of Hong Kong will apply to shares in OFCs unless the advertisement is approved by the SFC (in respect of a SFC authorised OFC) or an exemption under Sections 103(2) and (3) of the SFO can be relied upon.

Public OFCs can change their status to become private OFCs and vice versa subject to compliance with the requirements of the OFC Code and the UT Code.

Private OFCs can rely on the “professional investors” exemption in Section 103(3)(k) of the SFO. However, it should be noted that the Seventeenth Schedule of the Companies (Winding Up and Miscellaneous Provisions) Ordinance (C(WUMP)O) “safe harbours” from the prospectus registration regime do not apply to offers of shares in Private OFCs (i.e. those OFCs not authorised by the SFC). This is because OFCs are not “companies” under the Companies Ordinance and so the safe harbours under C(WUMP)O cannot apply. As such the issue of advertisements and marketing documents for OFCs which are not authorised by the SFC are only able to rely on the more limited SFO exemptions from the general prohibition on marketing funds to the public.

As mentioned above, an OFC is established by application to the SFC (not the Companies Registry (CR)) for registration and, after approval is given for registration by the SFC, a certificate of incorporation will be issued by the CR. A similar process applies to business registration for tax purposes with the IRD. A Business Registration Certificate will be issued by the Inland Revenue Department (IRD) simultaneously with the certificate of incorporation. In other words, everything will go through the SFC as an initial “one stop shop”. The documents submitted to the SFC are (i) the incorporation form (Form OFCNC1(SFC)) to be signed by any director of the OFC, (ii) a copy of the instrument of incorporation, and (iii) a notice to the Business Registration Office (IRBR3), together with a cheque.

For public OFCs the establishment process occurs alongside the application to the SFC for authorisation under the SFO. Accordingly the “standard” and “non-standard” SFC timings are applicable. For private OFCs the anticipated time to incorporation is less than a month.

Unlike companies regulated by the CR, an OFC is not required to file an annual return, to report any change in the share capital structure such as alteration of share capital or allotment of shares, to the CR. However, major changes in corporate particulars such as change of name, change of registered office address, change of directors and/or their personal particulars and alteration of instrument of incorporation are required to be reported to the CR. For changes which require SFC prior approval such as a change of name and appointment of new directors, the OFC is required to deliver the specified forms to the SFC and the SFC will then send the forms to the CR for registration. The forms for reporting are available on the CR’s website.

Consultation Proposals

The SFC is proposing changes to the OFC regime for private OFCs in the following four areas:

- custodian eligibility requirements for private OFCs;
- expansion of investment scope for private OFCs;
- re-domiciliation of overseas corporate funds; and
- significant controllers register requirements.

Some of these will be helpful if implemented, some will not.

Custodian eligibility

Under the current OFC Code, the custodian of an OFC should meet the same eligibility requirements for custodians of SFC-authorized funds as set out in the UT Code. These eligibility requirements essentially mean that a custodian must be a Hong Kong or overseas bank or a trustee of a registered scheme under the Mandatory Provident Fund Schemes Ordinance. This applies irrespective of whether the OFC is a private OFC or a public OFC. This has been an unduly restrictive requirement which extends retail custody requirements to private funds and limits the number of service providers available, in particular prime brokers, if an OFC is used.

The SFC now proposes to also allow an intermediary, which is licensed or registered to carry on Type 1 (dealing in securities) regulated activity, to act as a custodian of private OFCs, provided that the intermediary meets the following requirements:

- the intermediary's licence or registration granted under Section 116(1) or Section 119(1) of the SFO (as the case may be) is not subject to the condition that it shall not hold client assets. The terms "hold" and "client assets" are as defined in the SFO;
- where the intermediary is a licensed corporation, the licensed corporation meets the capital requirements of minimum paid-up share capital of HK\$10 million and minimum liquid capital of HK\$3 million – this is in line with the proposed capital requirement for custodians of SFC-authorized funds which are licensed corporations under the SFC's proposals to regulate the trustees/custodians of SFC-authorized funds (the proposed Type 13 (acting as a depository) regulated activity license);
- the private OFC is a client of the intermediary in respect of its Type 1 (dealing in securities) regulated activity business at all times; and
- the intermediary must be "independent" of the private OFC's investment manager. Independence for this purpose means that although the custodian and the investment manager may belong to the same group there must be functional separation.

Further, in order to ensure that the SFC has a sufficient regulatory nexus over the intermediary's custodian business, the SFC intends to impose a condition on the intermediary's licence or registration (as the case may be) to the effect that it must comply with all requirements applicable to it as a custodian of an OFC, including the requirements in the OFC Code and related guidance issued by the SFC from time to time (Custodian Condition).

The Consultation proposes amending the OFC Code with the insertion of an Appendix A setting out requirements for safekeeping private OFC scheme property. These additional rules are detailed and prescriptive. Whilst these rules anticipate sub-custodians, duties are imposed on the OFC custodian for the selection and ongoing monitoring of the sub-custodian.

Whilst in concept expanding eligible custodians for private OFCs is to be welcomed, the requirements demanded by the SFC seem onerous and unnecessary. The fact that an intermediary is licensed by the SFC, so long as its license permits it to hold client assets, should offer sufficient protection by itself. The Custodian Condition will create further administrative burdens via the need to obtain the condition from the SFC. Under the Fund Manager Code of Conduct (FMCC) the manager of an OFC will have obligations as to the selection and monitoring of custodians of private OFCs in any event.

Investment scope

Currently, under the OFC Code, a private OFC must invest at least 90% of its gross asset value (GAV) in securities and futures contracts and/ or cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts. A private OFC may also invest in other asset classes, but only up to 10% of its GAV (the 10% de minimis investment limit). This has limited the utility of an OFC for managers using many alternative strategies and, for private OFCs, has no logic.

The Consultation proposes expanding the investment scope of private OFCs by two common asset classes (loans and shares of private companies as defined under Section 11 of the CO) to help enhance the competitiveness of the OFC regime. The SFC's stated rationale is that allowing managers to use an OFC structure to invest in Hong Kong private companies' shares and debentures may facilitate investment in small Hong Kong business to the benefit of Hong Kong's economy. Apart from not falling within the "securities" definition under the SFO, Hong Kong private companies' shares and debentures are in essence no different in nature from shares and debentures of overseas private companies in which an OFC may currently invest freely without any limit under the OFC Code. Loans are an established asset class similar in terms of economic substance to debt securities.

Accordingly, the SFC will allow an expansion of the investment scope of private OFCs to include (a) loans and (b) shares and debentures of Hong Kong private companies, provided that the private OFC's assets include a portfolio of those asset types the management of which would constitute a Type 9 (asset management) regulated activity – i.e. securities. Although not a good reason, the justification for this is to ensure that the SFC has a sufficient regulatory nexus under the SFO in terms of its supervisory, investigatory, disciplinary and enforcement powers over the management and safekeeping of OFC assets.

These revisions are helpful but do not go far enough. As admitted in the Consultation, so long as the private OFC's assets include any securities, then the SFC has jurisdiction. For alternative funds, any asset class should be permitted. Moreover, as it is intended to revise the SFO (see below) the definition of Type 9 (asset management) regulated activity in Schedule 5 to the SFO could be amended to include OFCs (which is how this issue was addressed for REITs).

Redomicile

Under the current OFC regime, corporate funds from overseas jurisdictions can only "redomicile" to Hong Kong by limited and costly means, essentially by way of an asset transfer or share swap. These are uncommon ways for a fund to move between jurisdictions. This has long been recognised in offshore jurisdictions and accordingly a statutory redomiciling mechanism has usually been created by which, for example, a Bahamian or British Virgin Islands fund can become a Cayman Islands fund by deregistering in one jurisdiction and re-registering concurrently in the other. The SFC's rationale for adopting a statutory redomiciliation regime is that it might help take advantage of the latest regulatory developments in the traditional offshore fund jurisdictions, so that existing offshore funds might move to "onshore" jurisdictions such as Hong Kong. A redomiciliation mechanism has also been provided under the VCC regime in Singapore.

The Consultation thus proposes to enhance the OFC regime by introducing a statutory mechanism to facilitate the redomiciliation of overseas corporate funds to Hong Kong using the OFC structure. Under the proposed statutory mechanism, an existing fund's corporate identity, continuity and track record will be preserved i.e. no new legal entity will be created. Not having to establish a completely new legal entity will save costs for the fund, such as those incurred for re-entering or novating contracts with key operators and financing arrangements with banks, and re-acquiring investments. Further, since there will be no change in the legal personality of the corporate fund, there will be no "transfer" of assets from one legal person to another when the fund migrates to Hong Kong using the OFC structure. This may result in stamp duty savings and should preserve track records. The proposal will need to be effected by introducing new provisions in Part IVA of the SFO and making ancillary amendments to the OFC Rules. Like all matters to do with OFCs the process will be required to take effect through the SFC. The redomiciled overseas corporate fund's first financial year as an OFC would begin on the date of its registration as an OFC and end on a date determined by its directors within 18 months of redomicile.

Significant controllers register

As Hong Kong is a member of the Financial Action Task Force (FATF) and given the emphasis internationally on anti-money laundering and counter-terrorist financing (AML/CFT), the SFC is presently focused on the AML/CFT measures which are under its purview. Currently, there are AML/CFT obligations imposed on the investment managers of OFCs and SFC-licensed or registered intermediaries involved in the sale of OFC shares.

With regard to corporate beneficial ownership in respect of OFCs, the SFC proposes to impose requirements on OFCs for the keeping of a register of beneficial shareholders under the OFC Rules, which will be similar to the significant controllers register (SCR) requirements under the CO.

Under the CO, a company incorporated in Hong Kong is required to obtain and maintain up-to-date beneficial ownership information by way of keeping an SCR for inspection by law enforcement officers upon demand and to inform the Companies Registry of the place where the SCR is kept.

The Consultation proposes to adopt essentially the same definition of beneficial owner as that under the CO, such that a person will be considered to have significant control over an OFC if one or more of the following conditions are met:

- the person holds, directly or indirectly, more than 25% of the issued shares in the OFC or, if the OFC does not have a share capital, the person holds, directly or indirectly, a right to share in more than 25% of the capital or profits of the OFC;
- the person holds, directly or indirectly, more than 25% of the voting rights of the OFC;
- the person holds, directly or indirectly, the right to appoint or remove a majority of the board of directors of the OFC;
- the person has the right to exercise, or actually exercises, significant influence or control over the OFC; or
- the person has the right to exercise, or actually exercises, significant influence or control over the activities of a trust or a firm that is not a legal person, but whose trustees or members satisfy any of the first four conditions (in their capacity as such) in relation to the OFC.

Singapore

With the launch of the Singapore Variable Capital Companies Act (VCC Act) in January 2020, VCCs can now be incorporated in and redomiciled to Singapore. On launch, 20 VCCs have been incorporated or redomiciled. The strong interest in the VCC inevitably leads to comparison with the muted launch of the OFC in Hong Kong.

- **Custodian eligibility**

A VCC is not under a general obligation imposed by the Monetary Authority of Singapore (MAS) to appoint a custodian.

However, where the VCC is intended to be offered to “Accredited Investors” (as defined under the Securities and Futures Act of Singapore (SFA)) in Singapore under an exemption from the prospectus registration requirements set out in Section 305 of the SFA, one of the requirements of the exemption is that an “Eligible Custodian” be appointed by the VCC, unless the VCC is a closed end private equity or venture capital fund, in which case it is exempt from the custodian requirement.

Additionally, the Singapore manager of the VCC generally has an obligation to ensure that the assets of the VCC are custodised with an “Eligible Custodian”, unless the VCC is a closed end private equity or venture capital fund or the Singapore manager is otherwise exempt from this custodial requirement. As all VCCs are required to appoint a Singapore manager, the custodian requirement will accordingly, generally be indirectly applied to the VCC.

The definition of “Eligible Custodian” is broad and generally covers (i) certain specified Singapore entities which are licensed to provide custodial services; and (ii) any custodian outside Singapore which is licensed, registered or authorised to act as a custodian in the country or territory where the account is maintained.

- **Investment scope**

There are generally no restrictions or limitations on the investment scope of the VCC.

However, a VCC seeking to be authorised for offer to the retail public in Singapore is required to comply with the investment requirements under the MAS’ Code of Collective Investment Schemes.

For the avoidance of doubt, these requirements do not apply to private VCCs i.e. VCCs not authorised for offer to the retail public in Singapore.

- **Redomiciliation**

The VCC Act provides a statutory redomiciliation framework that permits foreign corporate funds comprising one or more collective investment schemes (e.g. standalone or umbrella funds) to redomicile into Singapore as a VCC by way of transfer of registration. Since the VCC Act took effect, several VCCs have been redomiciled pursuant to such a transfer of registration.

Transfer of registration does not create a new legal entity and generally has the effect of treating the foreign corporate fund as if it were a VCC with effect from the date of registration.

While the foreign corporate fund must be solvent, not be subject to insolvency, receivership or other related proceedings and be authorised under its governing law to transfer its incorporation and the transfer application must be made in good faith and not for the purpose of defrauding existing creditors, there are no asset under management or defined quantitative threshold hurdles to be met.

- **Significant controllers register**

A VCC is subject to certain Singapore AML/CFT obligations, including the requirement to identify and maintain a register of its beneficial owners (subject to certain exemptions).

In this regard, it is mandatory for the VCC to appoint a Singapore regulated entity to assist the VCC in discharging these obligations (which may be the Singapore manager of the VCC).

Singapore managers are already subject to Singapore AML/CFT obligations to identify the beneficial owners of investors into funds managed by such Singapore managers (whether such fund is formed as a VCC or otherwise).

Accordingly, in the context of the VCC, the beneficial ownership information already maintained by the Singapore manager would need to be maintained in the form of a register, which will not need to be made publicly available.

Conclusion

Whilst the Hong Kong Government's initiative to create OFCs was originally widely welcomed, the number of launches of OFCs to date indicates that there are flaws in the approach taken. The decision to "house" the regime under the SFO and make its operation dependent on the SFC immediately placed OFCs at a disadvantage to the extraordinarily successful Cayman Islands mutual funds regime – the "gold standard" in terms of flexibility and ease of establishment. For public OFCs the comparison with the leading offshore jurisdiction is perhaps not relevant given any fund seeking to be authorised for retail distribution in Hong Kong must in any event submit to the SFC's thorough vetting. However for private OFCs, these vehicles must compete with those vehicles available in other jurisdictions, including Singapore (the VCC), where as explained above there is a more flexible approach and a lighter touch.

The Consultation is a step in the right direction of trying to make OFCs more attractive for Hong Kong fund operators. However the proposals in the Consultation are, in respect of investment scope, too limited and, in respect of OFC custodians, too prescriptive and onerous. The redomicile mechanism is helpful but unless the regime for private OFCs becomes less regulated it is unlikely, sadly, to be used much.

Simmons & Simmons in Hong Kong advised on the formation and listing of the first exchange traded funds in the form of OFCs. These were the first public OFCs registered in Hong Kong (in January 2020). Simmons & Simmons JWS in Singapore has been actively involved in the development of the VCC regime, has been involved in establishing one of the first VCCs under the MAS' Pilot Programme and is a member of the VCC Working Group of the Promotion of Singapore Law Committee of the Singapore Academy of Law.

Contact us

Rolfe Hayden

Partner - Hong Kong

T +852 2583 8302

E rolfe.hayden@simmons-simmons.com

Cheryl Kong

Associate - Hong Kong

T +852 2583 8396

E cheryl.kong@simmons-simmons.com

Gaven Cheong

Partner - Hong Kong

T +852 2583 8323

E gaven.cheong@simmons-simmons.com

Miki Shi

Paralegal - Hong Kong

T +852 2583 8409

E miki.shi@simmons-simmons.com

Eva Chan

Partner - Hong Kong

T +852 2583 8216

E eva.chan@simmons-simmons.com

Long Jek-Aun

Partner - Singapore

T +65 6831 5591

E jekaun.long@simmons-simmons.com

Ivy Yam

Consultant - Hong Kong

T +852 2583 8415

E ivy.yam@simmons-simmons.com

Aik Kai Ng

Managing Associate - Singapore

T +65 6831 5593

E aikkai.ng@simmons-simmons.com

Louise Ma

Associate - Hong Kong

T +852 2583 8406

E louise.ma@simmons-simmons.com

Zixiang Sun

Supervising Associate - Singapore

T +65 6831 5599

E zixiang.sun@simmons-simmons.com

Ruby Ho

Associate - Hong Kong

T +852 2583 8375

E ruby.ho@simmons-simmons.com

Benedict Tan

Supervising Associate - Singapore

T +65 6831 5594

E benedict.tan@simmons-simmons.com

Candice Leung

Associate - Hong Kong

T +852 2583 8398

E candice.leung@simmons-simmons.com

Joshua Heng

Supervising Associate - Singapore

T +65 6831 5618

E joshua.heng@simmons-simmons.com

For additional information on our firm, please visit our website at [simmons-simmons.com](https://www.simmons-simmons.com).

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