

Client Alert

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Hong Kong's Open-Ended Fund Company regime launches in July 2018

Recent Developments

As part of the Hong Kong government's plans to strengthen the city's position as an international centre for both fund management activities and investment fund domiciliation, the framework for a new open-ended fund company (**OFC**) structure will be effective from **30 July 2018**. The key legislation and regulations that establish the OFC regime include:

- the Securities and Futures (Amendment) 2016 Ordinance¹ (**Amendment Ordinance**);
- the Securities and Futures (Open-ended Fund Companies) Rules (**OFC Rules**);² and
- the Code on Open-Ended Fund Companies (**OFC Code**).

The OFC Framework

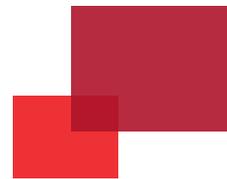
Essential Features

The key features of an OFC include the following:

- An OFC may be either publicly or privately offered. Both types of OFC will be subject to the Amendment Ordinance, the OFC Rules and the OFC Code
- An OFC will have a variable share capital structure with flexibility to meet subscription and redemption requests and pay distributions with net assets/capital
- An OFC can be used as a collective investment vehicle either as a stand-alone entity, or as an umbrella entity with separately pooled sub-funds
- An OFC is established by obtaining registration from the SFC and a certificate of incorporation from the Companies Registry (**CR**)
- An OFC must have at least two individual directors who are subject to fiduciary duties and the duty to exercise reasonable care, skill and diligence
- An OFC must have an investment manager who must be licensed by or registered with the SFC to carry out type 9 (asset management) regulated activity

¹ The Securities and Futures (Amendment) Ordinance 2016 was gazetted on 10 June 2016 but has not yet been enacted.

² Other than the OFC Rules, the subsidiary legislation comprises: (i) the Securities and Futures (Amendment) Ordinance 2016 (Commencement) Notice (Commencement Notice); and (ii) the Securities and Futures (Open-ended Fund Companies) (Fees) Regulation.



- An OFC must have a custodian to whom all scheme property must be entrusted for safe-keeping. The custodian must take reasonable care, skill and diligence to ensure the safe-keeping of the scheme property entrusted to it
- An OFC must appoint an auditor for each financial year of the OFC
- A solvent OFC may make an application to the SFC for the termination of its registration under a streamlined process

Key Operators

Directors

At least one of the two individual directors on the OFC's board must not be a director or employee of the custodian. Based on the practice in comparable overseas fund jurisdictions, the SFC has clarified that "independence" in this context means independent of the custodian, but *not of the investment manager*. The initial appointment of the directors is subject to approval from the SFC, which will seek to ensure each director is of good repute, appropriately qualified and experienced, and proper for the role. Subsequent appointments of directors are also subject to SFC approval and may be made by the OFC's directors pursuant to the OFC's instrument of incorporation or by ordinary resolution.

The directors are not required to be licensed by the SFC nor are they required to be Hong Kong residents. However, non-resident directors must appoint a process agent in Hong Kong.

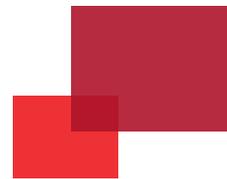
Investment Manager

An OFC must appoint an investment manager that is licensed by or registered with the SFC to carry on type 9 regulated activities. The investment manager's appointment is subject to SFC approval and must remain 'fit and proper' while appointed. While all investment management functions of an OFC must be delegated to an investment manager, the directors of the OFC remain *ultimately legally responsible* for overseeing the investment manager's activities.

Custodian

An OFC is required to appoint a custodian and the initial appointment of the custodian is subject to SFC approval. Custodians must meet the eligibility requirements set out in the Code on Unit Trusts and Mutual Funds (**UT Code**), regardless of whether the OFC is publicly or privately offered. While this level of SFC oversight will be familiar to custodians of SFC-authorized funds, privately offered OFCs may find the enhanced regulatory prescription challenging.

It should also be noted that certain proposed changes to the UT Code, which were the subject of a consultation in 2017, are still under consideration. Various issues were raised in the consultation regarding the liability of custodians for acts or omissions of their third-party delegates, which will be relevant to the custodian of an OFC. The revised UT Code should be reviewed in due course to determine the impact, if any, such amendments may have on the duties of an OFC's custodian.



Under the OFC Rules, subsequent appointments of custodians are to be made by the directors of the OFC, subject to SFC approval. While this is expected given the overarching role of the board, it appears to be inconsistent with the recent changes to the Fund Manager Code of Conduct which imposes responsibility for the appointment of a custodian on the fund manager (where that fund manager is responsible for the overall operation of the fund).

A non-Hong Kong resident custodian may be appointed provided that it appoints a process agent in Hong Kong.

Publicly offered OFCs

Similar to existing SFC-authorized funds, publicly offered OFCs must obtain SFC authorization under Part IV of the Securities and Futures Ordinance (**SFO**) (unless an exemption applies), and will be subject to the requirements and restrictions set out in the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products (collectively, the **SFC Handbook**).

Privately offered OFCs

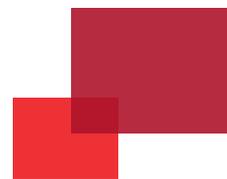
While privately offered OFCs are not subject to the SFC Handbook, they must comply with the investment restrictions, disclosure and operational requirements under section II of the OFC Code.

As the primary purpose of an OFC is to operate as an investment fund (and not as a corporate entity engaged in general commercial business and trade), the investment scope of privately offered OFCs is predominantly aligned with type 9 regulated activity under the SFO. Privately offered OFCs may therefore only invest in asset types such as securities and futures (and over-the-counter derivatives when the relevant laws are enacted) as well as cash, bank deposits, certificates of deposit and foreign currencies. However, a 10% *de-minimis* limit (i.e. a maximum of 10% of the gross asset value of the OFC) may be invested in asset classes other than those covered by type 9 regulated activities. Nevertheless, this tight threshold for investing in non-type 9 assets may make the OFC vehicle less appealing for certain types of funds such as private equity funds, which invest primarily in shares of private companies.

The SFC recognises that private OFCs need to customise the fund's investment policy and operations from time to time to meet the demands of private investors. Accordingly, it has removed its original requirement for SFC approval of any material changes to a private OFC's instrument of incorporation, and will instead only require shareholders approval and post-change filing.

Tax Position

To coincide with the introduction of the OFC regime, the Hong Kong government has enacted the Inland Revenue (Amendment) (No. 2) Ordinance 2018 (**IRAO**) to extend the profits tax exemption currently enjoyed by publicly offered funds and certain offshore privately offered funds, to onshore privately offered OFCs. The IRAO seeks to reduce the disparate tax treatment of overseas and domestic private funds, so as to encourage more private funds to domicile in Hong Kong.



We previously discussed the Inland Revenue (Amendment) (No. 4) Bill 2017 (**Bill**) in our client alert *Hong Kong Introduces Tax Exemption to Onshore Privately Offered Open-ended Fund Companies*. Some notable amendments have since been made to the Bill, which are reflected in the IRAO, and are summarized below:

- Change in the scope of the profits tax exemption afforded to privately offered OFCs that meet the qualifying criteria to:
 - cover profits derived from transactions in non-Schedule 16A assets (i.e. an asset not falling within the permissible asset class) carried out or arranged in Hong Kong by or through a qualified person;
 - carve out from the scope of the profits tax exemption any profits derived from the following transactions:
 - transaction in shares of or debentures issued by a private company which directly or indirectly holds real estate in Hong Kong and the value of the Hong Kong real estate exceeds 10% of the total value of the company's assets;
 - transactions in shares or debentures issued by a private company controlled by the OFC, and 50% or more of the value of the assets of the private company is in respect of short-term assets. A short term asset is specifically defined as non-Schedule 16A assets (excluding Hong Kong real estate) and has been held for less than 3 consecutive years before disposal; and
 - transactions from the direct trading or business undertaking in non-Schedule 16A assets;
- Addition of "shares of, or debentures issued by, a Hong Kong incorporated private company" as a Schedule 16A asset class; and
- Inclusion of sovereign wealth funds as a category of "qualified investors".

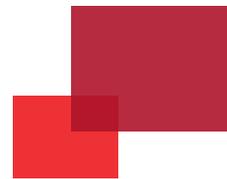
The amendments are primarily to address ring-fencing concerns whilst managing the risk of potential abuse of the exemptions.

In addition to the changes mentioned above, the requirement proposed in the bill that the OFC must invest in at least 90% of its asset in Schedule 16A assets was removed from the IRAO. This removal has limited practical significance as this requirement is already provided for in the OFC Code. Non-compliance can lead to deregistration of the OFC, and thus its exclusion from the profits tax exemption regime which only applies to OFCs.

It is worth noting that the legislation does not provide any specific stamp duty exemption to transfer of shares of an OFC. As such, the stamp duty rules will apply to transfer of shares of an OFC in the ordinary manner.

The Future Vehicle of Choice?

The introduction of the OFC vehicle provides a practical alternative for the constitution of funds and potentially more flexibility for fund managers to meet market demand. OFCs have the added benefit of being a familiar investment



vehicle for asset managers and regulators from non-Commonwealth jurisdictions such as the PRC. In particular, we may see OFCs becoming increasingly utilised by asset managers seeking to distribute investment products northbound into the PRC under the Mainland-Hong Kong Mutual Recognition of Funds Scheme (Scheme).³

An operational advantage in adopting a Hong Kong domiciled structure is that it avoids the complexities and costs of appointing additional layers of service providers and dealing with overseas regulators that comes with setting up in traditional fund jurisdictions. The new OFC regime will enable managers to deal with a single regulatory regime and with the SFC as the sole regulator.

Nevertheless, whether Hong Kong's OFC structure will become the preferred vehicle for global fund managers remains to be seen. A significant factor in the viability and success of the OFC regime is likely to be the proposed profit tax exemption for onshore private open-ended fund companies.

Hong Kong's new OFC regime will also be competing with a number of new investment vehicle structures launching in Singapore and Australia in 2018. Singapore's S-VACC, for example, shares many of the same features as Hong Kong's OFC regime, while also lending itself to a variety of investment strategies, including traditional, hedge funds, private equity and real estate funds. Unlike Hong Kong, the S-VACC also offers an inward re-domiciliation mechanism for foreign corporate fund vehicles to re-domicile in Singapore. For more detail on the proposed S-VACC structure, please see our briefing: [MAS Proposes Framework for Singapore Variable Capital Companies](#).

While the flurry of new investment vehicles may ultimately provide managers with more options for structuring their funds, it may also have the unintended consequence of inundating managers with too many new alternatives and lead them to opt for the familiarity and security of traditional fund jurisdictions. The Cayman Islands registered fund for example, is a commonly adopted structure for Asian private fund managers. By way of comparison, we provide in the Appendix an outline of the key regulatory features of both the Hong Kong private OFC and the Cayman Islands registered fund.

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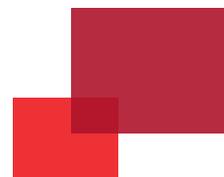
Conclusion

The OFC scheme represents Hong Kong's latest investment fund innovation, further supporting its value proposition as a unique domicile for funds. The new framework potentially offers increased opportunities for cross-border collaboration, as well as a wider investor base for fund managers to tap into. Nevertheless, the OFC is a highly regulated structure; while SFC-authorized funds may be more at ease with the level of oversight, private fund managers may not be as easily persuaded.

³ Launched since 1 July 2015, the Scheme enables asset managers to distribute eligible funds domiciled in the PRC or Hong Kong to each other.

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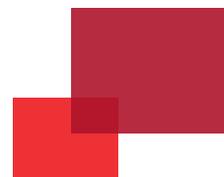


Appendix

		Hong Kong Private OFC	Cayman Islands Registered Fund
Regulator		Securities and Futures Commission (SFC)	Cayman Islands Monetary Authority (CIMA)
Relevant Law / Rules		Securities and Futures (Amendment) Ordinance Securities and Futures (Open-ended Fund Companies) Rules	Mutual Funds Law
Fund Registration	<u>Approval Requirements</u>	No prior approval is required. An OFC must be registered with the SFC and incorporated with the Companies Registry. <i>Licensing:</i> An OFC is not required to be licensed as a licensed corporation.	No prior approval is required, although the fund must be registered with CIMA.
	<u>Expected Timeline</u>	<i>Registration:</i> Expected to take less than one month <u>after the SFC has taken up the application</u> . ¹ <i>Incorporation:</i> Expected to occur within three business days following the SFC's registration.	<i>Registration:</i> Takes approximately five business days to register a fund. <i>Incorporation:</i> Can be finalized within one or two business days.
Capital Structure: Voting Rights of Shares		The bifurcation of voting rights (i.e., removal of directors vs. voting on general matters) is prohibited.	Flexible. Voting rights are often allocated differently between management shares and participating shares, where only management shares can vote on the removal of directors.
Directors	<u>Regulator Approval</u>	SFC approval required for both initial directors and changes to directors.	No approval from CIMA required for initial directors or changes to the directors. All directors are required to be registered.
	<u>Numbers</u>	An OFC must have a minimum of two directors.	A minimum of one director, but for regulated funds, CIMA has a policy of preferring two directors. ²
	<u>Independence</u>	One "independent" director is required who is independent of the custodian, but not necessarily the investment	No independence requirement. ²

¹ The registration will be granted as soon as practicable once the SFC is satisfied that all required documentation confirming due compliance with applicable requirements are in order

² For Hong Kong-based investment managers, profit tax considerations will likely impact the independence, number, and location decisions for the directors of a Cayman fund.

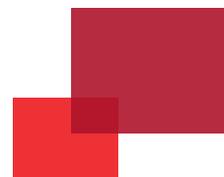


		Hong Kong Private OFC	Cayman Islands Registered Fund
		manager.	
	<u>Qualifications</u>	Each director must be of good repute, appropriately qualified, experienced and proper for the purpose of carrying out the business of the OFC. ³	No statutory qualifications, although a director must be 'fit and proper' with consideration to that director's (a) honesty, integrity and reputation; (b) competence and capability, and (c) financial soundness.
	<u>Corporate Directors</u>	Not permitted	Permitted
Instrument of Incorporation / Offering Documentation	<u>Statutorily Required Provisions</u>	Yes	No ⁴
	<u>Alterations</u>	<p><i>Material Changes (Instrument of Incorporations):</i> Material changes require shareholder approval.</p> <p><i>Material Changes (Offering Documentation):</i> Reasonable prior notice to shareholders is required.</p> <p><i>Immaterial Changes:</i> Immaterial changes may be made upon the directors' certification that the change is immaterial and the custodian having no objection to the change.</p>	<p><i>Material Changes (Instrument of Incorporations):</i> No statutory requirements.</p> <p><i>Material Changes (Offering Documentation):</i> Update offering documents within 21 days of material change and re-file the updated offering document.</p> <p><i>Immaterial Changes:</i> No statutory requirements.</p>
Investment Manager	<u>Regulator Approval</u>	SFC approval required for appointment.	No approval from CIMA required.
	<u>Licensing</u>	The investment manager of an OFC must be licensed by or registered with the SFC for Type 9 (asset management) regulated activity.	Not required to have an investment manager set up in the Cayman Islands. ⁵
	<u>Valuation and Pricing</u>	The OFC's valuation and pricing must be delegated to the investment manager as part of its investment management functions.	No statutory requirement. In practice, fund valuation and pricing is typically handled by the administrator in order to avoid potential conflicts of interest.

³ A director's relevant qualifications and experience will be assessed based on the fund's specific nature, investment objectives and policy of the fund. The SFC notes that the directors should have the technical knowledge and ability to perform their duties and satisfactory expertise in the business being conducted.

⁴ The offering document is required to describe the equity interests in all material respects and contain all material information to enable a prospective investor to make an informed decision.

⁵ It is common for a Hong Kong manager to establish a Cayman Islands investment manager for the fund that is often excluded from the licensing requirements of the Cayman Islands' Securities Investment Business Law. Under this arrangement, the Hong Kong manager would then serve as a sub-investment manager to the fund, which would require the Hong Kong manager to carry the appropriate regulated activity license from the SFC.



		Hong Kong Private OFC	Cayman Islands Registered Fund
Custodian / Prime Brokers ⁶	<u>Regulator Approval</u>	SFC approval required for appointment.	No approval from CIMA required.
	<u>Eligibility Requirements</u>	Must comply with the eligibility requirements under the Code on Unit Trusts and Mutual Funds (including status as a bank entity or qualifying trust company, capital and independence requirements).	No statutory requirements.
Investment Restrictions		<p><i>General Requirement:</i> Must not be a business undertaking for general commercial or industrial purposes.</p> <p><i>Permitted Investments:</i> Must invest at least 90% of its gross asset value in (1) securities and futures contracts (plus OTC derivatives - once the relevant regulations are effective) or (2) cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange.</p> <p><i>10% De Minimis Limit:</i> May invest a maximum of 10% of its gross asset value in other asset classes.</p>	No restrictions on fund's investment objectives, trading strategies or leverage. ⁷
Annual Financial Reports		Must be published within four (4) months of the end of the OFC's financial year and filed with the SFC.	Must be submitted to CIMA within six (6) months of the fund's financial year-end.

⁶ Many private funds engage their prime broker(s) to perform the function of the custodian. The SFC acknowledged this common arrangement and indicated that any prime broker providing custodial services on behalf of a private OFC would need to meet the eligibility requirements set out in the OFC Code.

⁷ In practice, these are viewed as commercial terms that will be negotiated between the private fund and prospective investors.