

## Client Alert

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## SFC proposes enhancements to Hong Kong's Open-ended Fund Companies regime

### Background

Following the introduction of a new framework for a Hong Kong open-ended fund company (OFC) structure in July 2018, the Securities and Futures Commission (SFC) has launched a public consultation ("**Consultation**") on proposed enhancements to the OFC regime, with a view to facilitating greater industry adoption of the new structure. Submissions to the Consultation are due on 20 February 2020. For a summary of the key features of the OFC framework, please refer to our briefing "[Hong Kong's Open-Ended Fund Company regime launches in July 2018](#)".

The proposed enhancements, which are largely a response by the SFC to certain market regulatory developments, as well as industry feedback received since the creation of the new regime, address the following key areas:

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

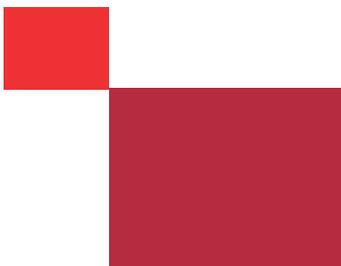
### Key Proposals

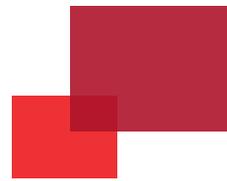
#### *Custodian Eligibility Requirements*

The custodian of an OFC is currently required under the Code on Open-ended Fund Companies ("**OFC Code**") to satisfy the same eligibility requirements for custodians of SFC-authorized funds as set out in the Code on Unit Trusts and Mutual Funds ("**UT Code**"). These include being a Hong Kong or overseas bank or a trustee of a registered scheme under the Mandatory Provident Fund Schemes Ordinance, and apply regardless of whether the OFC is a private or a public OFC.

Following industry feedback regarding the practical difficulties in meeting the UT Code eligibility requirements for custodians of private OFCs, the SFC proposes to allow an intermediary which is licensed or registered to carry on Type 1 regulated activity (Type 1 RA Intermediary), to act as a custodian of a private OFC. This will be subject to the Type 1 RA Intermediary satisfying the following requirements:

- holding a licence or registration under section 116(1) or section 119(1) of the SFO (as the case may be) that is not subject to the condition that it shall not hold client assets
- where the Type 1 RA Intermediary is a licensed corporation, meeting the capital requirements of minimum HK\$10 million in paid up share capital and minimum HK\$3 million in liquid capital





- ensuring the private OFC is its client in respect of its Type 1 RA business at all times
- being independent of the investment manager
- complying with all requirements applicable to it as a custodian of an OFC, including those contained in the OFC Code and related guidance issued by the SFC from time to time

The Consultation proposes more detailed requirements in a new Appendix A to the OFC Code, in order to provide further guidance on the obligations of an OFC custodian in Chapter 7 of the OFC Code. The SFC also notes that if the new proposed Type 13 regulated activity (acting as a depository of an SFC-authorized fund) comes into effect, an RA13 depository which also acts as a custodian of a private OFC, will have to comply with the requirements in the OFC Code (including those in the new Appendix A), and be subject to the same licensing conditions set out above. For an overview of the proposed RA13 regime, please refer to our client alert: "[SFC proposes to extend its licensing regime to trustees and custodians of public funds](#)".

### *Expansion of Investment Scope*

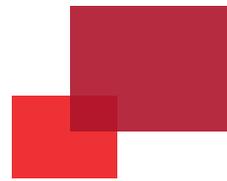
The OFC Code currently limits the investment scope of a private OFC to at least 90% of its gross asset value (GAV) in securities and futures contracts and/ or cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts, with only 10% of its GAV ("**10% de minimis**") being permitted to invest in other asset classes.

One of the concerns expressed by the industry was that private OFCs should be allowed greater scope to invest in loans and in shares and debentures of Hong Kong private companies (which do not fall within the definition of "securities" in the Securities and Futures Ordinance (SFO)), as these are common asset classes in which private funds invest. Increasing the 10% de minimis investment limit would arguably increase the appeal of the private OFC structure (particularly for private equity / hedge fund managers that originate or invest in private companies, loan participations and other asset classes which go beyond the narrow scope of securities and futures contracts) and boost the development of local Hong Kong companies.

In response to industry feedback, the SFC proposes to allow an expansion of the investment scope of private OFCs to include both loans and shares and debentures of Hong Kong private companies. However, in order to ensure that the SFC continues to have a regulatory nexus under the SFO to supervise the management of private OFC assets, the private OFC must also hold a portfolio of assets the management of which would constitute a Type 9 regulated activity under the SFO.

### *Re-domiciliation of Offshore OFCs*

There is currently no statutory mechanism to facilitate the re-domiciliation of overseas corporate funds in Hong Kong using the OFC structure. While corporate funds from overseas jurisdictions may re-domicile to Hong Kong via an asset transfer or share swap for example, there are additional benefits to enabling an overseas corporate fund to statutorily re-domicile, such as continuity of corporate identity and cost savings.



Having considered industry feedback in this regard, the SFC proposes to create a statutory re-domiciliation mechanism for OFCs by introducing new provisions into Part IVA of the SFO, and making ancillary amendments to the Securities and Futures (Open-ended Fund Companies) Rules ("**OFC Rules**"). The effect of the new mechanism will be that an overseas corporate fund will not need to establish a new legal entity or change its legal personality when re-domiciling in Hong Kong. This could result in substantial cost savings for the fund by obviating the need to re-enter into contracts, re-acquire financing or transfer assets. A particular advantage is the preservation of a fund's past performance track record, the reliance upon which is an important factor for investors.

The key features of the proposed statutory re-domiciliation mechanism are set out in Appendix II to the Consultation. Once re-domiciled in Hong Kong, the overseas corporate fund will become a Hong Kong OFC and subject to the applicable legislative and regulatory framework and the SFC's regulatory and enforcement powers.

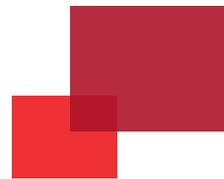
### *Significant Controllers Register*

From 1 March 2018, in order to enhance transparency of corporate beneficial ownership and fulfil Hong Kong's international anti-money laundering/counter-terrorist financing obligations, all Hong Kong incorporated companies (other than companies listed on the Hong Kong Stock Exchange) are required to maintain a register of significant controllers (SCR). For a summary of the SCR requirements, please refer to our client alert: "[Take immediate action – The Companies \(Amendment\) Ordinance 2018 will be in force on 1 March 2018](#)".

To ensure consistency with this position, the Consultation 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 SCR requirements under the Companies (Amendment) Ordinance 2018.

Essentially, a person will be considered to have significant control over an OFC if one or more of the following conditions are met:

- a) the person holds, directly or indirectly, more than 25% of the issued shares in the OFC or a right to share in more than 25% of the capital or profits of the OFC;
- b) the person holds, directly or indirectly, more than 25% of the voting rights of the OFC;
- c) the person holds, directly or indirectly, the right to appoint or remove a majority of the board of directors of the OFC;
- d) the person has the right to exercise, or actually exercises, significant influence or control over the OFC; or
- e) the person has the right to exercise, or 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 relation to the OFC.



## Implementation

If adopted, the SFC proposes to effect the enhancements to the OFC's custodian eligibility requirements and the investment scope by way of amendments to the OFC Code. As no legislative changes are required, these amendments will proceed first and take immediate effect. No indicative timing has been given at this stage.

The proposals to establish a re-domiciliation mechanism and require OFCs to keep a register of beneficial shareholders will require legislative amendments to the SFO and ancillary amendments to the OFC Rules. Subject to the Consultation feedback, the SFC has indicated that it will proceed to introduce an amendment bill to the Legislative Council to initiate the legislative process. It is proposed that the re-domiciliation mechanism will take effect immediately following completion of the legislative process while a six-month transition period will be provided in respect of the SCR requirements.

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