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# Oversight
## SFC updates OFC regime

September 2020

### Introduction

On 2 September 2020 the Securities and Futures Commission (SFC) issued its Consultation Conclusions on Proposed Enhancements to the Open-ended Fund Companies Regime and Further Consultation on Customer Due Diligence (Consultation Conclusions).

Open-ended fund companies (OFCs) were launched as a new legal vehicle in Hong Kong in July 2018. The launch was not a great success given, amongst other things, Hong Kong profits taxation for private OFCs. In addition under the OFC regime applicable to private funds, a number of deficiencies were identified by market participants including (i) restrictions on permitted investments, (ii) eligibility criteria for the custodians of OFCs, and (iii) the lack of any re-domiciliation mechanism to allow offshore funds to "onshore" themselves into OFCs.

Changes to the Inland Revenue Ordinance (IRO) have addressed the issue of taxation of private OFCs. These revisions to the IRO, effective 1 April 2019, in effect removed different Hong Kong tax treatment as between onshore and offshore funds. Recognising the other deficiencies (and perhaps because even as at the date of publication of this Oversight, only 5 private OFCs have been launched) the SFC published a Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies Regime in December 2019 (Consultation). In the meanwhile in Singapore a similar vehicle, the variable capital company (VCC), has enjoyed significant take up since its launch in January 2020. As at August 2020, over 100 VCCs have been incorporated or redomiciled.

This *Oversight* recaps the key features of OFCs and reports the forthcoming changes as set out in the Consultation Conclusions. It also looks at how the VCC regime in Singapore addresses similar issues.

## 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 (CO). Unlike ordinary companies under the CO, OFCs are designed to issue redeemable shares and have a variable capital. OFCs constitute collective investment schemes (CIS) as defined in the Securities and Futures Ordinance (SFO) and OFCs can be structured as a single or umbrella fund (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 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. Many developed asset management jurisdictions offer corporate mutual funds or equivalent as well as “protected cell” corporate umbrella funds such as Luxembourg’s société d’investissement à capital variable (SICAV) which is well known in the Hong Kong retail funds market.

Unlike the Cayman Islands – where the Cayman Islands Monetary Authority (CIMA) has comparatively limited (although increasing) 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 Part IVA into the SFO.

The Securities and Futures (Open-ended Fund Companies) Rules (OFC Rules), which is subsidiary legislation to the SFO, 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. As with the UT Code, the SFC has promulgated frequently asked questions (FAQs) on OFCs. The FAQs clarify the SFC’s expectations in respect of the OFC Code and are updated and revised from time to time.

## Establishment

OFCs can be structured as either "public OFCs" or "private OFCs" depending on the nature of the offering. Neither Part IVA of the SFO nor the OFC Rules differentiate between "public OFCs" and "private OFCs". A public OFC must be authorised by the SFC under the SFO. However 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. This is the same approach that the SFC takes to unit trusts.

Because OFCs are CIS, 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 CO 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 is issued by the CR. A similar process applies to business registration for tax purposes with the Inland Revenue Department (IRD). A Business Registration Certificate will be issued by the 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)) 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.

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## Consultation Conclusions

As mentioned above the Consultation proposed changes to the OFC regime for private OFCs in the following four key 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.

The Consultation Conclusions have addressed these issues.

### Custodian eligibility

It is a requirement under Section 112 ZA of the SFO that an OFC must have a custodian (regardless of whether it is "private" or "public").

Under the current OFC Code, the custodian of an OFC should meet the same eligibility requirements for custodians of SFC-authorised 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 Consultation proposed 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 met the following requirements:

- the intermediary's licence or registration granted under the SFO is not subject to the condition that it shall not hold client assets. The terms "hold" and "client assets" being as defined in the SFO;

- where the intermediary is a licensed corporation, it 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 authorised funds which are licensed corporations under the SFC's proposals to regulate the trustees/custodians of SFC authorised 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.

To ensure that the SFC has a sufficient regulatory nexus over the intermediary's custodian business, the Consultation proposed the imposition by the SFC of 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.

In the Consultation Conclusions, the SFC states that it will proceed with expanding custodian eligibility as set out in the Consultation. This should allow most Hong Kong based prime brokers to act as custodian to private OFCs.

The Consultation Conclusions confirm the SFC's intention to amend 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 this expansion of eligible custodians for private OFCs is welcome, the requirements demanded by the SFC are not necessary. 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.

By contrast to Hong Kong, 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 custodied 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

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 to date clearly limited the utility of an OFC for managers using many alternative strategies and, for private OFCs, has no logic.

The Consultation proposed 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 was 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 Consultation suggested 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. The SFC's stated justification for this very limited expansion was that it needed to ensure that there would be a sufficient regulatory nexus under the SFO in terms of the SFC's supervisory and enforcement powers over the management and safekeeping of OFC assets.

Feedback provided to the SFC was that this liberalisation did 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, most industry participants argued that any asset class should be permitted.

In its Consultation Conclusions the SFC has listened to industry comment. It notes that it has sufficient regulatory powers to further relax the permitted investments of private OFCs. Accordingly non-SFO assets will be allowed to be invested by private OFCs without limit. We agree with the SFC that in this regard, this will put private OFCs on a level playing field with other overseas corporate fund structures as well as other private fund structures in Hong Kong, including the recently enacted limited partnership funds (LPFs). Notwithstanding this, the Consultation Conclusions states that the OFC Code will be amended to require investment managers and custodians have sufficient expertise in managing and safekeeping asset classes in which an OFC invests.

In Singapore there are already 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.

## Redomicile

Under the current OFC regime, corporate funds from overseas jurisdictions can only "re-domicile" 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 re-domiciling 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 Consultation proposed adopting a statutory re-domiciliation regime so that existing "offshore" funds might move to "onshore" jurisdictions such as Hong Kong. The fact that the OFC regime as established does not cater for this was foolish. It is noted, for example, that a redomiciliation mechanism was provided under the VCC regime in Singapore.

The Consultation Conclusions confirm the SFC's intention to enhance the OFC regime by introducing a statutory mechanism to facilitate the re-domiciliation 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, 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.

Like all matters to do with OFCs the process will be required to take effect through the SFC. The re-domiciled 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 re-domicile. As the Consultation Conclusion notes, this change will need to be effected by introducing new statutory provisions in Part IVA of the SFO and making ancillary amendments to the OFC Rules.

The Variable Companies Act of Singapore (VCC Act) provides a statutory re-domiciliation framework that permits foreign corporate funds comprising one or more CIS (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.

## AML/CFT

As Hong Kong is a member of the Financial Action Task Force (FATF) and given the SFC's recent emphasis on anti-money laundering and counter-terrorist financing (AML/CFT), there are AML/CFT obligations imposed on the managers of OFCs and SFC-licensed or registered intermediaries involved in the sale of OFC shares.

However with regard to corporate beneficial ownership in respect of OFCs, the Consultation proposed 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 proposed 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.

Based on feedback provided to the SFC as a result of the Consultation, the SFC notes in the Consultation Conclusions that difficulties may arise in connection with open-ended OFCs and maintenance of SCRs. Accordingly the Consultation Conclusions will not take the above forward but instead include a further consultation on customer due diligence (CDD) for private OFCs. The SFC now proposes that like LPFs, OFCs should be required to appoint a responsible person to carry out AML/CFT functions specified in Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (AMLO). This is similar in effect to the CDD requirements applicable to LPFs.

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.

## Timing

No timeline is given in the Consultation Conclusions for the changes to the OFC Code but these can be effected quickly. As such the new custodian eligibility and investment scope will become available as soon as the new OFC Code is gazetted. For existing custodians of private OFCs there will be a 6 month transition period to allow compliance with Appendix A of the new OFC Code. The further consultation on AML/CFT and CDD under the AMLO runs until 5 October 2020. However the re-domiciliation mechanism will require amendment to the SFO. The SFC says it will do this as soon as possible. However such legislative process will likely take longer than other changes.

## 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 were 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, mostly unregulated, Cayman Islands mutual funds regime – the international "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 available in other jurisdictions, including Singapore (the VCC), where as explained above there is a more flexible approach and a lighter touch from inception. This has yielded significant industry interest in the VCC by comparison with the OFC.

However, weighed against the use of "offshore" jurisdictions such as the Cayman Islands is the increasing international regulatory and investor pressure on managers to "onshore" their investment products. This has been supported by the Hong Kong Government through the tax changes which took effect last year, the introduction of the LPF vehicle and the recent proposed tax concession for carried interest.

The Consultation Conclusions are a step in the right direction of trying to make OFCs more attractive for Hong Kong fund operators. The Consultation Conclusions are particularly welcome in respect of investment scope because the SFC's original proposal was too limited. Unfortunately the SFC's approach to OFC custodians is too prescriptive but in reality custody is increasingly likely to be more heavily regulated in most jurisdictions. The re-domicile mechanism is also helpful (but should always have been included). It remains to be seen if it is enough for private OFCs to compete with VCCs.

Simmons & Simmons in Hong Kong advised on the formation and listing of the first exchange traded funds in the form of an OFC. These were the first public OFCs registered in Hong Kong (in January 2020). Simmons & Simmons JWS in Singapore advised on the formation, authorisation and listing of the first exchange traded fund in the form of a VCC (to be authorised and listed in September 2020), advised on the establishment one of the first VCCs under the MAS' Pilot Programme and has been actively involved in the development of the VCC regime, having been represented on the VCC Working Group of the Promotion of Singapore Law Committee of the Singapore Academy of Law.

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