FSDC Research Paper No. 05

Proposals on Legal and Regulatory Framework for Open-ended Investment Companies in Hong Kong

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Background

1. According to data from the Securities and Futures Commission ("**SFC**")[1], out of the 1,845 authorized funds in Hong Kong as at 30 June 2013, only 318 were locally domiciled as unit trusts. Domiciliation of funds in Hong Kong will create more jobs and business opportunities for local fund managers, their service providers and other professionals servicing the industry. In order to attract more funds to domicile in Hong Kong, there needs to be greater flexibility in fund product structures, amongst other factors. Currently, unit trusts dominate the market, as the Companies Ordinance does not permit establishment of a variable capital investment vehicle in Hong Kong. The Financial Secretary announced in his 2013-14 Budget Speech that the laws would be changed to introduce open-ended investment companies ("**OEICs**") in Hong Kong. The introduction of an OEIC regime provides alternative flexibility as to the types of investment vehicle available for use in Hong Kong; unlike a unit trust it has separate legal personality and does not require a trustee; will provide an attractive investment vehicle for mutual recognition with the Mainland; and is easy to understand.

Details on proposed legal and regulatory framework for OEICs in Hong Kong

2. This paper summarises the key recommendations of the Financial Services Development Council ("**FSDC**") in respect of the main features of a proposed legal, regulatory and tax framework for OEICs in Hong Kong.

3. In reaching its recommendations, the FSDC has examined the current framework applicable to investment vehicles and companies in Hong Kong, as well as existing regimes for OEICs in other global investment fund centres, namely the United Kingdom, Luxembourg, Ireland, the United States of America and the Cayman Islands.

4. The FSDC wants to ensure that the OEIC proposals create a legal, regulatory and tax framework that fulfills the following criteria:

    - create competitive conditions for setting up OEICs in Hong Kong compared to other global investment fund centres;
    - maintain a level playing field with other types of investment vehicles commonly used by Hong Kong managers, in particular unit trusts; and
    - at all times ensure an appropriate level of investor protection.

[1] http://www.sfc.hk/web/pdf/published-resources/qr/20130406/efull.pdf

Public and private OEICs

5. The recommendations distinguish between public / SFC authorized OEICs ("**Public OEICs**"), which may be offered to the public subject to obtaining authorization from the SFC, and private / unauthorized OEICs ("**Private OEICs**"), which will not require SFC authorization and will therefore only be capable of being offered on a private placement basis (e.g. to professional investors).

6. The basic premise for Public OEICs is that, like retail unit trusts, these should mainly be governed by the SFC Code on Unit Trusts and Mutual Funds ("**Code**"). The FSDC did not consider it appropriate to impose additional requirements on Public OEICs which are not contained in the Code, except in very limited cases, nor to grant exceptions from Code requirements. The Code is neutral as to the legal form of schemes authorized by the SFC and already applies to foreign OEICs established in other jurisdictions seeking SFC authorization in Hong Kong.

7. On the other hand, Private OEICs should have greater flexibility without imposing undue restrictions on their terms or investment scope.

Legal framework, supervision and enforcement

8. Given that OEICs are in essence investment vehicles, the legislative framework would be issued under the Securities and Futures Ordinance, rather than the Companies Ordinance.

9. The incorporation of OEICs would be subject to approval by the SFC, but only Public OEICs would be considered regulated by the SFC. For Private OEICs, the SFC would exercise its supervisory function primarily through the SFC licensed or registered managers that operate and manage the OEICs.

10. A public registry for both Public and Private OEICs (e.g. through a registration with the Companies Registry) is recommended for purposes of transparency.

Investment scope

11. Hong Kong Private OEICs should be able to invest in any asset class, subject to any self-imposed restrictions which may be contained in the constitutional documents for that OEIC. On the other hand, Public OEICs will be subject to the investment requirements of the Code.

Investor protection

12. One of the cornerstones of investor protection will be a requirement that each OEIC, whether Public or Private, be operated and managed by an SFC licensed corporation or registered institution.

13. Another prerequisite for OEICs to strengthen investor protection will be a requirement for an independent eligible third party custodian to be appointed by the OEIC. This will ensure that all assets of the OEIC are safe kept by a third party and cannot be used for improper purposes.

Governance

14. To promote good corporate governance there will be requirements as to a minimum number or proportion of independent directors of the OEICs.

Tax framework

15. An essential part of the proposal is that OEIC will be tax neutral. Public OEICs should be placed on par with other existing SFC authorized funds, which are specifically exempt from Hong Kong profits tax under the Inland Revenue Ordinance. Private OEICs should benefit from the same profits tax exemptions currently available to offshore funds and on the same conditions, except that the central management and control of Private OEICs can take place in Hong Kong to promote good corporate governance. No stamp duty should be payable on the sale, purchase or transfer of shares in a Public OEIC. Provided the investment scope follows certain criteria, no stamp duty should be payable on the sale, purchase or transfer of shares in a Private OEIC.

Winding up

16. It is advisable for Hong Kong to adopt a simple and practical mechanism for the liquidation of OEICs. Where an OEIC is solvent, it is recommended that streamlined procedures be adopted.

About the Financial Services Development Council

The Hong Kong SAR Government announced in January 2013 the establishment of the Financial Services Development Council (FSDC) as a high-level and cross-sector platform to engage the industry and formulate proposals to promote the further development of Hong Kong's financial services industry and map out the strategic direction for development. The FSDC advises the Government on areas related to diversifying the financial services industry, enhancing Hong Kong's position and functions as an international financial centre of our country and in the region, and further consolidating our competitiveness through leveraging the Mainland to become more global.

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