

立法會
Legislative Council

LC Paper No. CB(1)1030/16-17(07)

Ref: CB1/PL/FA

Panel on Financial Affairs

Meeting on 5 June 2017

Updated background brief on open-ended fund company structure

Purpose

This paper provides background information on open-ended fund company ("OFC") structure. It also gives a brief account of the major views and concerns raised by Members on OFCs since the Fifth Legislative Council ("LegCo").

Background

Establishment of a legal framework for the open-ended fund company structure in Hong Kong

2. Currently, an open-ended investment fund may be established under the laws of Hong Kong in the form of a unit trust but not in corporate form due to various restrictions on capital reduction under the Companies Ordinance (Cap. 622). There are market calls for a more flexible choice of investment fund vehicle through introducing a new OFC structure in Hong Kong.¹ This will allow investment funds to be set up in the form of a company, but with the flexibility to create and redeem shares for investors to trade the funds, which is currently not enjoyed by conventional companies.

3. The Government conducted a public consultation on the legislative proposals for introducing the OFC structure in Hong Kong ("the OFC proposals") from March to June 2014, and introduced the Securities and Futures (Amendment) Bill 2016 ("the Bill") into LegCo in January 2016 to amend the

¹ The Financial Services Development Council published two research papers on the open-ended fund company ("OFC") framework and tax issues in November 2013 and December 2015 respectively.

Securities and Futures Ordinance (Cap. 571) ("SFO") to provide a legal framework for the OFC structure in Hong Kong. LegCo enacted the Securities and Futures (Amendment) Ordinance 2016 ("the Amendment Ordinance") in June 2016. The detailed operational and procedural matters of the OFC structure are to be set out in subsidiary legislation under SFO ("the OFC Rules") which are subject to negative vetting by LegCo.² The Amendment Ordinance will commence operation after the OFC Rules have been put in place. To facilitate compliance, SFC will also publish codes and guidelines ("the OFC Code") for reference by the industry.

Major characteristics of an open-ended fund company

Structure and key features

4. An OFC is an open-ended collective investment scheme, which is structured in corporate form with limited liability and variable share capital. Investment in OFC (as in the case of funds generally) is typically made by way of subscription and redemption of units/shares in the fund. The OFC structure and key operators under the Amendment Ordinance are illustrated in **Appendix I**. An OFC has characteristics similar to a conventional limited company in that:

- (a) it will have a legal personality;
- (b) it will have a constitutive document, namely the instrument of incorporation; and
- (c) it will be governed by a board of directors who are subject to fiduciary duties and the duty to exercise reasonable care, skill and diligence, and the liability of its shareholders will be limited to the amount unpaid on their shares in the company.

5. As OFC is an investment vehicle, it –

- (a) will not be bound by restrictions on the reduction of share capital applicable to companies formed under CO and instead, will have the flexibility to vary its share capital in order to meet shareholder subscription and redemption requests;

² According to the Government, the Securities and Futures Commission ("SFC") will conduct public consultation on the OFC Rules.

- (b) will not be bound by restrictions on distribution out of share capital applicable to companies formed under CO and instead, may distribute out of share capital subject to solvency and disclosure requirements; and
- (c) will not be required to be licensed as a licensed corporation under SFO, but will have to be registered with the Securities and Futures Commission ("SFC"), and should delegate its investment management functions to an investment manager licensed by or registered with SFC who is appointed by the OFC board.

Establishment and regulation

6. To incorporate an OFC, the applicant should apply to SFC for registration prior to applying to the Registrar of Companies ("CR") for incorporation. Besides, OFCs will be required to register under the Business Registration Ordinance (Cap. 310). OFCs seeking to offer their shares to the public must also seek the authorization of SFC under SFO.

7. SFC is the primary regulator responsible for the registration and regulation of OFCs under SFO. It is empowered by SFO to make subsidiary legislation and publish a code or guideline to regulate and provide guidance on the incorporation, management, operation, and business of OFCs. In addition, CR is responsible for the incorporation and administration of statutory corporate filings of OFCs.

Profits tax treatment

8. Currently, profits tax exemption is given under the Inland Revenue Ordinance (Cap. 112) ("IRO") to public funds (no matter whether their central management and control is located in or outside Hong Kong) authorized by SFC. The same profits tax exemption will apply to publicly offered OFCs. At present, for privately offered funds, profits tax exemption is also provided under IRO if they are offshore funds (i.e. with their central management and control locates outside Hong Kong). So profits tax exemption will apply to offshore privately offered OFCs. While profits tax exemption is not granted to onshore privately offered OFCs (i.e. with their central management and control locates in Hong Kong) under the Amendment Ordinance, the Financial Secretary announced in the 2017-2018 Budget the Government's plan to extend the profits tax exemption to such OFCs, and consult the industry on the relevant legislative proposals.

Stamp duty treatment

9. Under the Stamp Duty Ordinance (Cap. 117), exemption is given to all transfers of units under listed unit trust schemes (which are mainly exchange traded funds); and transfers of units under unlisted trust schemes by way of allotment and redemption. Under the regulatory framework for OFCs, the same stamp duty exemptions will apply to shares of listed and unlisted OFCs.

Concerns and views expressed by Members

10. The Government briefed the Panel on Financial Affairs ("FA Panel") on the legislative proposals for introducing the OFC structure in Hong Kong on 7 April 2014. On 16 March 2017, the Government further briefed FA Panel on the proposed amendments to IRO for extending profits tax exemption to onshore privately offered OFCs. The major views and concerns expressed by members of FA Panel at the above two meetings and meetings of the Bills Committee on the Securities and Futures (Amendment) Bill 2016 ("the Bills Committee") are summarized in the ensuing paragraphs.

Benefits of introducing the open-ended fund company structure in Hong Kong

11. Members noted that the fund industry was generally supportive of introducing the OFC structure in Hong Kong to provide an extra option for fund structure. The OFC structure would diversify Hong Kong's fund types, expand the fund distribution network and promote fund origination in Hong Kong to deepen and broaden Hong Kong's asset management industry. These would in turn drive demand for professional services and help strengthen Hong Kong's position as an international financial centre.

12. There was a suggestion that the Government should consider putting in place measures to facilitate or incentivize listing and trading of OFC shares on the stock exchange. SFC pointed out that so long as the Listing Rules and other applicable requirements were met, investment funds including OFCs could be listed on the stock exchange. The Government assured Members that it would continue to take forward initiatives to support the development of the asset management industry, including the potential establishment of the exchange distribution platform for funds in Hong Kong.

Profits tax treatment for an open-ended fund company

13. While Panel members in general had no objection to the Government's proposal of extending profits tax exemption to onshore privately offered OFCs, some members expressed concern about tax avoidance in providing profits tax

exemption to OFCs and enquired about the impact of profits tax exemption proposal on tax revenue.

14. The Government advised that in processing the applications for profits tax exemption, the Inland Revenue Department ("IRD") would examine the financial statements of OFCs to consider if the necessary conditions for profits tax exemption had been met. IRD would also conduct risk-based review of the financial statements for preventing tax avoidance. On the impacts of the proposed profits tax exemption on tax revenue, the Government pointed out that the legal framework for OFC structure in Hong Kong was established in 2016. It was expected that the new OFC structure would enhance Hong Kong's attractiveness as a location for domiciliation of funds, which would drive demand for professional services such as fund management and investment advice and might generate additional tax revenue for the Government.

Offering of open-ended fund company shares

15. The Bills Committee noted that in line with the existing arrangement adopted for fund offerings in Hong Kong and consistent with the practices adopted in overseas jurisdictions for corporate fund offerings, OFC share offerings would be made under an offering document, i.e. an advertisement, invitation or document ("the offering document"). While the offering document of a publicly offered OFC would be subject to SFC's authorization; no SFC's authorization would be required for the offering document of a privately offered OFC.³ Bills Committee members expressed concern about possible circumvention of the regulatory requirements applicable to publicly offered OFC by claiming the fund to be or disguising it as privately offered OFCs.

16. The Government emphasized that various measures were in place to prevent abuse of the exemption applicable to privately offered OFCs and protect the investors of OFCs, such as subjecting an offer to no more than 50 persons and a small-scale offer to restrictions under the relevant ordinance, and imposing pre-sale registration requirements for all OFCs and point-of-sale obligations on intermediaries selling the shares of publicly or privately offered OFCs. SFC would investigate into complaints and suspected non-compliance, and take enforcement action as appropriate. If disputes arose as to whether an OFC was privately offered or not, it would be for the court to decide having regard to the circumstances of individual cases.

³ The offering document of a privately offered OFC will contain or relate to a specified offer. Examples of specified offers include an offer to professional investors, an offer to no more than 50 persons, an offer in respect of which the total consideration payable for the relevant shares or debentures does not exceed \$5 million (i.e. a small-scale offer), etc.

17. The Bills Committee noted the industry's concerns that the Bill did not draw clear distinction between publicly and privately offered OFCs in the regulatory framework, and subjecting privately offered OFCs to the OFC Code would create disparity with private funds taking other forms (e.g. unit trusts).

18. The Government advised that the OFC Code was intended to lay down the basic or minimum operational requirements applicable to all OFCs. Other matters in respect of the operation of privately offered OFCs would remain largely governed by the OFCs' individual constitutive and offering documents. The Government also confirmed that privately offered OFCs would not be subject to the extensive requirements in the existing Code on Unit Trusts and Mutual Funds.

Incorporation and registration of open-ended fund company

19. The Bills Committee noted that while the Government had proposed a one-stop company incorporation and business registration regime to facilitate the incorporation and registration of OFCs, some deputations considered that the process for setting up privately offered OFCs should be streamlined to optimize the time to launch such OFCs in the market.

20. SFC explained that it would not register a proposed company as an OFC before it was satisfied that the OFC would fulfill all the registration requirements upon incorporation. SFC and CR would adopt a set of operational procedures to facilitate timely vetting of application documents for registration and incorporation of OFCs, and would publish the general processing time in handling relevant applications. The Government advised that it would consider how the one-stop regime could be further streamlined when conducting the consultation on the OFC Rules and the OFC Code.

Council question

21. Hon Kenneth LEUNG raised a written question on "Proposed New Open-ended Fund Company Structure" at the Council meeting of 16 April 2014 which sought details of the proposed OFC structure, including comparison with similar regimes of major asset management jurisdictions, investment of OFC assets, and the tax regime for OFCs. The question and the Government's written response are hyperlinked in the **Appendix II**.

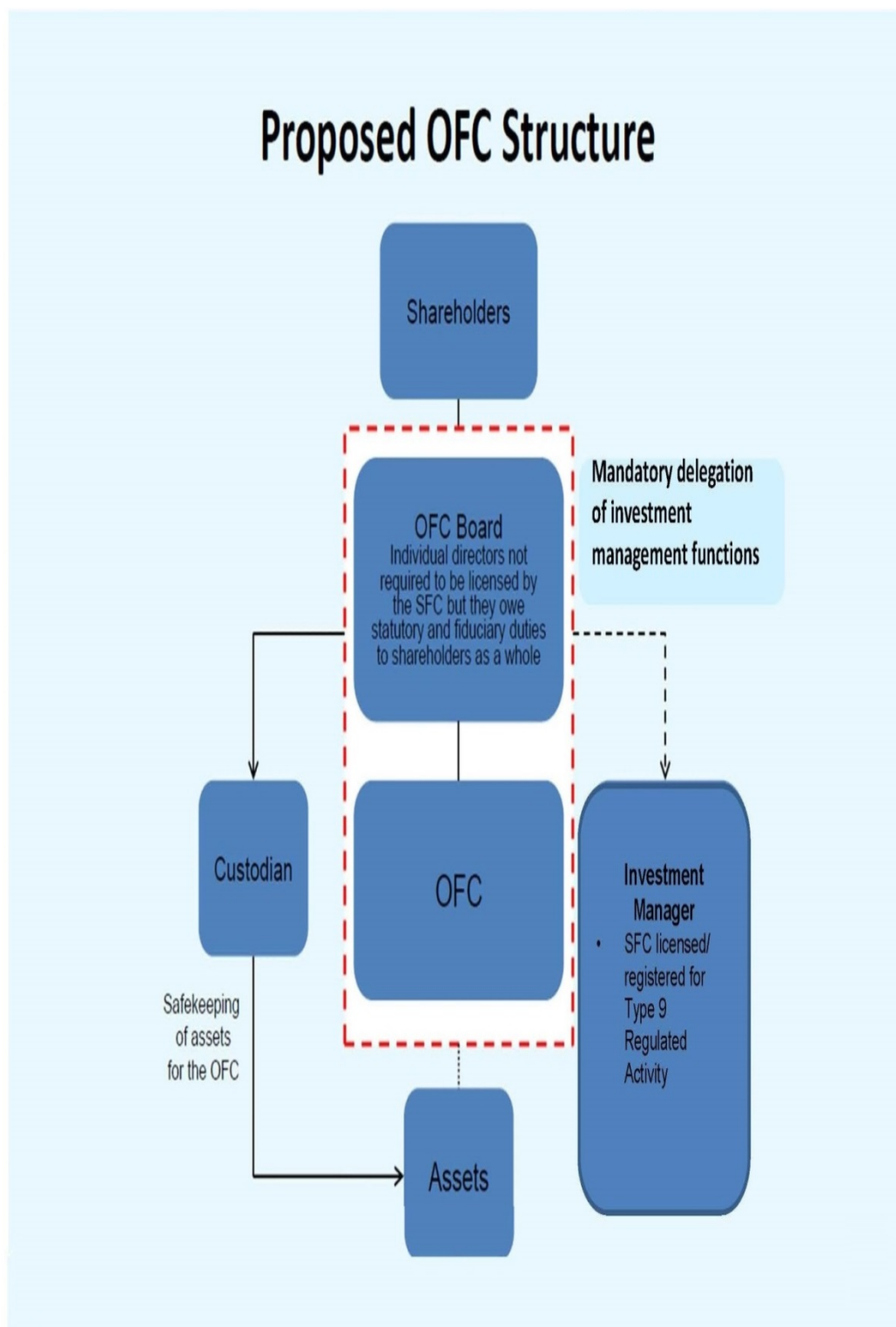
Latest development

22. The Government will brief FA Panel on the proposed rules and code setting out the operational details of the OFC regime at the meeting on 5 June 2017.

Relevant papers

23. A list of relevant papers is in the **Appendix II**.

Council Business Division 1
Legislative Council Secretariat
1 June 2017



[Source: Slide 8 of the power-point presentation materials provided by the Government for the meeting of the Bills Committee on the Securities and Futures (Amendment) Bill 2016 on 23 February 2016 (LC Paper No. CB(1)603/15-16(01)).]

List of relevant papers

Date	Event	Paper/Minutes of meeting
18 November 2013	The Financial Services Development Council ("FSDC") released a research paper entitled "Proposals on Legal and Regulatory Framework for Open-ended Investment Companies in Hong Kong"	Press release FSDC's research paper (English version only)
20 March 2014	The Government launched a public consultation on introducing a new open-ended fund company ("OFC") structure	Press release Consultation paper
7 April 2014	The Panel on Financial Affairs ("FA Panel") was briefed by the Government and the Securities and Futures Commission on the proposals in the public consultation on introducing a new OFC structure	Discussion paper (LC Paper No. CB(1)1180/13-14(05)) Minutes (LC Paper No. CB(1)1996/13-14) Follow-up paper (LC Paper No. CB(1)1316/13-14(02))
16 April 2014	Hon Kenneth LEUNG raised a written question on the proposed new open-ended fund company structure	Hansard (pages 10095 – 10098)
7 December 2015	FSDC released a paper on the tax issues on OFCs and profits tax exemption for offshore private equity funds	Press release FSDC's paper (English version only)

Date	Event	Paper/Minutes of meeting
15 January 2016	The Government released the consultation conclusions on OFC structure	Press release Consultation conclusions
2 June 2016	The Legislative Council passed the Securities and Futures (Amendment) Bill 2016	The Bill passed Report of the Bills Committee (LC Paper No. CB(1)896/15-16) Powerpoint presentation materials (LC Paper No. CB(1)603/15-16(01)) Legislative Council Brief (Ref: SF&C/1/2/22C(2015)) Legal Service Division report (LC Paper No. LS31/15-16)
16 March 2017	FA Panel was briefed by the Government the proposed amendments to the Inland Revenue Ordinance (Cap. 112) to extend profits tax exemption to onshore privately offered OFCs	Discussion paper (LC Paper No. CB(1)660/16-17(04))