立法會
Legislative Council

LC Paper No. CB(1)585/15-16(02)

Ref: CB1/BC/8/15

Bills Committee on Securities and Futures (Amendment) Bill 2016

Background brief

Purpose

This paper provides background information on the Securities and Futures (Amendment) Bill 2016 ("the Bill") which seeks to introduce a new open-ended fund company ("OFC") structure in Hong Kong. It also summarizes the major views and concerns expressed by members on the proposal during discussion of the Panel on Financial Affairs ("FA Panel") in the 2013-2014 legislative session.

Background

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) ("CO"). According to the Administration, there is a need for Hong Kong to introduce a new OFC structure to address the market demand for a more flexible choice of investment fund vehicle. OFC structure will allow funds to be set up in the form of a company, but with the flexibility to create and cancel shares for investors to trade the funds, which is currently not enjoyed by conventional companies. This would provide an extra option for fund structure and create a more flexible business environment for fund managers to meet market demand, which in turn could attract more publicly and privately offered funds to domicile in Hong Kong.

3. The Financial Secretary indicated in his 2013-2014 Budget Speech the Administration's plan to conduct consultation on the initiative to consider legislative amendments for introducing the open-ended investment company[1] so as to attract more traditional mutual funds and hedge funds to domicile in Hong Kong. On 20 March 2014, the Administration launched a three-month public consultation on introducing a new OFC structure[2]. The consultation

[1] The Administration later used the term OFC to denote the concept of open-ended investment company.
[2] In this connection, the Financial Services Development Council ("FSDC") published proposals on

conclusions were released on 15 January 2016. According to the Administration, the respondents were generally supportive of the introduction of an OFC structure in Hong Kong.

The Bill

4. The Bill was published in the Gazette on 15 January 2016 and received its First Reading at the Legislative Council meeting of 27 January 2016. The Bill seeks to amend the Securities and Futures Ordinance (Cap. 571) ("SFO") and other enactments to provide for: (a) the incorporation, registration, management, operation and regulation of OFCs; and (b) profits tax exemption for OFCs, exemption from stamp duty for transfers relating to the sale or purchase of shares or units of OFCs and other related matters. The main provisions of the Bill are explained in paragraph 16 of the Legislative Council Brief (File Ref: SF&C/1/2/22C(2015)), and paragraphs 5 to 21 of the Legal Service Division Report on the Bill (LC Paper No. LS31/15-16). The major proposals in the Bill are highlighted in paragraphs 5 to 11 below.

<u>Open-ended fund company structure, key operators and investment scope</u>

5. An OFC is an open-ended collective investment scheme, which is structured in corporate form with limited liability and variable share capital. The OFC structure will have characteristics similar to a conventional limited company[3]. An OFC can be a publicly or privately offered fund. Being an investment vehicle, an OFC:

(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;

(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

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18 November 2013 on the legal and regulatory framework for OFCs in Hong Kong. FSDC further released a paper on the tax issues on OFCs and profits tax exemption for offshore private equity funds in December 2015 to set out its recommendations on the two topics. The details are hyperlinked in the **Appendix**.

[3] The relevant characteristics include:
(a) an OFC will have a legal personality and a constitutional document (i.e. the Instrument of Incorporation);
(b) an OFC will be governed by a board of directors who are subject to fiduciary duties; and
(c) the liability of an OFC's shareholders will be limited to the amount unpaid on their shares in the company.

(c) will be required to be registered with the Securities and Futures Commission ("SFC").

6. The directors, the investment manager and the custodian will be the key operators of an OFC. There will be basic eligibility requirements for key operators to strengthen investor protection. The OFC board will be legally responsible for all the affairs of the OFC and will provide an additional layer of oversight for shareholders. The assets of an OFC must be segregated from that of the investment manager and entrusted to a separate, independent custodian for safekeeping.

7. Publicly offered OFCs will be allowed to invest in asset classes in accordance with SFC's product code requirements and authorization conditions[4] which is on par with the existing regime for publicly offered SFC-authorized funds. As for privately offered OFCs, their investment scope should align with Type 9 (asset management) regulated activity, with a 10% de-minimis exemption for other asset classes. An OFC may also be created as an umbrella fund[5] subject to a protected cell structure[6].

Incorporation, registration and regulation of an open-ended fund company

8. 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.

9. SFC will be the primary regulator responsible for the registration and regulation of OFCs under SFO. It will be 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 will be responsible for the incorporation and administration of statutory corporate filings of OFCs.

Termination and winding up of open-ended fund companies

10. It is proposed that OFCs should be allowed to be terminated in a more straight-forward and cost efficient manner. As such, an OFC may apply to SFC for cancellation of registration voluntarily upon termination. The

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[4] Investment would be mainly in securities, futures and over-the-counter derivatives.

[5] This means that an OFC could consist of a number of separately pooled sub-funds and each sub-fund would have a pool of assets that is managed in accordance with the investment objectives and policies for that particular sub-fund.

[6] Under the protected cell structure, the assets of a sub-fund of an umbrella OFC belong exclusively to that sub-fund and shall not be used to discharge the liabilities of or claims against the umbrella OFC or any other sub-fund.

winding up of OFCs, whether solvent or insolvent, will be by way of a winding-up process under the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32).

Tax treatment for open-ended fund companies

11. The Bill amends the Inland Revenue Ordinance (Cap. 112) so as to extend the existing profits tax exemption given to public funds and offshore funds to OFCs. Moreover, the Stamp Duty Ordinance (Cap. 117) ("SDO") will be amended to: (a) apply the current stamp duty treatments applicable to certain sale or purchase and transfers of units under a unit trust scheme to OFCs; and (b) exempt a contract note from execution or stamping for a transaction relating to sale or purchase of a share or unit of an authorized open-ended collective investment scheme under specified conditions and exempt the transfer that relate to the sale or purchase of such share or unit from stamp duty.

Major views and concerns expressed by members of the Panel on Financial Affairs

12. The Administration and SFC briefed FA Panel on the proposals in the public consultation on introducing a new OFC structure at the meeting on 7 April 2014. The major views and concerns expressed by members are summarized in the ensuing paragraphs.

Tax regime for open-ended fund companies

13. Members noted that while the Administration proposed applying the existing profits tax exemption for public funds to publicly offered OFCs, it was still considering whether similar exemption should be provided for privately offered OFCs with its central management and control ("CMC") located in Hong Kong (i.e. onshore). Some members opined that the Administration should consider extending the current profits tax exemption to privately offered OFCs so as to enhance Hong Kong's competitiveness in attracting domicile of overseas mutual funds and private funds. On the other hand, some members expressed reservation about applying tax exemption to publicly offered OFCs due to concerns about further narrowing Hong Kong's tax base and public resources required for the operation of OFC regime. Members also enquired about the tax incentives offered to OFCs by other fund jurisdictions.

14. Some members suggested that the Administration should consider exempting the transfer of shares in OFCs from payment of stamp duty as the tax could be avoided if such transfers were effected by simultaneously issuing and redeeming shares. However, other members were concerned that the suggestion would enhance attractiveness of OFC funds to investor, thereby putting stocks (the trading of which is subject to stamp duty) in an unlevel playing field.

15. The Administration agreed that taxation would be among the factors considered by market participants in making decisions on fund domicile. Currently, all offshore funds including privately offered OFCs with CMC located offshore had already been exempted from profits tax. As regards the suggestion of extending profits tax exemption to privately offered OFCs with CMC located onshore, the Administration would consider the issue carefully. It was observed that some fund jurisdictions had offered profits tax exemption to privately offered OFCs with CMC located onshore.

Structure and regulation of open-ended fund companies

16. Under the proposal, an OFC would be governed by a board of directors which would provide an additional layer of oversight for shareholders, but individual directors were not required to be licensed under SFO. Some members enquired how the directors, in particular non-executive and independent directors, could be held responsible for the affairs of the OFC, and the differences in the regulatory requirements for OFCs and conventional companies.

17. The Administration advised that, similar to the conventional company model, the directors of an OFC were subject to statutory and fiduciary duties. SFC added that as an OFC was a fund investment vehicle in corporate form, its characteristics would be similar to a conventional limited company in that the board of directors would bear legal responsibilities for the affairs of the company although the day-to-day management and investment functions of the OFC must at all times be delegated to an investment manager licensed by or registered with SFC. The OFC directors would be subject to the same fiduciary duties as those of the directors of conventional companies under CO as well as common law.

18. Members enquired about the investment scope of OFCs and related regulation (i.e. SFC authorization, product due diligence and risk management), including whether OFCs would be allowed to make high-risk investments, whether securities firms could handle the trading of OFC funds, and whether the Administration would encourage the listing of OFCs in Hong Kong.

19. The Administration explained that the proposal would enhance investor protection. For instance, currently privately offered funds were not subject to regulation by SFC under SFO, but OFCs (including privately offered OFCs) would be regulated by the new OFC regime under the oversight of SFC. On the investment scope of OFCs, the initial thinking was that an OFC might invest in asset classes broadly in line with those of a traditional investment fund within the remit of SFO, and aligned with those types of investment activities which were subject to licensing and regulation by SFC under SFO. SFC supplemented that publicly offered OFCs would need to comply with the

applicable SFC product codes, such as requirements for diversification of investment and risk disclosure, whereas privately offered OFCs would be provided with more flexibility in pursuing their investment strategies subject to compliance with basic governance principles and conduct requirements to be observed by their investment managers. As regards the trading and listing of OFC funds, SFC advised that securities traders could set up and undertake investment management of OFCs as long as they were licensed by or registered with SFC to carry out Type 9 regulated activity. Besides, relevant requirements under the Listing Rules for listing of funds would apply to the listing of OFCs.

20. Members noted that the proposed OFC might be created as an umbrella fund consisting of a number of separately pooled sub-funds, and the assets and liabilities of each sub-fund would be segregated such that it could be wounded up separately in the event of insolvency, without giving rise to contagion risk to other sub-funds. They enquired whether such a protected cell regime of OFCs was more advanced and competitive than the OFC structures available in other fund jurisdictions. SFC advised that the proposed protected cell regime had taken into consideration similar OFC structures and the latest developments in other major fund centres (e.g. the United Kingdom and Ireland).

Council questions

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 tax regime for OFCs. The question and the Administration's written response are hyperlinked in the **Appendix**.

Latest development

22. At the House Committee meeting on 29 January 2016, Members agreed to form a Bills Committee to scrutinize the Bill.

References

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

Council Business Division 1
Legislative Council Secretariat
22 February 2016

Appendix

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 Administration 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 was briefed by the Administration 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)
15 January 2016	The Administration released the consultation conclusions on OFC structure	Press release Consultation conclusions

Date	Event	Paper/Minutes of meeting
27 January 2016	The Securities and Futures (Amendment) Bill 2016 received its First Reading	The Bill Legislative Council Brief (Ref: SF&C/1/2/22C(2015)) Legal Service Division report (LC Paper No. LS31/15-16)