

Bills Committee on Securities and Futures (Amendment) Bill 2016

Responses to Follow-up Actions Arising from the Discussion at the Meeting on 23 February 2016

This paper sets out the responses from the Administration and the Securities and Futures Commission (“SFC”) to the issues raised by Members in relation to the Securities and Futures (Amendment) Bill 2016 (“Bill”) at the meeting of 23 February 2016.

Offering and investment scope of open-ended fund companies

Differentiation between publicly-offered and privately-offered OFCs

2. Pursuant to section 103 of the Securities and Futures Ordinance (Cap. 571) (“SFO”), it is an offence for a person to issue an advertisement, invitation or document (“offering document”) which contains an invitation or offer to the public to acquire an interest in or participate in a collective investment scheme, unless an authorization is granted by the SFC or an exemption applies. Such restriction under section 103 of the SFO will be applicable to open-ended fund companies (“OFCs”) as OFCs are collective investment schemes. Hence, an OFC which is publicly offered would be subject to the authorization of the SFC under section 104 of the SFO (and its offering documents have to be authorized under section 105 of the SFO) unless an exemption under section 103 applies, and has to comply with additional requirements in the SFC Handbook¹ including the Code on Unit Trusts and Mutual Funds (“UT Code”).

3. Section 103(2)(ga) provides that, in essence, where the offering document contains or relates to an offer set out in Part 1 of the Seventeenth Schedule to the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) (“CWUMPO”) (i.e. the specified offer), the offer would not be subject to the SFC-authorization requirements. The specified offers include -

¹ SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products.

- (a) an offer to professional investors²;
- (b) an offer to no more than 50 persons (“50 person private placement”) having regard to local and international securities and company laws³; and
- (c) an offer in respect of which the total consideration payable for the relevant shares or debentures shall not exceed \$5 million which are small-scale offers.

The relevant extract of the Seventeenth Schedule to CWUMPO with details of the specified offer is at *Annex*.

4. We propose to extend the exemption under section 103(2)(ga) to OFCs⁴. Various anti-avoidance measures are already in place under Part 4 of the Seventeenth Schedule to CWUMPO to prevent abuse of the exemption. Specifically, an offer to not more than 50 persons and a small-scale offer will be subject to the aggregation restriction under the CWUMPO. In other words, a repeated offer will not be exempted if the offer is, in brief –

- (a) of the same class of shares or debentures;
- (b) made by the same person; and
- (c) open at any time within a 12-month period ending with the date on which the first-mentioned offer is first made.

² The term “professional investor” as defined in Schedule 1 to the SFO as read together with the Securities and Futures (Professional Investor) Rules (Cap. 571D). For example, any individual, either alone or with any of his or her spouse or any child on a joint account, having a portfolio of not less than \$8 million.

³ The corresponding exemption in the UK legislation similarly stood at 50 persons at the time the exemption was introduced in CWUMPO. In the UK, this has been revised to 150 persons pursuant to subsequent legislative amendments.

⁴ Under the existing legislative framework, the exemption under section 103(2)(ga) is already available to comparable offshore investment funds structured in corporate form which are offered in Hong Kong. We consider it appropriate to extend the exemption under section 103(2)(ga) to OFCs for parity with the treatment of similar corporate funds established abroad.

The supervisory and enforcement regime for all OFCs

5. All OFCs will be subject to the regulatory regime under the Bill, the subsidiary legislation (“OFC Rules”) and the codes and guidelines of the SFC (“OFC Code”). The OFC Rules and OFC Code will be subject to public consultation.

6. There is an extensive range of requirements under the Bill and the SFO applicable to all OFCs. Specifically, the following investor protection measures will be put in place for both publicly and privately offered OFCs -

(a) Pre-sale registration requirements of all OFCs

Under the Bill, all OFCs are required to be registered with the SFC prior to carrying on its business as an OFC. The new OFC legislation and the OFC Code will set out the basic operational and structural requirements for the OFC. In particular, it will lay down the key eligibility criteria, functions and duties of the investment manager, directors and custodian (i.e. the key operators) of the OFC, all of which must be complied with for so long as the OFC remains registered with the SFC.

Specifically, the investment management functions of the OFC must be delegated to an investment manager who is licensed by or registered with the SFC to carry out asset management regulated activity (Type 9 licence). The investment manager has to comply with the existing conduct requirements and the new OFC Code. Accordingly, the SFC would have regulatory handle over both publicly-offered and privately-offered OFCs via oversight of the investment manager’s investment management activities.

The board of directors will be legally responsible for all the affairs of the OFC and provide an additional layer of oversight for the shareholders. The assets of the OFC must be entrusted to a separate, independent custodian for safekeeping.

(b) Point-of-sale obligations on intermediaries selling the shares of publicly and privately offered OFCs

Intermediaries who may be involved in the sale of the shares of OFCs, regardless of whether the OFCs are privately or publicly offered, would be required to be licensed by or registered with the SFC where they conduct a regulated activity under the SFO (for example, Type 1 for dealing in securities, and Type 4 for advising in securities, as applicable). Accordingly, such intermediaries will be subject to the SFC's Code of Conduct⁵. If the sale of OFC shares is conducted by unlicensed or unregistered persons, this will constitute a breach of section 114 of the SFO and such persons will be subject to criminal prosecution.

In particular, the SFC's Code of Conduct requires that the licensed or registered person should, when making a recommendation or solicitation, ensure the suitability of the recommendation or solicitation for the client is reasonable in all circumstances ("Suitability Requirement"). Where an intermediary provides services to a client in derivative products, the SFC's Code of Conduct further provides that the intermediary should assess the client's knowledge of derivatives and characterize the client based on his knowledge of derivatives.

The point-of-sale requirements would also be applicable to privately-offered OFCs. Specifically, the intermediary involved in the sale of the shares of privately-offered OFCs must be a SFC-licensed or registered intermediary. The SFC's Code of Conduct's relevant requirements on SFC-licensed or registered intermediaries will remain applicable to such sale accordingly. The SFC will amend the Code of Conduct under which intermediaries will not be exempt from the "know your client" obligations in conjunction with the Suitability Requirement when serving individual professional investors.

⁵ SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

(c) Post-sale supervision and investigation powers

The SFC has powers to supervise and investigate the SFC-licensed investment managers of OFCs, as well as SFC-licensed intermediaries selling the shares of OFCs, regardless of whether a publicly or privately offered OFC is involved. They will be subject to the current supervisory regime under Part VIII of the SFO as other intermediaries.

In particular, in respect of an OFC, the SFC can conduct inspections and make inquiries with the OFC's investment manager to ensure that they are complying with applicable legislative requirements, conditions or other regulatory requirements, including the OFC Code. An investigation may be commenced to ascertain whether the investment manager is contravening the law or the regulatory requirements of the SFC including the OFC Code.

In addition, the SFC will be able to investigate any suspected misconduct in connection with the management of an OFC or the safe-keeping of its scheme property or any breaches of the registration requirements of an OFC.

(d) Enforcement

The SFC can take enforcement action against an OFC, its key operators, intermediaries or other persons in the event of suspected circumvention of the legislative and/or regulatory requirements applicable to the offering/sale of the shares of an OFC –

(i) *Criminal prosecution on contraventions of the relevant provisions of the SFO*

It is a criminal offence if an offering document for the shares of an OFC is issued to the public without the SFC authorization or without any applicable exemption⁶. It is also an offence for an applicant for registration of an OFC to knowingly or recklessly

⁶ Section 103 of the SFO.

make a false or misleading misrepresentation in its application documents to the SFC⁷.

Moreover, it is an offence for any person (i) to make any fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire an interest in or participate in a collective investment scheme⁸; (ii) to make disclosure of false or misleading information about securities that is likely to induce transactions⁹; or (iii) to employ the use of fraudulent or deceptive devices, etc. in transactions in securities¹⁰.

(ii) Disciplinary sanctions against the investment manager and other licensed or registered intermediaries

The investment manager of an OFC, who must be licensed by or registered with the SFC to carry out Type 9 regulated activity, and other licensed or registered intermediaries could be subject to disciplinary proceedings under Part IX of the SFO, if they breach the applicable provisions of the SFO and the applicable requirements in the OFC Code or SFC's Code of Conduct. The disciplinary sanctions include public reprimand, fine and/or suspension or revocation of their licence.

(iii) Directions

The SFC would have the power to give a direction to the OFC and/or its investment manager under section 112ZF of the Bill to cease the issue or redemption of shares.

(iv) Cancellation of registration

The SFC would have the power to cancel the registration of an OFC under section 112ZI of the Bill,

⁷ Section 383 of the SFO.

⁸ Section 107 of the SFO.

⁹ Section 298 of the SFO.

¹⁰ Section 300 of the SFO.

in which case the OFC would have to terminate its business.

(v) *Winding up*

The SFC would have the power to apply to the Court of First Instance (“CFI”) under section 212 of the SFO for a winding up order against an OFC in the public interest.

(vi) *Injunctions and other court orders*

The SFC would have the power to apply to the CFI under the amended section 213 of the Bill for a court order in respect of an OFC. The amended section 213 makes available a range of remedial and/or protective orders. The orders sought can include, among other things, an order to unwind the securities sold in the OFC and return payments to investors. The SFC may also apply for a compliance order from the CFI under section 112ZG of the Bill if the OFC and/or investment manager fails to comply with a direction of the SFC.

Investment scope and strategies of privately-offered OFCs

Overseas practices

7. With regard to overseas practices, briefly, in the UK, the permitted asset classes for similar privately-offered corporate funds include transferable securities and money market instruments, deposits, financial derivative instruments, immovable property, precious metals, loans rights under certain pension schemes, commodities, contracts of insurance and other collective investment schemes. There are certain limitations on the maximum leverage of the fund and risk spreading requirements.

8. In Ireland and Luxembourg, there are no specific restrictions on the assets in which privately-offered corporate funds may invest, but limits or diversification of investment requirements apply to some types of securities.

9. While noting that there appears to be fewer specified formal restrictions on permitted asset classes and strategies in some of the overseas jurisdictions as noted above, we are given to understand that in practice, not all asset classes may be accepted and may depend on various factors, such as whether the custodianship requirements can be satisfied.

The proposed investment scope and strategies of privately-offered OFCs

10. Under the proposed regulatory framework for OFCs, the asset classes in which privately-offered OFCs could invest should fall predominantly within the definition of securities and futures (and OTC derivative products once the relevant legislative amendments to the SFO have become effective) under the SFO within the scope of Type 9 (asset management) regulated activity.

11. Taking into account the comments received in the public consultation process, we will introduce a degree of flexibility by allowing privately-offered OFCs a 10% *de minimis* limit (i.e. a maximum of 10% of the total gross asset value of the fund) for investing in other asset classes. For the avoidance of doubt, cash deposits and currencies, which are not inconsistent with Type 9 regulated activity, will be permissible asset classes not subject to the above 10% *de minimis* limit.

12. The proposed investment scope should be able to accommodate a very substantial part of the asset classes that privately-offered OFCs normally invest in (e.g. cash, currency forwards, loans or distressed debt structured in the form of securities). We also note that the investment scope of those privately-offered funds which seek to benefit from the existing profits tax exemption is already restricted in practice.

13. While noting the industry feedback proposed for a much wider investment scope to be allowed for privately-offered OFCs, we consider that the proposed investment scope and strategies for privately-offered OFCs is appropriate having regard that -

- (a) the OFC is not designed to operate as a corporate entity for the purposes of general commercial business or trade. Accordingly, the asset classes in which a Hong Kong OFC could invest should still fall predominantly within the definition of securities and futures (and OTC derivative products once the relevant legislative amendments to the SFO have become effective) under the SFO within the scope of Type 9 (asset management) regulated activity;

and

- (b) the investment activities of OFCs would be required to be delegated to an investment manager licensed by or registered with the SFC, therefore the investment scope should remain largely aligned with Type 9 (asset management) regulated activity. The proposed investment scope could ensure that the current regulatory framework in terms of licensing, supervision and enforcement, etc. could be applicable to investment managers of OFCs. This would also enable all existing fund managers licensed by or registered with the SFC to carry out Type 9 regulated activity to apply to manage OFCs without the need to apply for any new licences.

14. Unlike publicly-offered OFCs which are subject to the applicable restrictions in the SFC Handbook, investment managers of privately-offered OFCs may have the flexibility to pursue their own investment strategies, provided that basic governance principles are complied with. These will include conduct and disclosure requirements, which are in line with international regulatory standards.

Governance and termination of OFCs

Duties, powers and liabilities of directors

15. The board of directors of an OFC will assume legal responsibilities over the affairs of the OFC and function as an additional oversight of the investment activities conducted by the investment manager.

16. Specifically, under section 112U(3) of the Bill, the directors of an OFC will have the following “overarching duties” -

- (a) the same fiduciary duties to the OFC as the directors of an ordinary company (i.e. a company incorporated under the Companies Ordinance (Cap. 622) (“CO”)) have to the ordinary company. Such duties are imposed under the common law and include the duty to act in good faith in the best interests of the company and its shareholders, the duty to avoid conflict of interest between their duties as directors and their personal interests, and the duty to

exercise the directors' powers for proper purpose; and

- (b) the duty to exercise reasonable care, skill and diligence that is owed by the directors of an ordinary company to the ordinary company under section 465 of the CO¹¹. This includes, for example, the duty to take all reasonable steps to ensure the suitability and competence of persons that they hire and continue to monitor their performance.

17. The OFC Rules and OFC Code will also provide for the detailed duties of the directors, for example, in respect of filing obligations, duties to convene meetings and prepare financial statements, and to follow procedures on winding-up, etc.

18. Further, each individual OFC's Instrument of Incorporation¹² will specify the duties and powers of the directors specific to that OFC.

19. If a director of an OFC breaches his or her overarching duties, the director would be liable to the same consequences as if the director were a director of an ordinary company (as set out in section 112U(4) of the Bill). This would include civil liabilities and remedies under the common law. Where there is a breach of legislative or regulatory requirements, it may also attract specific civil and/or criminal liability depending on the breach involved.

Appointment and removal of investment manager

20. Under section 112Z of the Bill, an OFC is mandated to have an investment manager who is an intermediary licensed or registered with the SFC for Type 9 regulated activity. It is also a registration requirement for the OFC to have an investment manager in place. Where there is a contravention of section 112Z, it will constitute a ground for cancellation of the OFC's registration. Various regulatory actions may also be taken including the power to give directions (section 112ZF) and to apply to CFI for a court order under the amended section 213 of the Bill.

21. As part of their overarching duties, the directors have to oversee that the regulatory requirements are complied with, including that the investment manager is duly appointed for an OFC at all times to perform

¹¹ We will propose a Committee Stage Amendment to provide for this duty more clearly.

¹² Similar to the Articles of Association for an ordinary company.

its functions. Accordingly, the directors have to procure proper appointment of a new investment manager where the existing investment manager is to be removed or tenders a resignation. The requirement for the directors to bear primary responsibility for the appointment and removal of the investment manager is also consistent with industry practices locally and in major jurisdictions abroad.

22. Further, it is expected that the OFC Code will provide for the basic requirements concerning the appointment and removal of the OFC's investment manager. These would include, for example, that the SFC should be notified of any change of investment manager, which would be subject to the SFC's approval, and the succession procedures for retirement and appointment of the investment manager. If the OFC is unable to appoint an investment manager, it would be a breach of the registration requirement and the SFC could take appropriate regulatory action in the circumstances, including the cancellation of the registration of the OFC.

Mechanism for termination of solvent OFCs

Overview of the streamlined application under section 112ZH

23. Under section 112ZH of the Bill, the SFC is empowered to cancel the OFC's registration upon its application in accordance with the specific provisions in the Instrument of Incorporation. This makes available a streamlined termination for a solvent OFC. This approach is consistent with common market practice for funds locally and abroad. The triggering mechanism and parties who may apply for such termination will be laid down in the OFC Code and disclosed in the OFC's offering documents for clear disclosure to investors.

24. Investment funds are usually terminated for commercial reasons. Such triggering circumstances, which are commonly set out in the constitutive documents for SFC-authorized unit trusts and mutual funds include -

- (a) changes in the market conditions or investment trends resulting in the investment strategy becoming unviable;
- (b) fund size falling below a particular threshold and it is no longer economical or in the interest of shareholders for the fund to continue to operate;

- (c) the fund is a fixed term fund upon effluxion of time; and
- (d) imminent change in law which leads to impracticability of the continued operation of the fund, etc.

25. Given the nature of OFCs as investment funds, we propose to allow OFCs to be terminated in a more straight-forward and cost efficient manner, and without compromising investor protection, where –

- (a) the OFC is to be terminated in accordance with the specific provisions in the OFC's Instrument of Incorporation;
- (b) the OFC is solvent as certified by the OFC board and an independent and qualified auditor; and
- (c) reasonable prior notice has been given to shareholders.

26. The terms and initiating parties for the streamlined termination would be required to be disclosed in the OFC offering documents issued to the investing public pursuant to the OFC Code.

27. Once the OFC assets have been fully distributed to shareholders and all liabilities have been settled, the OFC board could apply to the SFC for cancellation of registration under section 112ZH of the Bill together with –

- (a) the final accounts of the OFC accompanied by the auditor's report; and
- (b) a declaration signed by the OFC board and the investment manager confirming that all assets have been distributed to shareholders in accordance with the OFC's Instrument of Incorporation and the OFC has no outstanding liabilities.

28. Under section 112ZH(2), the SFC may refuse the application to cancel the registration of the OFC if it considers that –

- (a) it is in the public interest that any matter concerning the company should be investigated before its registration is so cancelled; or

- (b) the cancellation would not be in the interest of the investing public (essentially, the shareholders of the OFC).

Parties who may initiate the streamlined termination of an OFC

29. The parties who may initiate, consent to, and resolve any disagreement regarding the application for a streamlined termination of a solvent OFC will be set out in an OFC's Instrument of Incorporation.

30. Generally, the board of directors is expected to be the primary party who may apply for such termination, consistent with general market practice for funds locally and for corporate funds in major jurisdictions abroad such as the UK, Ireland and Luxembourg.

31. In applying for such streamlined termination, the board of directors must observe the provisions under the Instrument of Incorporation, as well as the requirements under the Bill, the OFC Rules and the OFC Code.

32. The Instrument of Incorporation will be a binding contract between the OFC and its shareholders under section 112L of the Bill. By becoming a member (i.e. shareholder) of an OFC, the shareholders will be bound by the terms of the Instrument of Incorporation. That said, it is expected that the shareholders may amend the terms of the streamlined termination, by way of amending the Instrument of Incorporation. In accordance with the OFC Rules to be formulated and consistent with the CO, the Instrument of Incorporation can be revised by the shareholders of OFC by passing a special resolution to that effect. Separately, the shareholders of an OFC may opt to wind up the OFC voluntarily pursuant to the CWUMPO regime which will be extended to OFCs by way of the OFC Rules with appropriate modifications.

33. The detailed grounds of and parties who may apply for such termination will be formulated based on industry practices and be set out in the OFC Code which will be subject to public consultation.

**Financial Services and the Treasury Bureau
Securities and Futures Commission
March 2016**

**Part 1 of the Seventeenth Schedule to the
Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32)**

Specified Offers

1. An offer to professional investors within the meaning of section 1 of Part 1 of Schedule 1 to the Securities and Futures Ordinance (Cap. 571)(including professional investors falling within paragraph (j) of the definition of *professional investor* in that section).
2. An offer—
 - (a) to not more than 50 persons; and
 - (b) containing a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.
3. An offer—
 - (a) in respect of which the total consideration payable for the shares or debentures concerned shall not exceed the amount specified in Part 2, or its equivalent in another currency; and
 - (b) containing a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.
4. An offer—
 - (a) in respect of which the minimum denomination of, or the minimum consideration payable by any person for, the shares or, in the case of debentures, the minimum principal amount to be subscribed or purchased, is not less than the amount specified in Part 3, or its equivalent in another currency; and
 - (b) containing a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.
5. An offer in connection with an invitation made in good faith to enter into an underwriting agreement.
6. An offer in connection with a takeover or merger or a share buy-back which is in compliance with the Codes on Takeovers and Mergers and Share Buy-backs issued by the Commission as in force from time to time.

7. An offer of shares in a company—

(a) made—

- (i) for no consideration, to any or all holders of shares in the company;
or
- (ii) as an alternative to a dividend or other distribution, to all holders of shares of a particular class in the company, provided the offer is of fully paid-up shares of the same class; and

(b) containing a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.

8. An offer—

(a) of shares in or debentures of a company;

(b) to persons who are qualifying persons in respect of the company referred to in paragraph (a) or of another company which is a member of the same group of companies as the company referred to in that paragraph;

(c) by—

- (i) the company referred to in paragraph (a);
- (ii) another company which is a member of the same group of companies as the company referred to in paragraph (a); or
- (iii) the trustees—

(A) of a trust established by any one or more of the companies mentioned in subparagraphs (i) and (ii); and

(B) holding the shares or debentures the subject of the offer;

(d) on terms that the only persons who can acquire the shares or debentures are the qualifying persons to whom they are offered or, if the terms of the offer so permit, any qualifying person; and

(e) containing a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.

9. An offer by—

(a) a charitable institution or trust of a public character mentioned in section 88 of the Inland Revenue Ordinance (Cap 112); or

(b) an educational establishment within the meaning of section 2(1) of the Sex Discrimination Ordinance (Cap 480),

where—

(c) the proceeds of the offer will be applied towards the objectives of the charitable institution or trust, or educational establishment, as the case may be; and

(d) the offer contains a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.

10. An offer—

(a) to members, or applicants for membership, of a club or association—

(i) who can reasonably be regarded as having a common interest with each other and with the club or association in the affairs of the club or association; and

(ii) where the proceeds of the offer are to be applied for purposes which can reasonably be regarded as concerning the affairs of the club or association; and

(b) containing a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.

11. An offer—

(a) in respect of—

(i) an exchange of shares in the same company which does not result in an increase in the issued share capital of the company; or

(ii) an exchange of debentures of the same company which does not result in an increase in the aggregate principal amount outstanding under the debentures; and

(b) containing a statement specified in Part 3 of the Eighteenth Schedule to this Ordinance.

12. An offer—

(a) in connection with a collective investment scheme authorized under section 104 of the Securities and Futures Ordinance (Cap. 571); and

(b) in connection with which the issue of each advertisement, invitation or document has been authorized under section 105 of the Securities and Futures Ordinance (Cap. 571).