Submission from Timothy Loh Solicitors

COMMENTS ON THE PROPOSED OPEN-ENDED FUND COMPANIES STRUCTURE

Thank you Mr. Chairman and other members of this Committee for the opportunity to comment on the proposed regime for open-ended fund companies. We welcome the introduction of legislation to enable the establishment of open-ended fund companies and believe that such legislation can play a major role in promoting Hong Kong as a global fund management centre.

However, we are concerned that the proposed regime has been designed only to support the growth of Hong Kong as a centre for the management of public mutual funds to be sold in Hong Kong or in mainland China. We are concerned that this regime does not provide a definitive benefit since the law already supports Hong Kong as a centre for the management of unit trusts to be sold publicly in Hong Kong or in mainland China. We are concerned that the proposed regime will make no progress towards advancing Hong Kong as a centre for the management of hedge funds, private equity funds and other funds to be sold privately.

We draw the Committee's attention to 3 areas which we believe warrant re-consideration so as to maximize the opportunity for Hong Kong to progress as a global fund management centre. These 3 areas are the requirement for a custodian, the requirement for a Type 9 licensed asset manager and tax neutrality.

1. INVESTMENT MANAGERS

We turn first to the requirements for an investment manager licensed by the SFC for Type 9 asset management.

There is no need within this open-ended fund company regime to require that the investment manager be licensed for Type 9 asset management. If a fund will be authorized by the SFC for sale to the Hong Kong public or for sale through a reciprocal arrangement with mainland China, the fund will already be subject to requirements in respect of investment managers.

Imposing investment manager requirements will unduly limit the use of open-ended funds which will neither be sold to the public in Hong Kong nor into mainland China. Some funds, particularly private equity funds, do not exercise investment discretion at the investment manager level. Instead, investment discretion is exercised at the fund level. As a result, the SFC itself often refuses investment managers of private equity funds licenses for Type 9 asset management. Instead, it requires investment managers of private equity funds to be licensed for Type 1 dealing in securities. A requirement that open-ended fund companies appoint an SFC licensed Type 9 asset manager would impair the ability of the private equity industry to use the new open-ended fund company regime. It should suffice that the investment manager is licensed by the SFC.

2. CUSTODIANS

We turn next to the requirement for a custodian meeting minimum eligibility requirements.

As with investment managers, there is no need within this open-ended fund company regime to require that a fund have a custodian. If a fund will be authorized by the SFC for sale to the Hong Kong public or for sale through a reciprocal arrangement with mainland China, the fund will already be subject to requirements in respect of custodians and these custodians will need to meet minimum eligibility requirements.

Requiring a custodian will limit the use of open-ended funds which will neither be sold to the public in Hong Kong nor into mainland China. Some funds do not hold investments which are held by a custodian. For example, funds which invest in OTC derivatives are themselves the counterparties to these investments. Custodians generally will not take on the role of the counterparty as they will not assume the liability, sometimes unlimited, which comes with that role. Equally, for example, funds which invest in private equity investments do not hold investments through a custodian. Instead, they hold these investments in special purpose vehicles through which the funds can exercise various rights that are typically inserted into the agreements by which these investments are made. Custodians will not generally be parties to these agreements. As a result, the requirement for a custodian will limit the use of open-ended fund companies.

3. TAX NEUTRALITY

Finally, we turn quickly to tax neutrality. We note that the Administration has expressed the view that it wishes to defer the issue of tax exemption for open-ended fund companies sold privately. We believe that this deferral would have long term adverse consequences for open-ended fund companies in Hong Kong as once Hong Kong open-ended fund companies gain a reputation for being sub-tax optimal for private funds, it will be difficult to displace that reputation even with subsequent legislative change. The momentum is already against the use of Hong Kong open-ended fund companies as there are already many jurisdictions offering tax neutral fund vehicles. We ask the Administration to bear in mind that fund sponsors themselves do not fully control the choice of vehicle. This decision is often dictated by fund investors who are not always rational in their decisions.

We believe that it would be in the long-term interest of Hong Kong that immediate consideration be given to exempting open-ended fund companies from profits tax even if they are privately offered and even if the central management and control is located in Hong Kong. There would be practical difficulties for Hong Kong incorporated open-ended fund companies to arrange for offshore directors who may be unfamiliar with Hong Kong law requirements. It makes sense at the same time to locate directors of open-ended fund companies in Hong Kong if those funds are managed from Hong Kong.

4. CONCLUSION

In summary, the proposed regime is likely to assist only in the use of Hong Kong mutual funds which are offered for to the public in Hong Kong or in mainland China. It will not directly affect the use of Hong Kong unit trusts and will offer little to the hedge fund and private equity industries.

Thank you Mr. Chairman.

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