

# **立法會**

## ***Legislative Council***

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### **Paper for the House Committee meeting on 6 May 2016**

### **Report of the Bills Committee on Securities and Futures (Amendment) Bill 2016**

#### **Purpose**

This paper reports on the deliberations of the Bills Committee on Securities and Futures (Amendment) Bill 2016 ("the Bills Committee").

#### **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"). There are market calls for a more flexible choice of investment fund vehicle through introducing a new open-ended fund company ("OFC") structure in Hong Kong. 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.

#### **The Securities and Futures (Amendment) Bill 2016**

3. The Securities and Futures (Amendment) Bill 2016 ("the Bill") was published in the Gazette on 15 January 2016 to amend mainly the Securities and Futures Ordinance (Cap. 571) ("SFO") to introduce the OFC structure in Hong

Kong.<sup>1</sup> The Bill received its First Reading at the Legislative Council ("LegCo") meeting of 27 January 2016.

### **The Bills Committee**

4. At the House Committee meeting on 29 January 2016, Members agreed to form a Bills Committee to study the Bill. The membership list of the Bills Committee is in **Appendix I**. Under the chairmanship of Hon CHAN Kam-lam, the Bills Committee has held three meetings to discuss with the Administration, including one meeting to receive views from deputations. The Bills Committee has also received seven written submissions from deputations. A list of the organizations which have provided views to the Bills Committee is in **Appendix II**.

### **Deliberations of the Bills Committee**

5. The main subjects deliberated by the Bills Committee are set out below:
- (a) benefits of introducing the OFC structure in Hong Kong (paragraphs 6 – 7);
  - (b) structure and key features of OFC (paragraphs 8 – 9);
  - (c) legislative approach (paragraphs 10 – 13);
  - (d) incorporation and registration of OFC (paragraphs 14 – 25);
  - (e) key operators of OFC (paragraphs 26 – 43);
  - (f) investment of OFC (paragraphs 44 – 48);

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<sup>1</sup> The Bill also seeks to amend the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32), the Companies (Disqualification Orders) Regulation (Cap. 32I), the Inland Revenue Ordinance (Cap. 112), the Stamp Duty Ordinance (Cap. 117), the Business Registration Ordinance (Cap. 310), the Business Registration Regulations (Cap. 310A), the Resolution of the Legislative Council Establishing Companies Registry Trading Fund (Cap. 430B) and the Contracts (Rights of Third Parties) Ordinance (Cap. 623) for introducing the OFC structure in Hong Kong. In addition, the Administration has advised that it will move Committee Stage amendments to add new clauses to amend the Banking Ordinance (Cap. 155) and the Financial Reporting Council Ordinance (Cap. 588), as mentioned in paragraphs 59(f) to (h) of this report.

- (g) offering of OFC shares (paragraphs 49 – 53);
- (h) termination and winding up of OFC (paragraphs 54 – 58);
- (i) supervisory and enforcement powers of the Securities and Futures Commission ("SFC") (paragraphs 59 – 61); and
- (j) stamp duty and tax treatment in respect of OFC (paragraphs 62 – 63).

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

6. The Bills Committee notes that the fund industry is generally supportive of the introduction of the new OFC structure in Hong Kong to provide an extra option for fund structure. According to the Administration, introducing the OFC structure will 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 will in turn drive demand for professional services such as fund management and investment advice, as well as legal and accounting services; and help strengthen Hong Kong's position as an international asset management centre and foster the further development of the local financial services sector as a whole. While the envisaged benefits cannot be quantified in terms of the estimated number of funds to be attracted to domicile in Hong Kong after introduction of the OFC structure, the Administration advises that a number of fund managers have already indicated interest to establish OFC funds in Hong Kong.

7. Mr Christopher CHEUNG has suggested the Administration consider putting in place measures to facilitate or incentivize listing and trading of OFC shares on the stock exchange. SFC points out that so long as the Listing Rules and other applicable requirements are met, investment funds including OFCs can be listed on the stock exchange. The Administration assures members that it will 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.<sup>2</sup>

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<sup>2</sup> Exchange-based distribution platforms allow unlisted fund products to be transacted and/or settled via stock exchanges and their associated clearing and settlement systems. For detailed information of the relevant proposal, see the paper provided by the Administration and SFC for the meeting of the Panel on Financial Affairs on 22 March 2016 (LC Paper No. CB(1)686/15-16(04)).

## Structure and key features of open-ended fund company

8. Clause 6 of the Bill adds to SFO a new Part IVA which relates to OFCs. An OFC is an open-ended collective investment scheme ("CIS"), which is structured in corporate form with limited liability and variable share capital. Investment in the OFC (as in the case of funds generally) is typically made by way of subscription and redemption of units/shares in the fund.<sup>3</sup> The proposed OFC structure and key operators are illustrated in **Appendix III**.<sup>4</sup> The Bills Committee notes that 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.

9. The Bills Committee also notes that the OFC, being an investment vehicle,:

- (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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<sup>3</sup> According to the Administration, there will be no prohibition on share class creation (e.g. management shares and non-participating shares) for an OFC in the regulatory framework. Share class creation, if any, will be governed by the constitutive document of the OFC and subject to the relevant OFC Code requirements.

<sup>4</sup> Please refer to paragraphs 27 to 42 of this report for details of the key operators.

- (c) will not be required to be licensed as a licensed corporation under SFO, but will have to be registered with 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.

## **Legislative approach**

10. The Bills Committee notes that the corporate fund structure is found in a number of major fund centres, for example, the United Kingdom ("UK"), the United States, Ireland and Luxemburg. In developing the legislative proposal for OFCs, the Administration has considered the legal frameworks and regulatory regimes of other major asset management or funds jurisdictions, the relevant securities regulation principles published by the International Organization of Securities Commissions and the market landscape in Hong Kong. The Bills Committee also notes that the OFC structure is among the proposals put forth by the Financial Services Development Council of Hong Kong.<sup>5</sup>

11. Under the proposed legislative framework for OFCs, the enabling provisions to introduce the OFC structure in Hong Kong are set out in the new Part IVA to be added to SFO by the Bill while the detailed operational and procedural matters will be set out in new subsidiary legislation to be enacted under SFO ("the OFC Rules") and subject to negative vetting by LegCo.<sup>6</sup> The Bill, if enacted, 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.

12. Some deputations including The Hong Kong Association of Banks and the Hong Kong Bar Association have expressed concerns that it is unclear as to what extent the provisions under CO and the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) ("CWUMPO") are applicable to OFCs. The Administration clarifies that the provisions in CO and CWUMPO do not apply to OFCs because OFCs are not formed under CO. On the other hand, those provisions in CO or CWUMPO that are considered relevant to OFCs are set out either directly in the Bill or will be clearly set out/referred to in the OFC Rules, with relevant modifications as appropriate.

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<sup>5</sup> The Financial Services Development Council published a research paper on "Proposals on Legal and Regulatory Framework for Open-ended Investment Companies in Hong Kong" on 18 November 2013.

<sup>6</sup> The new section 112ZK of SFO set out in detail the matters which may be provided for in the OFC Rules. Separate public consultation on the OFC Rules will be conducted by SFC.

13. The Bills Committee further notes that the Bill amends the references to "company"<sup>7</sup> to "corporation"<sup>8</sup> in certain provisions of SFO to cover OFCs, which will not be incorporated under CO.

### **Incorporation and registration of open-ended fund company**

#### One-stop company incorporation and registration service

14. The new section 112D of SFO empowers SFC to register an OFC, whereas the new section 112E specifies the requirements for the registration, including requirements relating to the key operators of the OFC, and requirements relating to its name and registered office.

15. The Bills Committee notes that to incorporate an OFC, the applicant should apply to SFC for registration prior to applying to the Registrar of Companies ("CR") for incorporation. In addition to registration, like other SFC-authorized unit trusts and mutual funds, an OFC which seeks to offer its shares to the public must seek SFC's authorization. Since an OFC is an investment fund vehicle taking a corporate form, it is also required to register with the Inland Revenue Department ("IRD") under the Business Registration Ordinance (Cap. 310) ("BRO").<sup>9</sup> Under the proposed one-stop company incorporation and business registration regime, CR will issue to an OFC the first business registration certificate on behalf of the Commissioner of Inland Revenue simultaneously together with the certificate of incorporation.

16. The Bills Committee has enquired about the detailed operational procedures of the proposed one-stop company incorporation and business registration regime, in particular whether SFC will register a proposed OFC before all the requirements for registration are met. The Bills Committee notes that some deputations consider that the process for setting up privately offered OFCs should be streamlined to optimize the time to launch such OFCs in the market.

17. SFC has advised that it will not register a proposed company as an OFC before it is satisfied that the OFC will fulfill all the registration requirements upon incorporation. The following operational procedures will be adopted:

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<sup>7</sup> Under Schedule 1 to SFO, "company" means a company as defined in section 2(1) of CO.

<sup>8</sup> Under Schedule 1 to SFO, "corporation" means a company or other body corporate incorporated either in Hong Kong or elsewhere.

<sup>9</sup> Clause 36 expands the scope of section 5A of BRO so that the simultaneous business registration application will be extended to OFCs as well.

- (a) SFC will be the sole recipient of all application documents (including the documents required by SFC for registration, the documents to be provided to CR for incorporation and IRD for business registration);
- (b) SFC will then review those documents in relation to the application for registration to consider if the proposed company will meet the requirements for registration on the day on which the registration takes effect. Once SFC is satisfied that the proposed company is capable of meeting the registration requirements and decides to register it as an OFC, it will notify CR by way of a notice of registration. SFC will also forward the relevant documents and fees together with the notice of registration to CR for the OFC's incorporation purpose;
- (c) pursuant to the new section 112C of SFO, CR will incorporate the proposed company if it is satisfied that the requirements for incorporation have been met and it has been notified of the registration of the proposed company by SFC; and
- (d) under the new section 112D(3), the registration of the proposed company will take effect on the day of issue of the certificate of incorporation in respect of it by CR under the new section 112C(3)(b).

18. The Administration points out that certain filings will not be applicable to OFCs, such as share allotment, redemption, transfer and increase in share capital.<sup>10</sup> The requirement for OFCs to file an annual return has also been removed after taking into account the comments received during the public consultation.<sup>11</sup> The Administration will consider how the one-stop process can be further streamlined at the next stage of consultation on the OFC Rules and the OFC Code. As regards the industry's concerns about the timeframe of the one-stop process, the Administration advises that SFC and CR will publish the general processing time in handling relevant applications, which is expected to be broadly in line with existing practice.

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<sup>10</sup> Filings in relation to information on company secretary, list of members, information on mortgages and charges will also be inapplicable to OFCs.

<sup>11</sup> The Financial Services and the Treasury Bureau published a consultation paper on OFCs in March 2014. The consultation paper is available from: <http://www.legco.gov.hk/yr13-14/english/panels/fa/papers/fa0407cb1-1180-5-e.pdf> [Accessed April 2016].

Imposition of conditions by the Securities and Futures Commission for registration or cancellation of registration of open-ended fund company

19. The Bills Committee notes that SFC may impose any condition that it considers appropriate on registering a proposed OFC and on cancelling the registration of the OFC under the new sections 112D(6) and 112ZH(3) of SFO respectively. In addition, SFC may impose on an OFC new conditions in respect of its registration, and impose on an OFC the registration of which is cancelled new conditions in respect of the cancellation under the new sections 112F and 112ZH(4) respectively. The Bills Committee has requested the Administration to clarify the means by which the aforementioned conditions or new conditions are imposed and when the conditions or new conditions will take effect. The Bills Committee has also enquired whether the proposed/registered OFC affected by SFC's decision to impose the conditions or new conditions will be given an opportunity to be heard, and whether such decision will be subject to review or appeal.

20. The Administration advises that pursuant to section 232(2) of SFO, the conditions in respect of registration and cancellation of registration will take effect either on the expiry of the period (i.e. 21 days) for appeal against such decisions, or when the party on whom such conditions are imposed notifies SFC that the conditions are accepted. In practice, during the application process for registration of a proposed OFC, SFC will inform the applicant that SFC is minded to impose the proposed registration conditions and the applicant will have an opportunity to be heard. If the applicant accepts SFC's proposed conditions, such conditions will take effect at the same time when the OFC is registered. Under the new section 112D(5), SFC may refuse to register a proposed OFC if it is not satisfied that the registration is in the interest of the investing public. The acceptance of registration conditions by the applicant will be a factor to be taken into account by SFC for registration. For any new conditions which may be imposed after registration and new conditions in respect of cancellation of registration, a similar process will apply. The OFC will be provided with a reasonable period to give its views prior to the imposition of such conditions/new conditions. As the imposition will be "specified decisions" defined under section 215 of SFO, it will be subject to appeal pursuant to section 217 of SFO at the Securities and Futures Appeal Tribunal.<sup>12</sup>

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<sup>12</sup> Pursuant to Clause 22 of the Bill, the imposition of the relevant conditions will fall under "specified decisions" by way of the addition of items 15B, 15C, 15G, 15H, 15J and 15K to Division 1 of Part 2 of Schedule 8 to SFO.



Publication of matters relating to open-ended fund company by the Securities and Futures Commission

21. The Bills Committee observes that under the new section 112G of SFO, SFC "may" publish, in any manner it considers appropriate, particulars of an OFC. Under the new sections 112ZH and 112ZI, SFC "may" publish notice of cancellation of the registration of an OFC and the reasons for the cancellation in any manner that it considers appropriate. The Bills Committee has sought clarification on whether the policy intent is to make the publication of the above matters discretionary, and if so, the circumstances under which SFC will or will not make the publication. If the publication is mandatory, the Bills Committee has suggested the Administration consider replacing the word "may" with "must" in these provisions and provide a time frame for the publication.

22. The Administration advises that notwithstanding the use of the word "may" in similar existing provisions in relation to the authorization of investment products (e.g. sections 104(8) and 104A(8) of SFO), for transparency purpose, it is SFC's established policy to publish the relevant particulars of the investment products as soon as practicable following SFC's authorization. Further, CR will be responsible for maintaining the statutory filings of the OFC. SFC may provide a link to CR's website for accessing the particulars of the OFC kept by CR. If SFC is required mandatorily to publish the particulars of OFCs, it may result in duplication with the functions of CR. The Administration considers the use of the word "may" in the new section 112G appropriate and allow flexibility to be retained with regard to the publication of the OFC's particulars by SFC, where appropriate. It does not propose to specify in the legislation a time frame for publication of such information as the uploading of information to the website will be more of a logistical matter following the checking of accuracy of all information received.

23. As regards the publication of the notice of cancellation of an OFC and the reasons for the cancellation, the Administration advises that the new sections 112ZH and 112ZI of SFO refer to two different scenarios in which cancellation of registration may take place. Section 112ZH provides for the cancellation of registration upon the OFC's own application. As the OFC will be the party initiating the termination, the OFC should generally be the primary party to issue such notification to the investors with explanation of the grounds for termination. If there are exceptional circumstances which call for a notice of the cancellation to be published with regard to such termination, section 112ZH(8)(b) will enable SFC to make such publication. On the other hand, section 112ZI provides for the cancellation of registration by SFC of its own volition in the circumstances specified in section 112ZI(1). These circumstances essentially being where a relevant contravention has occurred, or

where SFC is not satisfied that the continued registration of the OFC is in the interests of the investing public, or if a winding-up order has been made by the court. Whilst in general SFC intends to publish a notice of cancellation of registration where this takes place under section 112ZI, there may be circumstances where alternative means of communication will more effectively serve the purpose of notification. SFC would like to retain the discretion to use other effective means of notification where there is no apparent public interest consideration which calls for a publication of notice.<sup>13</sup> SFC will act reasonably in deciding if a notice is required to be published.

24. For the reasons stated above, the Administration considers the use of the word "may" in the new sections 112ZH and 112ZI of SFO appropriate. This will also achieve consistency with existing provision in SFO in respect of the withdrawal of authorization for CISs. Nonetheless, SFC will establish a policy to make known the cancellation of the registration of an OFC to the public by way of disclosure on SFC's website. Specifically, SFC will remove the name of an OFC from the list of registered OFCs immediately following a cancellation of registration. In addition, similar to the current practice of publishing a monthly list on the CISs from which authorization has been withdrawn, SFC will publish on its website on a regular basis a list of all the cancellation of registrations of OFCs.

Permission for open-ended fund company to carry on essential business operations on cancellation of registration

25. The new section 112ZJ of SFO provides for SFC's power to permit an OFC whose registration has been cancelled to carry on essential business operations. While the new section 112ZJ(5) provides that a permission given or a condition imposed takes effect at the time of the service of the notice or such later time as specified in the notice to permit the continuation of the OFC's essential business operations, there is no similar provision for amendment or revocation of conditions or imposition of new conditions under the new section 112ZJ(6). To be consistent with the new section 112ZJ(5), the Administration has advised that it will move a Committee Stage amendment ("CSA") so that an amendment or revocation of conditions or imposition of new conditions under the new section 112ZJ(6) also takes effect at the time of notice or such later time as specified in the notice.

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<sup>13</sup> For example, where an OFC involved is a privately offered OFC which has no or very few remaining investors, or has only a few overseas investors and no outstanding creditors, it may be more administratively efficient to give direct notification to them.

## **Key operators of open-ended fund company**

26. The Bills Committee notes that the directors, the investment manager and the custodian are the key operators of an OFC. To strengthen investor protection, the key operators will have to meet some basic eligibility requirements, as explained in paragraphs 27 to 42 below.

### Directors

#### *Eligibility, duties and liabilities*

27. Under the proposed legislative framework, an OFC is to be governed by a board of directors who are subject to statutory and fiduciary duties, and there should be at least two natural-person directors. 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 new sections 112T, 112U, 112V, 112W, 112X, 112ZC, 112ZD and 112ZE of SFO specify the eligibility, duties and liabilities of OFC directors. The Bills Committee notes that an OFC director will be subject to a range of eligibility requirements including that he/she has to be a natural person, of good repute and be experienced for the purpose of carrying out the business of the OFC, and not be an undischarged bankrupt. When considering an application for registration as an OFC, SFC will take into account whether, among other things, the requirements relating to OFC directors will be met. In addition, OFC directors will be subject to regulatory requirements and potential liabilities or offences under the Bill and the OFC Rules. According to the Administration, the overall proposed regulatory framework covering the directors of OFCs is more extensive than that for directors of ordinary companies.

28. Under the new section 112U(3) of SFO, a director of an OFC "owes the OFC the same fiduciary and other duties that are owed by a director of an ordinary company to the ordinary company". Since not all duties of the directors of an ordinary company, particularly those prescribed under CO, are applicable to OFC directors,<sup>14</sup> the Administration has advised that it will move a CSA to specify in the said section that the "other duties" owed by a director of an OFC should only comprise the duty to exercise reasonable care, skill and diligence that is owed by the directors of an ordinary company to the ordinary

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<sup>14</sup> For example, duties in relation to distributions, capital maintenance, shares buy-back and redemptions, and financial assistance to acquire own shares are not applicable to OFC directors.

company under section 465 of CO.<sup>15</sup> With this CSA, the revised new section 112U(3) will read as:

*"A director of an open-ended fund company owes the open-ended fund company –*

- (a) the same fiduciary duties that are owed by a director of an ordinary company to the ordinary company; and*
- (b) the duty to exercise reasonable care, skill and diligence that is owed by a director of an ordinary company to the ordinary company under section 465 of the Companies Ordinance (Cap. 622)."*

29. Mr Alan LEONG has requested the Administration to review the drafting of the CSA to the new section 112U(3) with a view to clarifying whether any duty other than those stated in the provision will apply to OFC directors. The Administration confirms that the proposed amendment is not intended to impose upon a director of an OFC any duty that is not falling within the revised new section 112U(3)(a) or (3)(b). The policy intention is that such "other duties" refer specifically to the overarching duty of the OFC directors to exercise reasonable care, skill and diligence. The Administration also stresses that as far as the OFC is concerned, only SFO (including the new Part IVA to be added by the Bill and the OFC Rules), and not CO, will apply to OFC directors. Specific operational matters of the OFC that the directors have to assist with will be specifically set out in the OFC Rules.

#### *Residency of directors*

30. Noting that it was proposed during the public consultation on OFCs that at least one director of the OFC Board must be a Hong Kong resident to ensure that there would be a local contact, the Bills Committee has enquired about the reasons for not including this requirement under the Bill.

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<sup>15</sup> The Administration has advised that similarly, in UK under the Open-Ended Investment Company Regulations and in Ireland under the Irish Collective Asset-management Vehicles Act, the directors' duties are prescribed specifically for their comparable corporate fund vehicles rather than incorporating the directors' duties on a wholesale basis from their respective conventional company law regimes.

31. The Administration advises that some respondents of the public consultation have suggested removal of the requirement for at least one Hong Kong-resident OFC board member lest it results in difficulties for an OFC to recruit Hong Kong personnel or to contend that its central management and control is not exercised in Hong Kong so as to enjoy profits tax exemption for offshore funds. Given the requirement that the investment management functions of an OFC must be delegated to an investment manager who must be SFC-licensed or registered, the Administration considers it acceptable to remove the said requirement in respect of OFC directors. While there will be no requirement for OFC directors to be residents of Hong Kong, each of the non-resident directors of the OFC will be required to appoint a process agent in Hong Kong to accept service of process.<sup>16</sup>

#### *Sanctions on directors*

32. As OFC directors will not be required to be licensed under SFO, Mr SIN Chung-kai has expressed concern as to whether the Bill provides for sufficient regulation of and sanctions on OFC directors for failing to perform their duties in governing the OFC activities. The Administration advises that:

- (a) where SFC discovers that a director of an OFC has committed an offence under the relevant provisions in SFO or engaged in defalcation, fraud, misfeasance or other misconduct, SFC can exercise enforcement powers, including taking prosecution action and/or applying to the court for a wide range of remedial orders. Where an investment manager of an OFC commits any contravention of SFO, and a director consented to or was otherwise involved in (such as knowingly aided and abetted) such contraventions, SFC can make an application to the court for an order against the director even if he/she is not directly engaged in such contraventions;
- (b) SFC may apply to the court for various court orders (which may be directed against a director of an OFC) under the new section 214A of SFO if the business or affairs of the OFC have been conducted in a manner which is oppressive or unfairly prejudicial to its shareholders, or involving defalcation, fraud, misfeasance or other misconduct. Such orders include an order

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<sup>16</sup> According to the Administration, the process agent is expected to serve the purpose of receiving legal documents rather than conferring jurisdiction of the Hong Kong courts. Given the procedural and logistical role of the process agent, the relevant provision will be placed in the OFC Rules and/or the OFC Code instead of in the Bill.

for the OFC to bring proceedings against directors for compensation and an order to disqualify directors for up to 15 years;

- (c) SFC may apply for appropriate court orders under section 213 of SFO where there is a contravention by the key operators of an OFC (including OFC directors) of any provisions in SFO. In addition, orders may be sought against a director under section 213 in cases where the director is involved in, or aiding and abetting any contraventions by other persons such as the investment manager. Orders which may be sought under section 213 include an order requiring a director to take steps to compensate or restore the affected parties (including investors) to any transaction to the position in which they were before the transaction was entered into; and
- (d) an OFC director will be criminally liable if he/she engages in fraudulent or deceptive activities,<sup>17</sup> or has otherwise colluded with the investment manager in such contraventions.

At the request of the Bills Committee, the Administration has provided for members' reference the details of the contraventions/offences and the corresponding remedies/sanctions under SFO applicable to OFC directors.<sup>18</sup>

33. The Administration further advises that where a director of an OFC engages in market misconduct,<sup>19</sup> SFC can bring actions against such a

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<sup>17</sup> The fraudulent or deceptive activities include (a) carrying on of any business of an OFC for any fraudulent purpose (new section 112ZT of SFO); (b) employing the use of fraudulent or deceptive devices, etc. in transactions in securities (which will include the shares of OFC) (section 300); (c) making any fraudulent or reckless misrepresentation for the purpose of inducing another person to acquire an interest in or participate in a CIS (including shares in an OFC) (section 107); and (d) making false or misleading representations in applications to SFC or when providing information in compliance with a requirement (sections 383 and 384).

<sup>18</sup> See Annex to the Administration's paper (LC Paper No. CB(1)826/15-16(02)) issued to the Bills Committee on 21 April 2016.

<sup>19</sup> Market misconduct is defined under section 245 of SFO to mean (a) insider dealing; (b) false trading within the meaning of section 274; (c) price rigging within the meaning of section 275; (d) disclosure of information about prohibited transactions within the meaning of section 276; (e) disclosure of false or misleading information inducing transactions within the meaning of section 277; or (f) stock market manipulation within the meaning of section 278, and includes attempting to engage in, or assisting, counselling, or procuring another person to engage in, any of the conduct referred to in (a) to (f) above.

director.<sup>20</sup> Pursuant to the established common law, where a director of a company is in breach of his/her duties, he/she may be subject to civil liabilities including the payment of damages, rescission (i.e. to unwind a transaction and restore the parties to their former position), or specific performance (i.e. to do or not to do something). Besides, the new section 112ZC of SFO specifically renders void any provision in the OFC's instrument of incorporation or any contract purporting to exempt a director for liability for misconduct (which is defined under the new section 112T to refer to negligence, default, breach of duty or breach of trust in the course of performing duties in relation to the OFC).

### Investment managers

34. The Bills Committee notes that under the new section 112Z of SFO, an OFC is mandated to have an investment manager licensed by or registered with SFC for carrying out asset management regulated activity (i.e. Type 9 licence),<sup>21</sup> including all investment management functions subject to oversight of the OFC board. The detailed duties and functions of the investment manager will be set out in the OFC Code.

35. The Bills Committee has enquired about how the investment management functions of an OFC can be maintained properly in the event of a succession gap given rise by the resignation or removal of the investment manager by the OFC board. Mr Christopher CHEUNG suggests mandating the appointment of at least two responsible officers ("ROs") for the investment manager of an OFC, similar to the existing requirement of at least two ROs for each SFC-regulated activity conducted by a corporation. He has also suggested appointing two investment managers for an OFC. On the other hand,

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<sup>20</sup> The market misconduct provisions under Parts XIII and XIV of SFO are generally applicable to listed corporations and therefore will apply to listed OFCs which are also "listed corporations". For instance, under Part XIII of SFO, SFC may institute proceedings in the Market Misconduct Tribunal ("MMT") against OFC directors. Pursuant to section 258 of SFO, the MMT may impose sanctions against a director for any market misconduct attributable to him/her for breach of the duty under section 279 to take all reasonable measures to ensure that market misconduct is not perpetrated by the OFC. The orders that may be made by the MMT include orders for a director to pay to the Government the profit gained as a result of the market misconduct or prohibiting a person to continue to be a director or to deal in any securities specified in that order. Under section 281 of SFO, the director can also be made subject to civil liability and to pay compensation by way of damages for any pecuniary loss sustained by another person as a result of the market misconduct.

<sup>21</sup> Type 9 regulated activity on asset management includes managing a portfolio of securities or futures contracts for clients on a discretionary basis.

some deputations consider that the investment managers of privately offered OFCs should be subject to fewer regulatory requirements than those imposed on their counterparts of publicly offered OFCs. For instance, in addition to persons licensed by or registered with SFC to carry out Type 9 regulated activity, privately offered OFCs should be allowed to appoint overseas management companies (i.e. offshore managers) from a jurisdiction with an inspection regime acceptable to SFC.<sup>22</sup>

36. The Administration advises that where there is a contravention of the new section 112Z of SFO on the requirements in relation to OFC investment manager, it will constitute a ground for cancellation of the OFC's registration, and various regulatory actions may also be taken by SFC. It is incumbent upon the OFC board of directors to oversee that the regulatory requirements on OFCs are complied with, including that the investment manager is duly appointed for an OFC at all times to perform 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 OFC Code will provide for the basic requirements concerning the appointment and removal of the OFC's investment manager.

37. The Administration maintains its position that the investment management functions of an OFC (publicly or privately offered) should be delegated to SFC-licensed or registered managers such that they will be subject to the applicable requirements under the relevant legislation and codes. The Administration also notes from recent data gathered by SFC that the majority of Hong Kong-domiciled publicly offered funds are managed by SFC-licensed or registered investment managers, and considers that the licensing requirement in question should not have a significant impact on OFCs' operations. The Administration further points out that as an investment manager of an OFC must be licensed by or registered with SFC for carrying out Type 9 regulated activity, the investment manager is already subject to the two-RO requirement. The Administration considers it not necessary to further require appointment of at least two investment managers for an OFC lest it unduly increases the OFC's operational costs.

### Custodians

38. The Bill mandates that the scheme property of an OFC must be entrusted to a custodian, who is separate and independent from the investment

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<sup>22</sup> Similar to the Recognized Jurisdiction Schemes under SFC's Code on Unit Trusts and Mutual Funds which currently allows overseas managers to manage publicly offered SFC-authorized funds.



manager, for safe keeping. According to the Administration, aside from a custodian incorporated in Hong Kong, an OFC may appoint an overseas custodian, provided that it has a place of business or an agent in Hong Kong for the purpose of accepting the service of notices and legal documents in Hong Kong. The custodians, whether incorporated in Hong Kong or overseas, will be subject to basic eligibility requirements as generally referable to those applicable to custodians of SFC-authorized publicly offered funds. For example, the custodian will have to be substantial financial institutions such as banks or their subsidiaries, and should be independent from the investment manager. The custodian must be independently audited and has minimum issued and paid-up capital and non-distributable capital reserves of HK\$10 million or its equivalent in foreign currency. Such requirements will be set out in the OFC Rules and/or the OFC Code. The Administration stresses that it is necessary to put in place the custodian requirement in respect of both publicly and privately offered OFCs, having regard that segregation of assets is an important safeguard to the scheme property of an OFC for investor protection.

39. Under the new section 112ZA(4) of SFO, the custodian of an OFC must take reasonable care, skill and diligence to ensure the safe keeping of the scheme property of the OFC that is entrusted to it. The new section 112ZA(5) provides that a custodian is not prohibited from entrusting to or authorizing a third party for the safe keeping of the scheme property. Operational matters and requirements relating to custodians, as well as sub-custodians and delegation, are to be set out in the OFC Rules and the OFC Code. Notwithstanding such sub-delegation, the custodian will remain responsible for all of its regulatory responsibilities and will be expected to put in place appropriate measures to ensure adequate risk management.

40. The Bills Committee has requested the Administration to consider adding a provision to the effect that the requirement to take reasonable care, skill and diligence as provided in the new section 112ZA(4) of SFO also applies to a sub-custodian to whom any scheme property of the OFC is entrusted for safe keeping. The Administration has also been requested to consider adding provisions elaborating on the care, skill and diligence required for the sake of clarity.

41. The Administration advises that the requirement to take reasonable care, skill and diligence as provided in the new section 112ZA(4) will apply to a sub-custodian to whom any scheme property is entrusted for safe keeping. Such requirement on sub-custodians will be set out in the OFC Rules. As the care, skill and diligence required are expected to be that under the common law, it will not be appropriate to add elaborative provisions in this regard, so as to

avoid limiting the scope of application of such care, skill and diligence, which will be determined by the court based on the facts of the case in accordance with common law principles.

42. The Bills Committee notes that the Administration will move a CSA to the new section 112ZA of SFO to reflect the policy intent to allow sub-custodial arrangements to be conducted by a custodian or a sub-custodian in respect of the scheme property of an OFC, which is in line with the existing market practice.

43. The Bills Committee further notes that while shareholders do not have any day-to-day management rights or control over the underlying scheme property held by the OFC, they have the right to participate in the income/profits arising from the management of and transactions in the scheme property which is typically paid via distributions. The new section 112Q of SFO provides that the liability of shareholders of an OFC is limited to any amount unpaid on the shares held by the shareholders.

## **Investment of open-ended fund company**

### Investment scope

44. The Administration advises that publicly offered OFCs may invest in asset classes in accordance with SFC's product code requirements and authorization conditions, i.e. mainly in securities, futures and over-the-counter ("OTC") derivatives. This is on par with the existing regime for publicly offered SFC-authorized funds. As regards privately offered OFCs, their investment scope should align with Type 9 regulated activity, with a 10% de minimis exemption for other asset classes (i.e. a maximum of 10% of the total gross asset value of the fund for investing in other asset classes). 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. OFCs (publicly or privately offered) may invest in structured products so long as they are within the respective investment scope of publicly offered or privately offered OFCs and the applicable governance principles (e.g. licensing, conduct and disclosure requirements) are complied with.

45. The Bills Committee notes that some deputations have raised concerns that the proposed investment scope of OFCs, and privately offered OFCs in particular, may be overly restrictive, taking into account that privately offered funds in general are currently not subject to similar regulatory constraints. Mr Dennis KWOK has queried whether the restriction may render OFC less attractive as a Hong Kong-domiciled investment fund vehicle, and suggested

greater flexibility be given to the investment scope of privately offered OFCs.

46. The Administration stresses that the primary purpose of an OFC will be to operate as an investment fund and not a corporate entity for the purposes of general commercial business or trade. The definition of securities, futures and OTC derivative products is very wide and it accommodates a broad range of asset classes. The proposed investment scope aims to ensure the current regulatory handle of SFC in terms of licensing, supervision and enforcement will also apply to the investment managers of OFCs. It will also enable all existing fund managers licensed by or registered with SFC to carry out Type 9 regulated activity to manage OFCs without the need to apply for any new licences. Notwithstanding the above considerations, flexibility has already been given to the investment scope of privately offered OFCs through the 10% de minimis exemption, which should be able to accommodate a very substantial part of the asset classes that privately offered OFCs normally invest in (e.g. currency forwards, loans or distressed debt structured in the form of securities). Besides, the investment scope of those privately offered funds which seek to benefit from the existing profits tax exemption in Hong Kong is restricted in practice. Furthermore, unlike publicly offered OFCs which will be subject to the applicable restrictions in the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products ("the SFC Handbook"),<sup>23</sup> investment managers of privately offered OFCs have the flexibility to pursue their own investment strategies, provided that the basic governance principles are complied with.

47. At the request of the Bills Committee, the Administration has provided information on the regulation of the investment scope and strategies of privately offered corporate funds in UK, Ireland and Luxemburg.<sup>24</sup> While there appears to be fewer specified formal restrictions on the permitted asset classes and strategies in some of the overseas jurisdictions, the Bills Committee notes that in practice, not all asset classes may be accepted and various factors are at play, such as whether the custodianship requirements can be satisfied.

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<sup>23</sup> As explained in paragraph 49 of this report, pursuant to SFO, a publicly offered CIS (including investment funds in the form of an OFC) and its offering documents are subject to SFC's authorization unless an exemption under SFO applies. In considering an application for authorization of an investment fund, and whether such investment fund and its offering document should remain authorized, SFC will have regard to the SFC Handbook, which sets out guidelines for the authorization and ongoing compliance requirements. Hence, a publicly offered OFC seeking SFC's authorization will be subject to the SFC Handbook, as in the case of other publicly offered investment funds.

<sup>24</sup> Please see paragraphs 7 and 8 of the paper provided by the Administration for the meeting of the Bills Committee on 21 March 2016 (LC Paper No. CB(1)691/15-16(02)).

### Protected cell regime

48. The new section 112R of SFO provides that an OFC may divide its scheme property into separate parts, with each part forming a sub-fund. An OFC may also be created as an umbrella fund meaning that the OFC can consist of a number of separately pooled sub-funds and each sub-fund will have a pool of assets that is managed in accordance with the investment objectives and policies for that particular sub-fund. The protected cell structure is shown in **Appendix IV**. The Bills Committee notes that with the protected cell regime in place, the assets of a sub-fund of an umbrella OFC will 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.

### **Offering of open-ended fund company shares**

#### Authorization by the Securities and Futures Commission

49. In line with the existing arrangement adopted for fund offerings in Hong Kong and consistent with practices adopted in overseas jurisdictions for corporate fund offerings, OFC share offerings will be made under an offering document, i.e. an advertisement, invitation or document ("the offering document"). Members note that an OFC which is publicly offered will be subject to SFC's authorization under section 104 of SFO (and its offering documents have to be authorized under section 105) unless an exemption under section 103 applies, and has to comply with additional requirements in the SFC Handbook. On the other hand, the new section 103(2)(ga) provides, in essence, that where the offering document contains or relates to a specified offer set out in Part 1 of the Seventeenth Schedule to CWUMPO ("specified offer"), the offer will not be subject to the SFC-authorization requirements. The specified offers include:<sup>25</sup>

- (a) an offer to professional investors; or
- (b) an offer to no more than 50 persons ("50 person private placement") having regard to local and international securities and company laws; or
- (c) an offer in respect of which the total consideration payable for the relevant shares or debentures shall not exceed \$5 million

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<sup>25</sup> For details of other specified offers under Part 1 of the Seventeenth Schedule to CWUMPO, please refer to the Annex to the Administration's paper provided for the meeting of the Bills Committee on 21 March 2016 (LC Paper No. CB(1)691/15-16(02)).

which are small-scale offers.

The Bill will extend the exemption under section 103(2)(ga) to OFCs. Mr SIN Chung-kai has expressed concern about possible circumvention of the regulatory requirements applicable to public offering of OFC by claiming the fund to be or disguising it as privately offered OFCs, such as by making repeated offers of OFC shares to not more than 50 investors (who are not professional investors) each time so as to obviate the need for SFC's authorization.

50. The Administration emphasizes that various anti-avoidance measures are already in place under Part 4 of the Seventeenth Schedule to CWUMPO to prevent abuse of the exemption in question. Specifically, an offer to not more than 50 persons and a small-scale offer will be subject to the aggregation restriction under CWUMPO. A repeated offer will not be exempted if the offer is, in brief, of the same class of shares or debentures; made by the same person; and open at any time within a 12-month period ending with the date on which the first-mentioned offer is first made. The Administration also draws members' attention that investor protection measures will be put in place for all OFCs through:

- (a) pre-sale registration requirements of all OFCs;
- (b) point-of-sale obligations on intermediaries selling the shares of publicly or privately offered OFCs;
- (c) post-sale supervision and investigation powers of SFC; and
- (d) enforcement powers of SFC.

The details of specific investor protection measures are set out in **Appendix V**. The Administration stresses that SFC will investigate into complaints and suspected non-compliance, and take enforcement action as appropriate. If disputes arise as to whether an OFC is privately offered or not, it will be for the court to decide having regard to the circumstances of individual cases.

51. Some depositions have raised concerns that the Bill does not draw clear distinction between publicly and privately offered OFCs in the regulatory framework, and subjecting privately offered OFCs to the OFC Code will create disparity with private funds taking other forms (e.g. unit trusts). The Administration advises that the OFC Code is 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 will remain largely governed by the OFCs' individual constitutive and offering documents. The Administration also confirms that privately offered OFCs will not be subject to the extensive requirements in the existing Code on Unit Trusts and Mutual Funds. The imposition of certain essential regulatory requirements on a privately offered corporate fund is broadly in line with the approach in UK, Ireland and Luxembourg.

### Suitability obligations

52. Under the existing regulatory regime,<sup>26</sup> intermediaries licensed by or registered with SFC who may be involved in the sale of shares of OFCs, regardless of whether the OFCs are privately or publicly offered, 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"). Mr Christopher CHEUNG has expressed concern about the potential difficulty for securities brokers to ascertain whether the shares of a particular OFC are suitable for sale to individual investors. Mr CHAN Kam-lam suggests that SFC may rate the risks of OFCs for reference by investors and securities brokers.

53. The Administration advises that the offering documents of an OFC should comply with disclosure requirements including disclosure of product risks. The disclosure is required to be complete, accurate and fair, and be written and presented in a clear, concise and effective manner and in such manner as to be readily understood by the investing public. SFC is currently reviewing the need to give more guidance on the suitability requirement, including in the context of the initiative to establish an exchange distribution platform for funds in Hong Kong. SFC considers that being the regulator of securities and futures, it will not be appropriate for SFC to rate the risks of these products including the shares of OFCs. This is also not an approach commonly adopted in overseas jurisdictions.

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<sup>26</sup> Intermediaries will be required to be licensed by or registered with SFC where they conduct a regulated activity under SFC (for example, Type 1 for dealing in securities, and Type 4 for advising in securities, as applicable). Accordingly, such intermediaries will be subject to SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

## **Termination and winding up of OFC**

### **Termination**

54. Given the nature of OFCs as investment funds, which can be terminated for commercial reasons (e.g. changes in the market conditions resulting in the investment strategy becoming unviable, the size of the fund dropping below a certain level, or changing investment trends), the Bill provides for a mechanism for an OFC to be terminated in a straight-forward and cost efficient manner. An OFC may apply to SFC for cancellation of registration voluntarily upon termination, where:

- (a) the OFC is to be terminated in accordance with the 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.

55. The Bills Committee has enquired about the triggering mechanism for termination of solvent OFCs, including which parties may apply for the termination, whether the consent of other relevant parties has to be sought and if so, the arrangement in case of disagreement among these parties on the termination.

56. The Administration advises that the triggering mechanism and parties who may apply for streamlined termination of an OFC will be laid down in the OFC Code and disclosed in the OFC's constitutive and offering documents for clear disclosure to investors. Once the OFC assets have been fully distributed to shareholders and all liabilities have been settled, the OFC board can apply to SFC for cancellation of registration under the new section 112ZH of SFO together with the final accounts of the OFC accompanied by the auditor's report, and 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. Under the new section 112ZH(2), SFC may refuse the application to cancel the registration of the OFC if it considers that it is in the public interest that any matter concerning the company should be investigated before its registration is so cancelled; or the cancellation will not be in the interest of the investing public (essentially, the shareholders of the OFC).

57. As regards the parties who may initiate, consent to, and resolve any disagreement regarding the application for a streamlined termination of a solvent OFC, the Administration advises that these matters are expected to be set out in an OFC's instrument of incorporation, whereas 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. Generally, the OFC board of directors is expected to be the primary party who may apply for streamlined termination of an OFC, consistent with general market practice for funds locally and for corporate funds in major jurisdictions abroad. In applying for such streamlined termination, the board of directors must observe the provisions under the instrument of incorporation,<sup>27</sup> as well as the requirements under SFO as amended by the Bill, the OFC Rules and the OFC Code.

### Winding-up

58. The Bills Committee notes that, similar to conventional companies, winding up of OFCs, whether solvent or insolvent, will be by way of a winding-up process similar to that applicable to conventional companies under CWUMPO. The CWUMPO regime will be extended to OFCs through incorporation by reference in the OFC Rules with appropriate modifications. If an OFC is wound up due to insolvency or negative equity, the remaining assets of the OFC will be sold and the liabilities on the shareholders will be limited to loss of the capital they have invested in the OFC.

### **Supervisory and enforcement powers of the Securities and Futures Commission**

59. Under the proposed regulatory framework for OFCs, SFC will be the primary regulator responsible for the registration and regulation of OFCs under SFO. SFC will be empowered by SFO to make the OFC Rules and the OFC Code to regulate and provide guidance on the incorporation, management, operation, and business of OFCs.<sup>28</sup> The Bills Committee has taken note of SFC's supervisory and enforcement powers in the regulatory and investor

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<sup>27</sup> The instrument of incorporation will be a binding contract under seal between OFC and its shareholders under the new section 112L of SFO. By becoming members 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 CO, the instrument of incorporation can be revised by the shareholders of OFC by passing a special resolution to that effect.

<sup>28</sup> The relevant powers for SFC to make the rules and publish the codes and guidelines for those purposes are provided for in the new sections 112ZK, 112ZL, 112ZM and 112ZR of SFO.



protection regime for OFCs as outlined in **Appendix V**. The Bills Committee also notes that the Administration will move the following CSAs:

Securities and Futures Ordinance

- (a) CSA to the new section 112ZF to enable the directions and any amendment or revocation of such directions made by SFC under this section to take effect at the time of notice or a later time as specified in the notice. The Administration explains that pursuant to section 232(2) of SFO, decisions of SFC which are subject to appeal to the Securities and Futures Appeal Tribunal (other than those in Division 5 of Part 3 of Schedule 8) do not become effective until the expiry of the 21-day period in which the person affected may appeal. As the power to issue directions under the said section 112ZF is an intervention power which is intended to enable SFC to take action swiftly to safeguard investor interests, the CSA is to ensure that directions issued under this section and any amendment or revocation of a direction can be immediately effective;
- (b) CSA to the new section 112ZK to provide for SFC's rule-making power in respect of the creation of personal liability of a person acting as a director or being involved in the management of an OFC while being an undischarged bankrupt or acting in contravention of a disqualification order. The provisions to be made under this power will be similar to those in section 168O of CWUMPO;
- (c) CSA to the new section 213(3A) to ensure that the orders that can be sought by SFC from the Court of First Instance in the case where an OFC or a director, an investment manager, a custodian or a sub-custodian of an OFC has contravened any of the relevant provisions or conditions of any licence or registration under SFO will also include the circumstances where a person aids, abets, assists or induces such contraventions by an OFC or its key operators. This will ensure that the grounds for seeking the additional orders in respect of OFCs are consistent with those in respect of contraventions by other persons as set out in section 213(1) of SFO;
- (d) CSA to the new section 213(3B) to include any ancillary order that the Court of First Instance considers necessary for the purposes of subsection (3A). Similar orders can be made by the

Court of First Instance under the existing section 213(2)(g) of SFO;

- (e) CSA to the new section 214A to provide that SFC must first consult the Monetary Authority ("MA") when making applications under the new section 214A(1) for orders against an authorized financial institution (or a corporation which is a controller of an authorized financial institution, has as its controller an authorized financial institution or has a controller that is also a controller of an authorized financial institution). The proposed amendment is in line with the existing section 214(3);

#### Other legislation

- (f) CSA to amend the definition of "misconduct" and section 58A in the Banking Ordinance (Cap. 155) ("BO") respectively to ensure that MA has the power to take disciplinary action against a relevant individual or an executive officer guilty of misconduct in relation to an OFC;<sup>29</sup>
- (g) CSA to amend section 71C of BO to ensure that MA shall not form any opinion that any act or omission by a relevant individual relating to an OFC is prejudicial to the interest of the investing public or to the public interest, unless he has also had regard to such of the provisions set out in the codes and guidelines published by SFC under the new section 112ZR of SFO; and
- (h) CSA to amend section 2 of the Financial Reporting Council Ordinance (Cap. 588) ("FRCO") so that the Financial Reporting Council will be able to investigate into possible auditing and reporting irregularities as well as to enquire into possible non-compliance with accounting requirements in relation to a

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<sup>29</sup> A relevant individual is an individual who performs any regulated function in a regulated activity for a registered institution under BO. Under sections 58A and 71C of BO, MA has the power to take disciplinary action against a relevant individual or executive officer where the relevant individual or executive officer is guilty of misconduct. The CSA is consequential to the amendment to the definition of "misconduct" in section 193(1) of SFO under the Bill to include an act or omission relating to the carrying on of certain activity for an OFC.

listed OFC.<sup>30</sup>

60. The Bills Committee has requested the Administration to review the drafting of the Chinese text of the new sections 112ZK(4)(ga) and 214A(5) under the CSAs mentioned in paragraph 59(b) and (e) above, with a view to enhancing the readability and comprehensibility of the provisions. After consideration, the Administration takes the view that the proposed formulation for section 112ZK(4)(ga) is accurate in reflecting the meaning of the provision. As regards section 214A(5), the Administration has taken on board the Bills Committee's suggestion and will move a CSA to simplify the bilingual texts of the section.

Consultation with the Monetary Authority before making applications for orders against authorized financial institution

61. In connection with the CSA for SFC to consult MA before making applications under the new section 214A of SFO for orders against an authorized financial institution, etc., Mr SIN Chung-kai has cautioned the Administration and SFC about the potential delay or other adverse impact on such applications (in particular if the orders under application may involve prosecutions or other criminal proceedings), if SFC inadvertently omits the step to consult MA before making the applications. The Administration has explained that such a consultation provision is consistent with the existing section 214 of SFO, and that the purpose of the orders in question is to make remedies in case of unfair prejudice etc. to the interests of shareholders of OFCs if it appears to SFC that at any time since the incorporation of an OFC, the business or affairs of the company have been conducted, for instance, in a manner oppressive or unfairly prejudicial to its shareholders. These orders may not necessarily involve or give rise to criminal proceedings. Besides, SFC will need to consult MA only if the order is made against an authorized financial institution; or a corporation that, to the knowledge of SFC, is a controller of an authorized financial institution (or has as its controller an authorized financial institution, or has a controller that is also a controller of an authorized financial institution). SFC explains that appropriate measures will be put in place for relevant consultation with MA to be conducted before making the said applications.

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<sup>30</sup> The term "relevant code" is now defined in section 2(1) of FRCO as a code or guideline published by SFC under section 399 of SFO for providing guidance in relation to the SFC's authorization of CISs. As OFCs will be CISs, and may be opted for as a new structure of listed CISs, the CSA will amend the definition of "relevant code" in section 2(1) of FRCO to include the new OFC Code published under section 112ZR of SFO.

## **Tax and stamp duty treatment in respect of open-ended fund company**

62. Under the Stamp Duty Ordinance (Cap. 117) ("SDO"), 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. The Bill incorporates amendments to SDO such that the same stamp duty exemptions will apply to shares of listed and unlisted OFCs. Further, the existing profits tax exemption for public funds will apply to publicly offered OFCs. For privately offered OFCs, profits tax exemption will be available under the existing regime if the OFCs are offshore funds with their central management and control located outside Hong Kong.

63. Some deputations consider that profits tax exemption should also be granted in respect of onshore privately offered OFCs. The Administration has responded that it recognizes that tax treatment is usually one of the main considerations influencing the decision of fund managers on the jurisdiction where the fund is domiciled and managed. On the other hand, exempting onshore privately offered OFCs may give rise to concerns about tax avoidance. It is necessary to be mindful of possible adverse Base Erosion and Profits Shifting ("BEPS") implications and the effectiveness of any safeguards to avoid such tax incentive being labelled as a harmful tax practice under the BEPS action plan of the Organisation for Economic Co-operation and Development.<sup>31</sup> In this regard, the Administration has issued a concept paper on "Proposed extension of profits tax exemption to onshore privately offered OFCs" to industry associations and professional bodies in order to gauge the industry's preliminary views on the issue. The Administration will carefully consider the views received and critically review the necessary safeguards to plug possible loopholes for abuse. Necessary amendments for any further profits tax exemption will be taken forward in a separate exercise.<sup>32</sup>

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<sup>31</sup> BEPS refers to tax planning strategies that exploit the gaps and mismatches in tax rules (which may exist among economies) to artificially shift profits to low or no-tax locations where there is little or no economic activity, resulting in little or no overall corporate tax being paid. The final BEPS package released by the Organisation for Economic Co-operation and Development in October 2015 seeks to ensure multinational corporations paying a fair share of taxes, realign taxation with economic activities, and standardise international tax rules to eliminate double non-taxation.

<sup>32</sup> According to the Administration, it will also address issues raised by some deputations that the amendments to IRO are not sufficient to achieve the necessary demarcation between the sub-funds of an OFC (i.e. each sub-fund within an OFC structure should be treated as a separate person for profits tax purposes) when formulating the possible proposal of extending profits tax exemption to onshore privately offered OFCs.

### **Committee Stage amendments to be moved by the Administration**

64. The Bills Committee notes that apart from the CSAs mentioned in paragraphs 25, 28, 42, 59 and 60 above, the Administration will move other CSAs to the Bill relating to technical aspects to improve the drafting of provisions or which are consequential in nature. The major ones are as follows:

#### **Securities and Futures Ordinance**

- (a) CSA to the new section 112A, which is consequential to the proposed amendment to the new section 112ZA(5), to ensure that the enforcement powers of SFC will reach sub-custodians;
- (b) CSA to the new section 112ZG, having regard to the views of the Judiciary, to remove all references to "inquiry" in the section to avoid giving the impression that the Court of First Instance will conduct inquiries in respect of a person's failure to comply with SFC's directions;
- (c) CSA to include the specified decisions of SFC made under the new sections 112ZF and 112ZJ in Division 5 of Part 3 of Schedule 8, in accordance with the existing section 232(2) (which provides that any specified decision taking effect upon expiry of 21 days unless included in Division 5 of Part 3 of Schedule 8). The amendment is consequential to the CSAs mentioned in paragraphs 25 and 59(a) of this report; and

#### **Stamp Duty Ordinance**

- (d) CSAs to clauses 27, 30 to 33 of the Bill, which are technical amendments involving only re-numbering in relation to the Inland Revenue (Amendment) (No.4) Bill 2015.<sup>33</sup>

65. The Bills Committee has examined and raised no objection to the CSAs to be moved by the Administration. A full set of the CSAs is in **Appendix VI**. The Bills Committee will not propose any CSAs to the Bill.

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<sup>33</sup> The Inland Revenue (Amendment)(No.4) Bill 2015 is pending resumption of its Second Reading debate.

**Resumption of Second Reading debate**

66. The Bills Committee raises no objection to the Administration's proposal to resume the Second Reading debate on the Bill at the Council meeting of 25 May 2016.

**Advice Sought**

67. Members are invited to note the deliberations of the Bills Committee above.

Council Business Division 1  
Legislative Council Secretariat  
5 May 2016

**Bills Committee on Securities and Futures (Amendment) Bill 2016**

**Membership list**

**Chairman**            Hon CHAN Kam-lam, SBS, JP

**Members**            Hon TAM Yiu-chung, GBS, JP  
Hon Andrew LEUNG Kwan-yuen, GBS, JP  
Hon WONG Ting-kwong, SBS, JP  
Hon Alan LEONG Kah-kit, SC  
Hon Dennis KWOK  
Hon Christopher CHEUNG Wah-fung, SBS, JP  
Hon SIN Chung-kai, SBS, JP

(Total: 8 members)

**Clerk**                Ms Angel SHEK

**Legal Adviser**      Miss Rachel DAI

## **Appendix II**

### **Bills Committee on Securities and Futures (Amendment) Bill 2016**

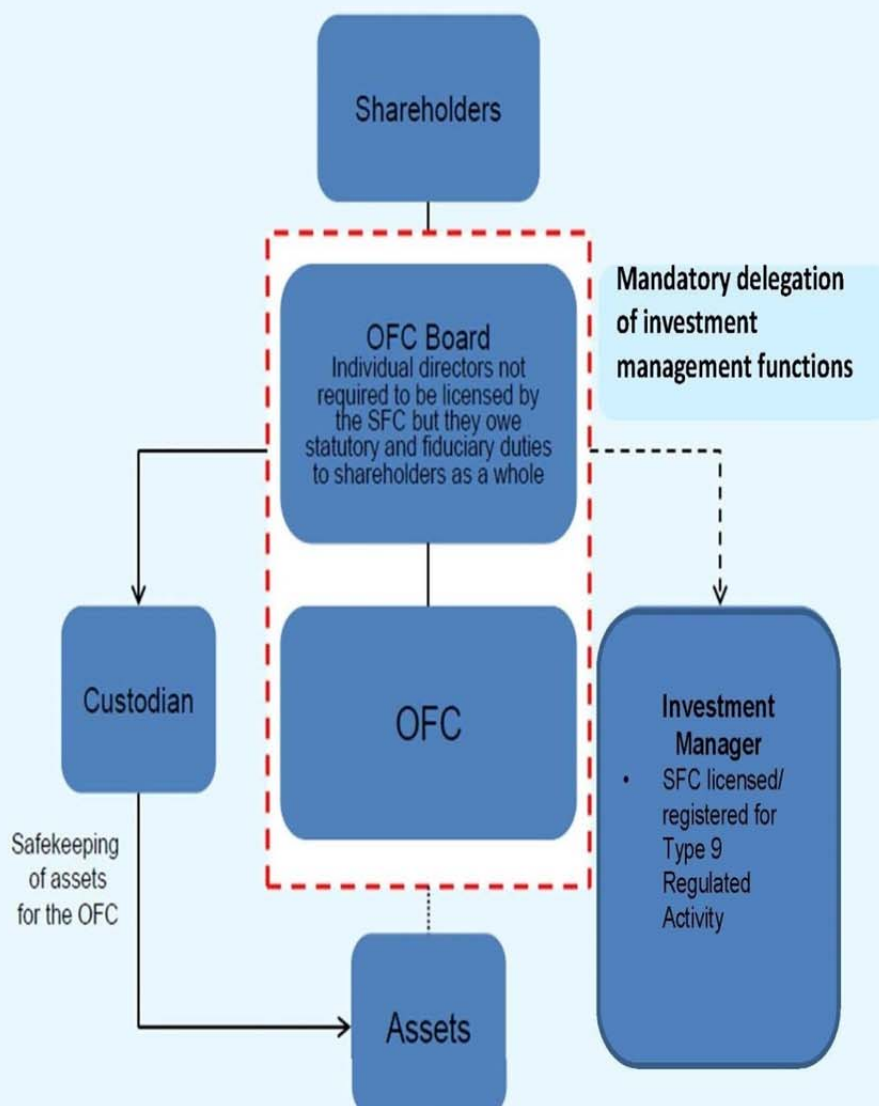
#### **List of organizations from which the Bills Committee has received views**

1. CompliancePlus Consulting Limited
- \*2. Hong Kong Bar Association
3. Hong Kong Investment Funds Association
4. Hong Kong Securities Association
- \*5. Joint Liaison Committee on Taxation
- \*6. The Hong Kong Association of Banks
- \*7. The Hong Kong Institute of Chartered Secretaries
- \*8. The Hong Kong Institute of Directors
9. Timothy Loh Solicitors
10. Vanguard Investments Hong Kong Limited

\* views given by written submission only

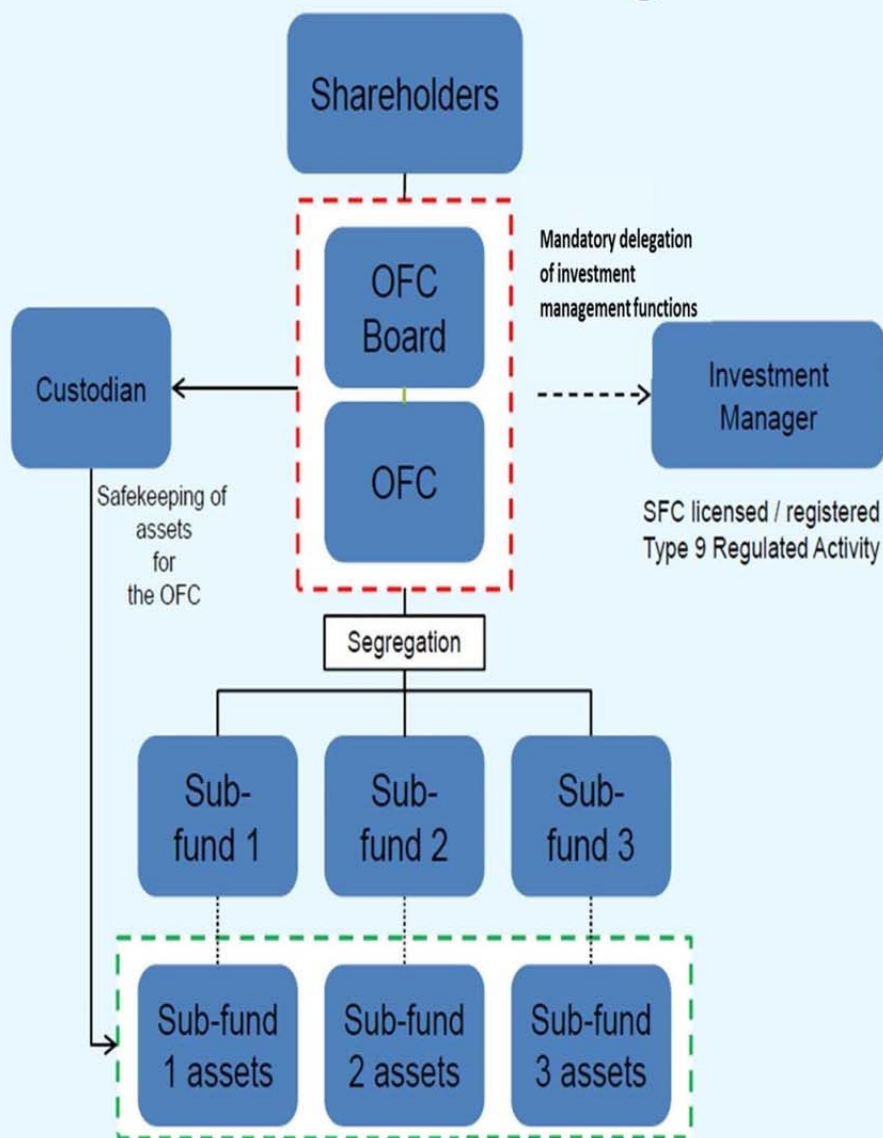


## Proposed OFC Structure



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

## Protected Cell Regime



[Source: Slide 13 of the power-point presentation materials provided by the Administration for the meeting of the Bills Committee on 23 February 2016 (LC Paper No. CB(1)603/15-16(01)).]

### **Regulatory and investor protection regime for open-ended fund companies**

#### **(a) Pre-sale registration requirements**

Under the Bill, all open-ended fund companies ("OFCs") are required to be registered with the Securities and Futures Commission ("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 so long as the OFC remains registered with SFC.

Specifically, the investment management functions of the OFC must be delegated to an investment manager who is licensed by or registered with 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, SFC will 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 serves an additional layer of oversight for the shareholders. The assets of the OFC must be entrusted to a separate, independent custodian for safe keeping.

#### **(b) Point-of-sale obligations on intermediaries**

Intermediaries who may be involved in the sale of the shares of OFCs, regardless of whether the OFCs are privately or publicly offered, will be required to be licensed by or registered with SFC where they conduct a regulated activity under 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 Conduct.<sup>1</sup> If the sale of OFC

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<sup>1</sup> SFC's Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

shares is conducted by unlicensed or unregistered persons, this will constitute a breach of the existing section 114 of 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 will 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. 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.

(c) Post-sale supervision and investigation powers

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 SFO as other intermediaries.

In particular, in respect of an OFC, 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 SFC including the OFC Code.

In addition, 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

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 Securities and Futures Ordinance (Cap. 571)*

It is a criminal offence if an offering document for the shares of an OFC is issued to the public without SFC's authorization or without any applicable exemption.<sup>2</sup> It is also an offence for an applicant for registration of an OFC to knowingly or recklessly make a false or misleading misrepresentation in its application documents to SFC.<sup>3</sup>

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 scheme;<sup>4</sup> (ii) to make disclosure of false or misleading information about securities that is likely to induce transactions<sup>5</sup>; or (iii) to employ the use of fraudulent or deceptive devices, etc. in transactions in securities.<sup>6</sup>

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

The investment manager of an OFC, who must be licensed

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<sup>2</sup> Section 103 of SFO.

<sup>3</sup> Section 383 of SFO.

<sup>4</sup> Section 107 of SFO.

<sup>5</sup> Section 298 of SFO.

<sup>6</sup> Section 300 of SFO.

by or registered with SFC to carry out Type 9 regulated activity, and other licensed or registered intermediaries can be subject to disciplinary proceedings under Part IX of SFO, if they breach the applicable provisions of 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*

SFC will 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*

SFC will have the power to cancel the registration of an OFC under section 112ZI of the Bill, in which case the OFC will have to terminate its business.

(v) *Winding up*

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

(vi) *Injunctions and other court orders*

SFC will have the power to apply to CFI under the amended section 213 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. SFC may also apply for a compliance order from the CFI under the new section 112ZG if the OFC and/or investment manager fails to comply with a direction of SFC.

[Source: Adapted from paragraph 6 of the Administration's paper provided for the meeting of the Bills Committee on 21 March 2016 (LC Paper No. CB(1)691/15-16(02)).]

Securities and Futures (Amendment) Bill 2016

**Committee Stage**

Amendments to be moved by the Secretary for Financial Services and the Treasury

<u>Clause</u>	<u>Amendment Proposed</u>
6	In the proposed section 112A, in the definition of <i>sub-custodian</i> , by deleting “by virtue of section 112ZA(5)(a) or (b)” and substituting “, other than the custodian of the company”.
6	By deleting the proposed section 112U(3) and substituting— “(3) A director of an open-ended fund company owes the open-ended fund company— (a) the same fiduciary duties that are owed by a director of an ordinary company to the ordinary company; and (b) the duty to exercise reasonable care, skill and diligence that is owed by a director of an ordinary company to the ordinary company under section 465 of the Companies Ordinance (Cap. 622).”.
6	By deleting the proposed section 112ZA(5) and substituting— “(5) This section does not prohibit any of the following persons from entrusting, by an agreement in writing, to another person for safe keeping any or all of the scheme property of an open-ended fund company that is entrusted to the first-mentioned person— (a) a custodian of the company; (b) a person to whom any scheme property of the company is entrusted for safe keeping under an agreement in writing, other than the custodian of the company.”.

- 6 In the proposed section 112ZF, by adding—
- “(3A) A direction given under subsection (1), or an amendment or revocation of such a direction under subsection (3), takes effect—
- (a) at the time of the service of the notice in respect of the direction, amendment or revocation; or
  - (b) if a later time is specified in the notice, at that time.”.
- 6 In the proposed section 112ZG—
- (a) in the heading, by deleting “**for inquiry into**” and substituting “**in respect of**”;
  - (b) by deleting subsection (1);
  - (c) in subsection (2), by deleting “In the inquiry, the Court of First instance” and substituting “If a person fails to comply with a direction given under section 112ZF, the Commission may apply to the Court of First Instance in respect of the failure and the Court”;
  - (d) in subsection (2)(a), in the Chinese text, by deleting “有關人士不遵從有關” and substituting “該人不遵從該”;
  - (e) in subsection (2)(b), in the Chinese text, by deleting “有關” and substituting “該項”.
- 6 In the proposed section 112ZJ, by adding
- “(6A) An amendment or revocation of a condition, or a new condition imposed, under subsection (6) takes effect—
- (a) at the time of the service of the notice in respect of the amendment or revocation of the condition or the imposition of the new condition; or
  - (b) if a later time is specified in the notice, at that time.”.
- 6 In the proposed section 112ZK(4), by adding—
- “(ga) the liability of a person acting in contravention of section 112X or of an order made by the



Court of First Instance under rules made under paragraph (g);”.

- 12(1) (a) By deleting the proposed section 213(3A) and substituting—
- “(3A) If the contravention involved in a case is a contravention by an open-ended fund company or a director, an investment manager, a custodian or a sub-custodian of an open-ended fund company, the Court of First Instance may also, on the application of the Commission, make any of the orders specified in subsection (3B).
- (3AB) The power under subsection (3A) may be exercised whether or not the Commission also applies for an order specified in subsection (2).”.
- (b) In the proposed section 213(3B)(a)(vi), by deleting “; and” and substituting a semicolon.
- (c) In the proposed section 213(3B)(a), by adding—
- “(viii) any ancillary order that the Court of First Instance considers necessary as a result of the making of any of the orders referred to in subparagraphs (i), (ii), (iii), (iv), (v), (vi) and (vii); and”.
- (d) In the proposed section 213(3B)(b)(i), by deleting “paragraph (a)” and substituting “paragraph (a)(i), (ii), (iii), (iv), (v), (vi) and (vii)”.
- (e) In the proposed section 213(3B)(b)(iii), by deleting “; and” and substituting a semicolon.
- (f) In the proposed section 213(3B)(b)(iv), by deleting “rules.” and substituting “rules; and”.
- (g) In the proposed section 213(3B)(b), by adding—
- “(v) any ancillary order that the Court of First Instance considers necessary as a result of the making of any of the orders referred to in subparagraphs (i), (ii), (iii) and (iv).”.

12 By deleting subclause (6).

- 13 In the proposed section 214A, by adding—
- “(2A) If the order to be applied for under subsection (1) is an order against—
- (a) an authorized financial institution; or
  - (b) a corporation that, to the knowledge of the Commission—
    - (i) is a controller of an authorized financial institution;
    - (ii) has as its controller an authorized financial institution; or
    - (iii) has a controller that is also a controller of an authorized financial institution,
- the Commission must not make the application unless it has first consulted the Monetary Authority.”.

- 13 In the proposed section 214A, by adding—
- “(5) In this section—
- controller*** (控制人) means an indirect controller or a majority shareholder controller as defined by section 2(1) of the Banking Ordinance (Cap. 155).”.

- 22 (a) By renumbering the clause as clause 22(1).
- (b) By adding—
- “(2) Schedule 8, Part 3, Division 5, after item 2—
- Add**
- |      |   |                                      |
|------|---|--------------------------------------|
| “2A. | A specified decision set out in item 15D of Division 1 of Part 2. | Section 112ZF(3A) of this Ordinance. |
| 2B.  | A specified decision set out in item 15E of Division 1 of Part 2. | Section 112ZF(3A) of this Ordinance. |

- |     |   |  |
|-----|---|--|
| 2C. | A specified decision set out in item 15L of Division 1 of Part 2. | Section 112ZJ(5) of this Ordinance.      |
| 2D. | A specified decision set out in item 15M of Division 1 of Part 2. | Section 112ZJ(6A) of this Ordinance.”.”. |

27

By deleting the clause and substituting—

**“27. Section 19 amended (contract notes, etc. in respect of sale and purchase of Hong Kong stock)**

Section 19(1DA)—

**Repeal**

“or Part 2 of Schedule 9”

**Substitute**

“, Part 2 of Schedule 9 or Part 2 of Schedule 10”.”.

30

By deleting the clause and substituting—

**“30. Section 63 amended (regulations)**

Section 63(c)—

**Repeal**

“and 9”

**Substitute**

“, 9 and 10”.”.

31

By deleting the clause and substituting—

**“31. First Schedule amended**

(1) First Schedule—

**Repeal**

“8 & 9]”

**Substitute**

“8, 9 & 10]”.

(2) First Schedule, head 2(4), Note 2—

**Repeal**

“or Part 4 of Schedule 9”

**Substitute**

“, Part 4 of Schedule 9 or Part 3 of Schedule 10”.”.

- 32 By deleting “Sch. 9]” and substituting “Sch. 10]”.
- 33 By deleting “**Schedule 9**” (wherever appearing) and substituting “**Schedule 10**”.
- 33 By deleting “After Schedule 8” and substituting “After Schedule 9”.
- New By adding—

**“Division 4A—Amendments to Banking Ordinance (Cap. 155)**

**33A. Section 58A amended (disciplinary action in respect of relevant individuals)**

- (1) Section 58A(6), definition of *misconduct*, paragraph (a)—

**Repeal**

“; or”

**Substitute a semicolon.**

- (2) Section 58A(6), definition of *misconduct*, paragraph (b)(ii)—

**Repeal**

“public interest,”

**Substitute**

“public interest; or”.

- (3) Section 58A(6), definition of *misconduct*, after paragraph (b)—

**Add**

“(c) an act or omission of the individual

that—

- (i) relates to the carrying on of any activity that—
  - (A) is not a regulated activity; and
  - (B) the registered institution, in relation to which the individual is a relevant individual, may carry on for an open-ended fund company under the Securities and Futures Ordinance (Cap. 571); and
- (ii) in the opinion of the Monetary Authority, is or is likely to be prejudicial to the interest of the investing public or to the public interest,”.

(4) Section 58A(7)—

**Repeal**

“paragraph (b)”

**Substitute**

“paragraphs (b) and (c)”.

(5) Section 58A(7), before “399”—

**Add**

“112ZR or”.

**33B. Section 71C amended (executive officers of registered institutions require Monetary Authority’s consent)**

(1) Section 71C(12), definition of *misconduct*, paragraph (b)(ii)—

**Repeal**

“; or”

**Substitute a semicolon.**

(2) Section 71C(12), definition of *misconduct*, paragraph (c)(ii)—

**Repeal**

“public interest,”

**Substitute**

“public interest; or”.

- (3) Section 71C(12), definition of *misconduct*, after paragraph (c)—

**Add**

“(d) an act or omission of the officer that—

- (i) relates to the carrying on of any activity that—

(A) is not a regulated activity; and

(B) the registered institution, in relation to which the officer is an executive officer, may carry on for an open-ended fund company under the Securities and Futures Ordinance (Cap. 571); and

- (ii) in the opinion of the Monetary Authority, is or is likely to be prejudicial to the interest of the investing public or to the public interest,”.

- (4) Section 71C(13)—

**Repeal**

“or (d)”

**Substitute**

“, (d) or (e)”.

- (5) Section 71C(14)—

**Repeal**

“paragraph (c)”

**Substitute**

“paragraphs (c) and (d)”.

- (6) Section 71C(14), before “399”—

**Add**

“112ZR or”.”.

New

By adding—

**“Division 7A—Amendment to Financial  
Reporting Council Ordinance (Cap. 588)**

**43A. Section 2 amended (interpretation)**

Section 2(1)—

**Repeal the definition of *relevant code***

**Substitute**

**“*relevant code* (有關守則) means—**

- (a) a code or guideline published under section 112ZR of the Securities and Futures Ordinance (Cap. 571), as in force at the material time; or
- (b) a code or guideline published under section 399 of that Ordinance for providing guidance in relation to the operation of section 104 of that Ordinance, as in force at the material time;”.