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Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies Regime

Response of Charltons Solicitors

BY EMAIL (ofc-2019consultation@sfc.hk)

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The Securities and Futures Commission

35/F Cheung Kong Center

2 Queen's Road Central

Hong Kong

Dear Sirs

Re: Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies Regime

We refer to the "*Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies Regime*" published by the Securities and Futures Commission (**SFC**) on 20 December 2019 (the **Consultation Paper**).

We welcome and appreciate the SFC's efforts in introducing the open-ended fund companies (**OFC**) regime in Hong Kong to develop Hong Kong as a fund domicile and full-service asset management centre, and the SFC's current initiative to improve the OFC regime by addressing issues which in practice have discouraged the use of OFCs.

Set out below are our responses to your questions in the Consultation Paper. Unless otherwise specified, terms defined in the Consultation Paper have the same meanings in this response.

A. Custodian eligibility requirements for private OFCs

Question 1

Do you agree with the proposal to allow intermediaries licensed or registered for RA1 to act as custodians for private OFCs? Please explain your views.

Our response

Yes. In our experience, many small and medium-sized private funds, particularly hedge funds, use prime brokers licensed or registered for RA1 to act as their custodians, principally due to cost. The proposal to allow intermediaries licensed or registered for RA1 to act as custodians for private OFCs would reduce costs for private OFCs, and likely improve the attractiveness of the structure.

Question 2

Do you have any comments on the proposed eligibility criteria applicable to RA1 intermediaries which intend to be private OFC custodians? Do you have any other suggestions?

Our response

We generally agree with the proposed eligibility criteria for RA1 intermediaries which will act as private OFC custodians.

However, we note that one of the proposed eligibility criteria is that an RA1 intermediary which acts as custodian for a private OFC must be independent of the investment manager. A custodian is permitted to be a member of the same corporate group as the investment manager, but it must be functionally independent of the investment manager where this can be achieved via systems ensuring that separate staff fulfil the separate functions.

In practice, however, many RA9 intermediaries which act as fund investment managers are affiliated with an RA1 intermediary, and they often share responsible officers and/or directors (executive and non-executive). This is particularly true of smaller fund managers. Further guidance from the SFC would assist in clarifying whether an RA1 custodian would be considered to be functionally independent of an affiliated RA9 investment manager in these circumstances.

We would also reiterate the point made by respondents to the original consultation paper that the requirement for private OFCs to appoint a single custodian does not reflect the practice of many hedge funds who typically appoint two or more prime brokers in order to minimise counterparty risk. Section 112ZA of the SFO requires that "*All the scheme property of an open-ended fund company must be entrusted to a custodian of the company for safe keeping*" (our emphasis) meaning that only one custodian of an OFC's assets is allowed. Moreover, only one sub-custodian is allowed under section 112ZA(5) which again does not reflect market practice.

We also note that comparable European corporate fund structures, including Ireland's Qualifying Investor Alternative Investor Fund and Luxembourg's Reserved Alternative Investment Fund, (please see our summary in the Annex to this response) allow a prime broker to act as depositary/custodian of the fund's assets provided that: (i) it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker; and (ii) the arrangement is disclosed to fund investors. These structures also permit a depositary to delegate custody tasks to one or more prime brokers. Consideration should be given to including comparable provisions in the Hong Kong private OFC framework.

Question 3

Do you have any comments on the proposed requirements in the new Appendix A to the OFC Code to be imposed on all private OFC custodians, including existing private OFC custodians, RA1 intermediaries which intend to be private OFC custodians and RA13 intermediaries which also act as custodians of private OFCs when the RA13 regime comes into effect?

No. We generally agree with the proposed requirements in the new Appendix A to the OFC Code, the purpose of which is to ensure the safekeeping of private OFC scheme property by custodians, whether they are existing private OFC custodians, RA1 intermediaries or RA13 intermediaries. The application of the same requirements to these types of custodian should act to level the playing field for all private OFC custodians.

Question 4

Do you have any comments on the other proposed amendments to Chapter 7 of the OFC Code?

No. We generally agree with the other proposed amendments to Chapter 7 of the OFC Code.

B. Expansion of investment scope for private OFCs

Question 5

Do you have any comments on the proposed expansion of the investment scope of private OFCs to loans and shares and debentures of Hong Kong private companies? Please explain your views.

We welcome the SFC's proposal to expand private OFCs' permitted investment scope to include loans, and shares and debentures of Hong Kong private companies. The current regime which allows investment in the shares of private companies incorporated offshore, but not those incorporated in Hong Kong, is illogical and we thus support the proposal to remedy this inconsistency. We also agree that private OFCs should be allowed to invest in loans which are not inherently different to debentures.

At the time of the original consultation on an open-ended fund regime, the Financial Services and Treasury Bureau (**FSTB**) acknowledged industry views that there should be no restriction on private OFCs' permitted investment scope.[1] As is evident from the extremely limited use of the private OFC structure since the implementation of the OFC regime, private fund managers do not regard it as an alternative to corporate structures available in other jurisdictions. The excessive restrictions on private OFCs' permitted investments is likely the primary reason for this. Although the present consultation's proposals are welcome, they do not go far enough to achieve the desired result, i.e. to make the OFC a viable alternative to the most commonly used private fund investment vehicle, the Cayman Islands' exempted company, which is not subject to any restrictions on investment type. Moreover, since the OFC regime was implemented, Singapore – Hong Kong's major competitor as an asset management hub in the Asia Pacific region – adopted its own variable capital company framework aimed at encouraging more funds to domicile in Singapore. Like the Cayman Islands, Singapore's corporate fund vehicle is not subject to restrictions on investment type, and the variable capital company can be used for real estate funds, private equity, venture capital and hedge funds. The lack of investment restrictions for private funds incorporated in other jurisdictions (including Luxembourg, the Cayman Islands, Ireland, Singapore and the UK) make the requirements for Hong Kong private OFCs unattractive by comparison. Moreover, there are no investment restrictions on private funds established in Hong Kong as unit trusts. PwC predicts that assets under management (**AUM**) in Asia Pacific countries (**APAC**) will grow faster than in any other region worldwide, and has predicted that APAC AUM will reach US$29.6 trillion in 2025, up from US$15.1 trillion in 2017.[2] As an asset management centre, Hong Kong faces competition from Singapore as well as Australia and Japan. It is therefore imperative that the corporate fund vehicle available in Hong Kong provides an attractive alternative to Cayman exempted companies and Singapore's variable capital companies in particular, as well as other offshore corporate fund vehicles, if Hong Kong is to prove an attractive domicile for private funds.

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1 FSTB. Open-ended Fund Companies Consultation Paper. March 2014. Paragraph 68.

2 PwC. Asset & Wealth Management 2025: The Asian Awakening. January 2019. Available at: https://www.pwc.com/sg/en/asset-management/assets/asset-management-2025-asia-pacific.pdf

PwC also anticipates significant growth in the popularity of alternative assets including real estate and infrastructure investments. Private funds incorporated in Singapore or in the Cayman Islands would be able to invest in these assets, whereas Hong Kong OFCs are subject to a 10% cap on such assets. Virtual assets are another category of investment which is likely to increase in popularity and which is also subject to the 10% restriction. We would therefore suggest giving serious consideration to whether the restrictions on investments are necessary, particularly given that private OFCs can only be offered to professional investors or in a private placement in Hong Kong. Further, licensed intermediaries are subject to the suitability obligations of the SFC Code of Conduct for Persons Licensed by or Registered with the SFC.

We also oppose the adoption of proposed paragraph 11.1A which will require the assets of a private OFC to include a portfolio of assets whose management will constitute Type 9 regulated activity, i.e. assets which are "securities" or "futures contracts" as defined in the Securities and Futures Ordinance (**SFO**). The rationale for the provision is apparently to ensure that the management and safekeeping of the OFC's assets are subject to regulation under the SFO and SFC Codes. The reasons for our opposition to this proposal are as follows:

1) Since shares and debentures of Hong Kong private companies fall outside the SFO's definition of "securities", while those of offshore private companies are within it, venture capital and private equity funds cannot use the OFC structure if they invest solely in Hong Kong private companies, but can use it if they invest in offshore private companies. This position is illogical and detrimental from the perspective of Hong Kong start-up companies. The proposal would also mean that the manager of a fund investing in offshore private companies would need to be licensed for RA9, while the manager would not be required to be licensed if the fund invests in Hong Kong private companies. There is no logical reason for the differentiation in the regulatory position of the two fund types.

2) It is not clear what the SFC would regard as a "portfolio" of securities and futures contracts. Would it be sufficient for a private OFC to invest in just one security under the SFO? If that were the case, and the inclusion of just one security acts purely as a mechanism to bring the activities of the manager within the scope of Regulated Activity Type 9, and thus within the SFC's regulatory regime, the requirement may be acceptable to some private fund managers. The requirement would then operate in much the same way as the SFC's licensing regime for virtual asset trading platforms, where the requirement to trade at least one virtual asset that is a security brings the platform operator within the SFC's regulatory net. However, this seems an unduly artificial solution which may prove unattractive to private fund managers who wish to use a private OFC for funds investing in alternative investments, such as property, virtual assets, art, wine or other luxury goods. This requirement would then force these funds to: (i) invest in assets (i.e. securities) which are outside their primary investment scope; and (ii) become licensed for RA9 notwithstanding that their primary investments are not in securities or futures contracts. This may prove unattractive particularly as there is no RA9 licensing requirement for managers of funds established as unit trusts that invest in assets that are not securities or futures contracts.

   We see no reason why a private OFC should not be able to invest exclusively in assets that are not securities or futures contracts. The definition of an OFC in the SFO is "a collective investment scheme constituted as a corporation".[3] A collective investment scheme is defined in terms of arrangements relating to "any property" where the definition of "property" includes: (a) money, goods, choses in action and land; and (b) obligations, easements and every description of estate, interest and profit … arising out of or incident to property within (a).[4] As highlighted above, equivalent corporate fund structures in other jurisdictions do not restrict funds' investment scope in this way.

3) With respect to the prohibition on private OFCs engaging in a money lending business (at paragraph 25 of the Consultation Paper), a distinction should be made between a money lending business which wishes to incorporate as an OFC (as opposed to a traditional company) and a fund which lends money for a return as part of its investment activities. The former situation is already prevented by the requirement that an OFC is a collective investment scheme constituted as a company and the existing OFC Code prohibition on an OFC being used as a business undertaking for general commercial or industrial purposes (at paragraph 11.3 of the OFC Code). The latter situation of a fund lending money for a return is not unusual for certain fund managers, particularly hedge fund managers, for whom lending is an important part of their investment activities. We do not see any reason why a private OFC should not be able to conduct this activity either itself, or through a wholly-owned subsidiary.

Further, while not directly relevant to the question of permitted investment scope, we would also point to the broader exemptions from the prospectus offering regime and SFC authorisation requirement under section 103 SFO that are available to offshore incorporated funds. As OFCs are established under the SFO, they cannot rely on the exemptions set out in the Seventeenth Schedule to the Companies (Winding Up and Miscellaneous Provisions) Ordinance which are available to overseas corporate funds. Hence, private OFCs can be offered only to "professional investors" (as defined in the SFO) and/or in an offer not amounting to an offer to the public (i.e. via a private placement). An offshore corporate fund can however additionally rely on the Seventeenth Schedule exemptions for offers: (i) to no more than 50 persons in a 12-month period; (ii) for a total consideration of no more than HK$5 million in a 12-month period; or (iii) with a minimum subscription amount of HK$500,000 per investor. This discrepancy has long existed between funds established as unit trusts and corporate funds and should be removed, particularly as Hong Kong's offering regime is now weighted in favour of funds established overseas to the detriment of locally incorporated funds.

C. Re-domiciliation of overseas corporate funds

Question 6

Do you have any comments on the proposed re-domiciliation mechanism to facilitate the migration of overseas corporate funds to Hong Kong or the mechanism's specific features and requirements? Please explain your views.

[3] Section 112A of the Securities and Futures Ordinance.
[4] Definition of "property" in Part 1 of Schedule 1 to the Securities and Futures Ordinance.

No. We welcome the SFC's initiative for introducing a statutory re-domiciliation regime of overseas corporate funds in Hong Kong. However, the restriction on the investment scope of private OFCs and the fact that private funds can only be offered to professional investors or in a private placement (as discussed in our response to Question 5 above) will likely mean that re-domiciliation to Hong Kong is less attractive than it would be if these aspects were removed.

D. Significant controllers register requirements

Question 7

What are your views on the proposed adoption of the significant controllers register requirements under the CO in the OFC regime?

We generally agree to the proposed adoption of the significant controllers register requirements under the CO in the OFC regime as such requirements can further enhance the AML/CFT measures in respect of OFCs in line with the FATF principles provided that the significant controllers register will not be open to public inspection. Similar requirements exist in the Cayman Islands, British Virgin Islands and Singapore.

Implementation timeline

Question 8

Do you have any comments on the proposed implementation timelines?

We generally agree with the Consultation Paper's proposed implementation timelines, subject to our response to Question 9 below.

Question 9

Would there be any difficulty for existing private OFC custodians to comply with the proposed requirements in the new Appendix A to the OFC Code if they were to take immediate effect? Please explain your views.

We would suggest a transition period of three or six months to enable existing private OFC custodians to comply with the proposed requirements of new Appendix A to the OFC Code.

Yours faithfully

Charltons

Comparison of Investment Restrictions and Custodian Requirements for Private Corporate Funds in Other Jurisdictions

Charltons is a Hong Kong law firm and is not qualified to advise on the laws and regulations of the jurisdictions referred to in this table. While the following represents our understanding of the requirements for private funds in those jurisdictions, it should not be relied upon.

	INVESTMENT RESTRICTIONS	CUSTODIAN REQUIREMENTS
CAYMAN ISLANDS - privately offered fund in the form of an exempted company	Generally, no investment restrictions except that an exempted company with authority to issue bearer shares cannot hold land in the Cayman Islands.[5]	No requirement to appoint a custodian.
IRELAND - Irish Qualifying Investor Alternative Investment Fund (**QIAIF**) established in the form of an Irish collective asset management vehicle (**ICAV**)). QIAIFs can be marketed only to qualifying investors.	No investment restrictions.	QIAIFs must entrust assets to an independent depositary for safe keeping.[6] A prime broker may be appointed as the depositary provided that it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker and the potential conflicts of interest are properly identified, managed and disclosed to investors. A depositary can also delegate custody tasks to one or more prime brokers or other third parties. Prime brokers may provide prime brokerage services to the QIAIF in addition to delegated custody tasks.[7]
LUXEMBOURG - Reserved Alternative Investment Fund (**RAIF**) constituted in the form of a société d'investissement à capital variable (**SICAV**) (i.e. open-ended investment company with variable capital).	There are no restrictions on the type of assets a RAIF can investment in. Real estate funds, art funds and infrastructure funds can be established as RAIFs as well as equity, bond or	The assets of a RAIF must be entrusted to a depositary for safe-keeping. The depositary must be a Luxembourg credit institution or investment firm meeting requirements under the Alternative Investment Funds Law. A professional depositary can be appointed for assets that are not financial

[5] Section 32 of the Companies Law. At: https://www.cima.ky/upimages/commonfiles/CompaniesLaw2020Revision_1579811065.pdf

[6] See: page 104 of the AIF Rulebook. At: https://www.centralbank.ie/docs/default-source/regulation/industry-market-sectors/funds/aifs/guidance/aif-rulebook-march-2018.pdf?sfvrsn=6

[7] EU Directive 2011/61/EU on Alternative Investment Fund Managers. 8 June 2011. Paragraph 43. At: https://eur-lex.europa.eu/legal-content/EN/TXT/?uri=CELEX%3A32011L0061

Investment in RAIFs is limited to "well informed" investors.	hedge funds. However, RAIFs must comply with the principle of risk spreading,[8] unless they invest solely in risk capital. The interpretation of risk spreading in relation to specialised investment funds (**SIFs**) applies. The CSSF's Circular 07/309 on risk spreading in the context of SIFs provides that SIFs should not invest more than 30% of their assets or commitments in subscribing securities of the same type issued by the same issuer.[9]	instruments. A prime broker which acts as a counterparty to a RAIF can only act as a depositary for that RAIF if it has functionally and hierarchically separated the performance of its depositary functions from its tasks as prime broker.[10] A depositary can delegate its custody tasks to a prime broker if conditions specified in the Law on Alternative Investment Fund Managers are met.[11]
SINGAPORE - Restricted Variable Capital Company (**VCC**) A restricted VCC can be offered only to accredited investors or must have a minimum consideration amount of S$200,000.	No investment restrictions.	Restricted VCCs must keep their assets with a "prescribed entity". Prescribed entities are: (i) a bank licensed under the Banking Act (Cap. 19); (ii) a merchant bank approved as a financial institution under the Monetary Authority of Singapore Act (Cap. 186); (iii) a finance company licensed under the Finance Companies Act (Cap. 108); (iv) a depository agent within the meaning of section 81SF of the Securities and Futures Act (Cap. 289) (SFA) for the custody of securities listed for quotation or quoted on Singapore Exchange Securities Trading Limited or deposited with the Central Depository (Pte) Ltd; (v) an Approved Trustee; (vi) any person licensed under SFA to provide custodial services for securities; or

8 Reserved Alternative Investment Funds Law, at Article 1.

9 Commission de surveillance du secteur financier. Circular CSSF 07/309. Available at: https://www.cssf.lu/fileadmin/files/Lois_reglements/Circulaires/Hors_blanchiment_terrorisme/cssf07_309eng.pdf

10 Law on Alternative Investment Fund Managers, Article 19(4)(b).

11 Law on Alternative Investment Fund Managers, Article 19(11).

		(vii) a foreign custodian that is licensed, registered or authorised to conduct banking business or to act as a custodian in the country or territory where the account is maintained. PE/VC Funds do not need to appoint a custodian provided they have disclosed to their investors and obtained investors' acknowledgement that no custodian has been appointed.
UK - Qualified Investor Scheme (**QIS**) in the form of an open-ended investment company (**OEIC**) (also called "investment company with variable capital"). QIS can only be offered to professional clients and retail clients who are sophisticated investors. They are subject to restrictions on promotion under COBS 4.12.3 R.	A QIS in the form of an OEIC generally has no investment restrictions.[12]	All the scheme property of an OEIC (or ICVC) must be entrusted for safekeeping to a person appointed for the purpose (i.e. a depositary) subject to certain exceptions.[13]

[12] COLL 8.1.4 of the FCA Handbook. Available at: https://www.handbook.fca.org.uk/handbook/COLL/8/?view=chapter

[13] See The Open-Ended Investment Companies Regulations 2001. Available at: https://www.legislation.gov.uk/uksi/2001/1228/contents/made