



# AIMA Hong Kong Education Seminar New OFC Rules and Code

6 August 2018

## Speakers:

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THE ALTERNATIVE INVESTMENT  
MANAGEMENT ASSOCIATION

# What we will cover today

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- Timing for implementation
- Potential for OFCs
- SFC Supervision and Enforcement
- Structure of an OFC and Service Providers
- Regulatory Framework
- Filing Process
- Key features of an OFC
- Operators / Eligibility
- Investment Restrictions
- Termination / Winding Up
- Tax Issues

# Timing for implementation

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- New rules effective on **30 July 2018**
- OFC documents available on SFC website:
  - Application forms/ information checklist
  - Template Instrument of Incorporation
  - FAQs
- Applications can now be made to the SFC

# Potential for OFCs?

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Retail fund managers



Private fund managers

# SFC Supervision and Enforcement

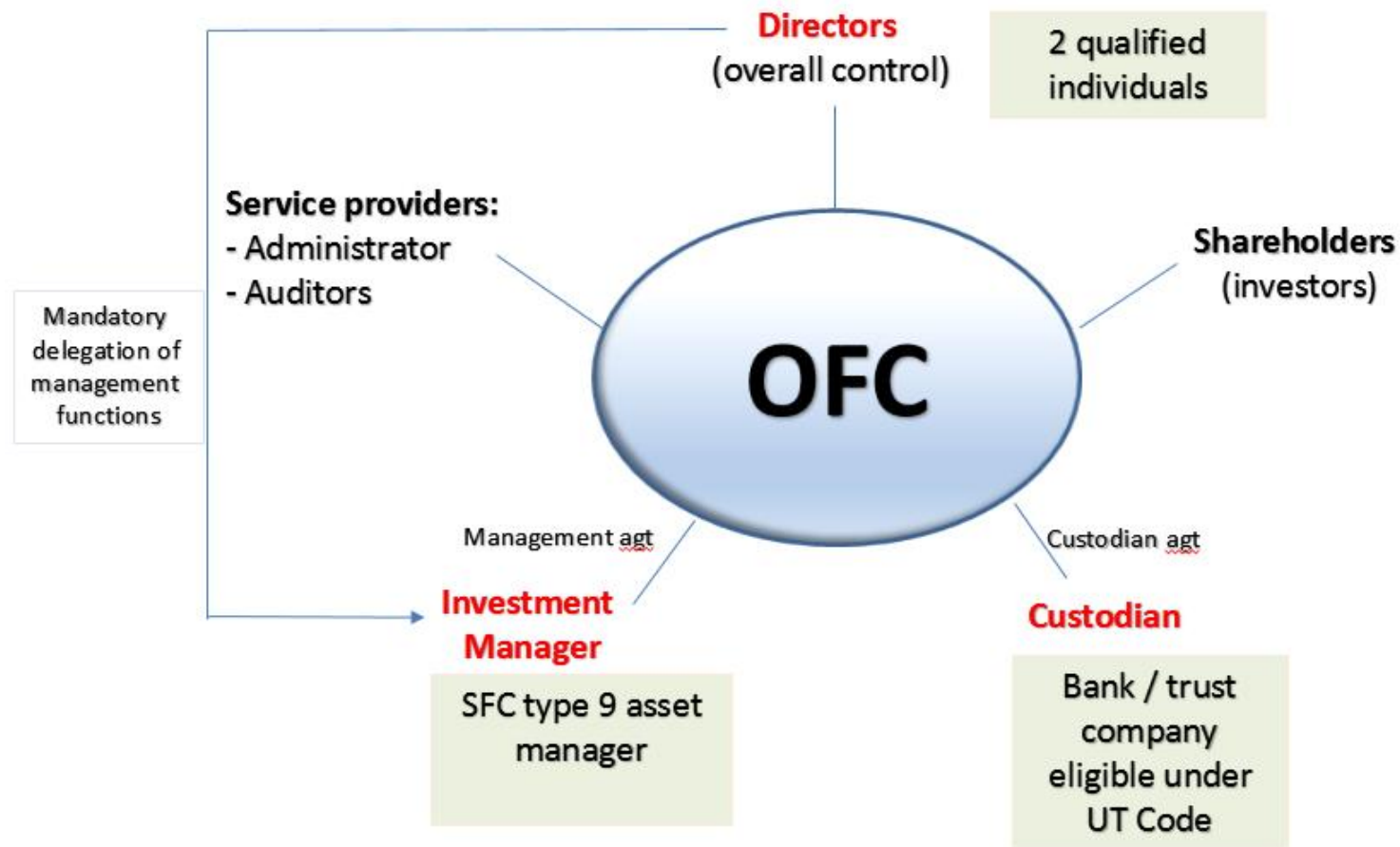
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The logo for AIMA (Association of Insurance and Money Actuaries) is located in the top right corner. It consists of a dark blue square with the word "AIMA" in white, sans-serif capital letters. Below the blue square is a horizontal magenta bar.

SFC Powers of:

- Investigation
- Supervisory
- Intervention
- Enforcement

# Structure of an OFC and service providers



# Regulatory framework

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Legislation and Regulation on OFC and other amended legislation:

- **the Securities and Futures Ordinance - Part IVA (SFO)**
- **the Securities and Futures (Open-ended Fund Companies) Rules (OFC Rules)**
- **the Code on Open-Ended Fund Companies (OFC Code)**
  
- the Securities and Futures (Open-ended Fund Companies) (Fees) Regulation
- Inland Revenue Ordinance (profits tax for private OFCs)
- Companies (Winding Up and Miscellaneous Provisions) Ordinance (CWUMPO)
- SFC Products Handbook (Code on Unit Trusts and Mutual Funds) (public OFCs)

# Filing process - overview

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OFCs to be established under the Securities and Futures Ordinance (**SFO**) and regulated by the Securities and Futures Commission (**SFC**)

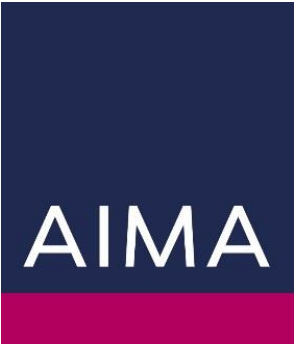
Streamlined filing processes:

- “One stop” approach: registration and incorporation filed with SFC only
- SFC will pass on documents to CR
- Processing by SFC: 1 – 3 months for public OFC (in tandem with authorisation); <1 month for private OFCs
- CR expects the certification of incorporation to be issued within 3 business days
- Separate filings to SFC and CR after incorporation



# Commencing an Application

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Submission to SFC comprising:

- Duly signed and completed Application Form
- Duly signed and completed Information Checklist
- Instrument of Incorporation
- Required Confirmations and/or undertakings
- Application Fee

# SFC Application Forms and Checklists

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## CAUTION

The applicant should note that any representation in, or referred to in, this application, and any representation made from time to time in support of this application which is false or misleading in a material particular, the provision of any information to the Securities and Futures Commission (the “Commission” or the “SFC”) which is false or misleading in a material particular and the provision of any record or document which is false or misleading in a material particular may constitute an offence under either section 383(1), 384(1) and/or 384(3) of the Securities and Futures Ordinance (“SFO”).

# Key features of OFCs

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## **Name**

- Must indicate it is an OFC (s.112H SFO), must not (in the opinion of the SFC) be misleading or otherwise undesirable, must not be the same as the name of another existing OFC, must end with “Open-ended Fund Company” or “OFC” (4.4 OFC Code)

## **Registered office**

- Must have a registered office in Hong Kong (s.112I SFO)

## **Limited liability**

- Shareholder liability is limited to the amount unpaid on shares (s.112Q SFO)

# Key features of OFCs

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## Shares

- Different classes of shares permitted
- For a resolution of removal of directors, no greater voting rights than in relation to the “generality of matters” (r.103(6) OFC Rules)
- Any change to the “class rights” attaching to a class of shares can only be made in accordance with the OFC’s instrument of incorporation (r. 57 OFC Rules)

## Register

- Prescribed details to be entered in register of shareholders
- Register of shareholders open to be inspected by shareholders, investment manager, custodian, SFC and public bodies

# Key features of OFCs

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## Shareholder meetings

- Requirements for meetings set out in Part 5 of OFC Rules; no requirement for annual meetings of shareholders
- Meeting requirements in OFC Rules to override any inconsistent provisions in the instrument of incorporation (r.87(2) OFC Rules)
- Written resolutions are permitted, subject to being executed by all shareholders within a specified timeframe (r.90, 92, 93 OFC Rules)
- Resolutions need to be notified to all shareholders in the OFC (r.94(a) OFC Rules)
- OFCs must keep records of meetings (r.96 OFC Rules)

# Key features of OFCs – umbrella funds

- OFCs can be structured as umbrella funds, with multiple sub-funds (s.112R SFO)
- Each sub-fund has statutory segregated liability (s.112S SFO)
- Terms limiting liability of an OFC to the assets of the relevant sub-fund are implied into contracts entered into by an OFC (r.158 OFC Rules)
- Each sub-fund is not a separate legal entity but the OFC can sue or be sued in respect of any sub-fund (s.112S SFO)
- The ability for one sub-fund of an OFC to invest in another sub-fund of the same OFC is permitted (r.159 OFC Rules)

## **Instrument of incorporation**

- Must have an instrument of incorporation that includes prescribed matters (s.112K SFO), including a statement of the objects and powers of the OFC, investment types, corporate administrative provisions

## **Offering document**

- Complies with the disclosure principles in OFC Code; certain mandatory disclosure items (limited liability, segregation, warning statement, custodial arrangements, termination, information and enquiries)

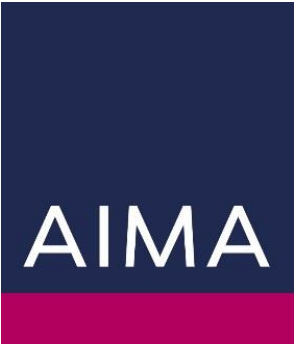
# Operators of OFCs – Directors



- OFC must have a minimum of 2 directors, who must be individuals, aged 18 or above
- At least 1 director must be an independent director, who must not be a director or employee of the custodian (5.2 OFC Code)
- Directors can be located either in or outside Hong Kong
- Appointment of directors subject to SFC approval (r.101(3) OFC Rules)
- The experience and expertise of the persons appointed as directors, taken together, must be appropriate for carrying on the business of the company (r.100 OFC Rules); SFC to consider various factors (5.1 OFC Code)
- Owe fiduciary duties and duty to exercise reasonable care, skill and diligence (same as those of an ordinary company) (ss.112U-112Y SFO)
- Duty to oversee the activities of the investment manager and the custodian (5.4 OFC Code)

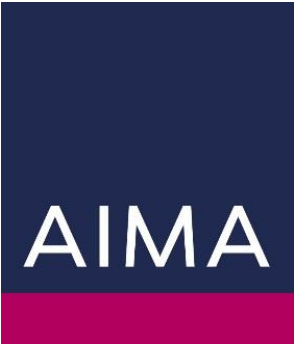


# Operators of OFCs – Investment manager



- The OFC must appoint an investment manager that is licensed with the SFC for type 9 regulated activity (s.112Z SFO)
- SFC must approve the investment manager (r.124(3) OFC Rules)
- The investment manager must “be and remain fit and proper at and after the time of registration of the OFC” (6.1 OFC Code)
- The OFC is required to have in place a management agreement in writing with the investment manager.
- The written delegation agreement is required to include investment management, valuation and pricing of the scheme property of the OFC (5.3 OFC Code)
- Must carry out the management functions of the OFC in accordance with the instrument of incorporation and management agreement (6.2 OFC Code)

# Operators of OFCs – Custodian



- The OFC must appoint a custodian (s.112ZA SFO)
- All property of the OFC must be entrusted to the custodian (s.112ZA SFO)
- SFC must approve the custodian (r.114(3) OFC Rules)
- The custodian must meet the same eligibility requirements as set out in the UT Code (7.1 OFC Code)
- Statutory obligations to take reasonable care, skill and diligence to ensure safe-keeping of OFC's property (s112ZA SFO)
- Further custodial obligations are set out in 7.3 OFC Code (Custody, asset segregation, verification of ownership)

# Restrictions on investments of OFCs

## **For public OFCs** (authorised under s.104 of the SFO):

Subject to investment restrictions in the Code on Unit Trusts and Mutual Funds – Chp 7 and 8

## **For private OFCs:**

- At least 90% of the gross asset value of a private OFC must consist of (1) securities, futures contracts and OTC derivative products, and/or (2) cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts (11.1 OFC Code)
- Up to 10% of the gross asset value of a private OFC may be invested in other asset classes (11.2 OFC Code)
- 10% de minimis rule applies to each sub-fund of an umbrella OFC
- In case of breach SFC expects investment manager to inform SFC and rectify as soon as possible

# Scheme changes

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**Name change** and **change of key operators** (director, investment manager or custodian) requires SFC approval

## For **private** OFCs:

- **For alteration of Instrument of Incorporation** – removed SFC prior approval requirement: any “material change” requires shareholder approval, “immaterial changes” requires (1) shareholder approval or (2) board certification
- **“material change”** includes (1) material changes to the OFC’s investment objectives and policy, (2) other changes which may materially prejudice shareholders’ rights

# Termination and winding up an OFC

## Termination

- The decision to terminate must take due account of the best interests of shareholders; shareholders shall be treated fairly (10.2, OFC Code)
- The board of directors must approve a solvency statement (10.4 /10.5 OFC Code)
- OFC to issue a notice of termination to shareholders (SFC approval only required for public OFCs)

## Winding up

- Phased approach
- Initially OFCs subject to disqualification and court winding up process under Companies (Winding Up and Miscellaneous Provisions) Ordinance (CWUMPO) as “unregistered company”
- Ultimately winding up rules apply to OFCs in the same manner as conventional companies under CWUMPO

# Hong Kong's New OFC Tax Exemption

Malcolm Prebble

Tax Partner – M&A and Funds

6 August 2018



# Agenda

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- Framework of new tax exemption
- Qualifying conditions
- Tax treatment of Sub-funds
- Challenges, concerns and out views on its success

# New OFC Exemption Framework – Section 20AH

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4 conditions for an OFC to qualify for exemption from tax on profits from qualifying transactions:



Hong Kong Resident



Profits from Qualifying Transactions



Non-Closely Held



Qualified Person

However, there are certain investments which are specifically excluded, i.e. the profits don't qualify for exemption



# Residence – Qualifying Condition

The AIMA logo consists of the letters "AIMA" in white, sans-serif font, positioned above a solid magenta horizontal bar. The entire logo is set against a dark blue rectangular background.

## **Condition 1 : The OFC must be a Hong Kong Resident**

- The Fund's central management and control must be exercised in Hong Kong
- Typically, this would mean that the OFC would have a majority of Hong Kong based directors, have board meetings in Hong Kong and the highest level of decision making is exercised in Hong Kong

# Non-closely held – Qualifying Condition

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## Condition 2: The OFC must be Non-closely held

- Strict qualifying criteria on the composition of investors in the Fund
- A minimum of 5 or 10 investors, depending on whether the Fund has a “Qualifying Investor” (“QI”)
- An investor excludes the originator (and associates)
- A Qualifying Investor in relation to an OFC means:
  - Certain types of institutional investors, including non-profit organizations, pension funds, publicly offered funds, and government bodies

# Non-closely held – Qualifying Condition

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## Fund without QI

Number of investors:	$\geq 10$
Participation interest of at least 10 investors:	$\geq$ HK\$20m per investor
Participation interest of each investors:	$\leq 50\%$ of the Fund's issued share capital
Participation interest of the originator and its associates	$\leq 30\%$ of the Fund's issued share capital

## Fund with QI

Number of investors:	$\geq 5$
Participation interest of each <b>QI</b> investor:	$\geq$ HK\$200m
Participation interest of at least 4 <b>non-QI</b> investors:	$\geq$ HK\$20m per investor
Participation interest of each <b>non-QI</b> investors:	$\leq 50\%$ of the Fund's issued share capital
Participation interest of the originator and its associates	$\leq 30\%$ of the Fund's issued share capital

# Non-closely held – Qualifying Condition

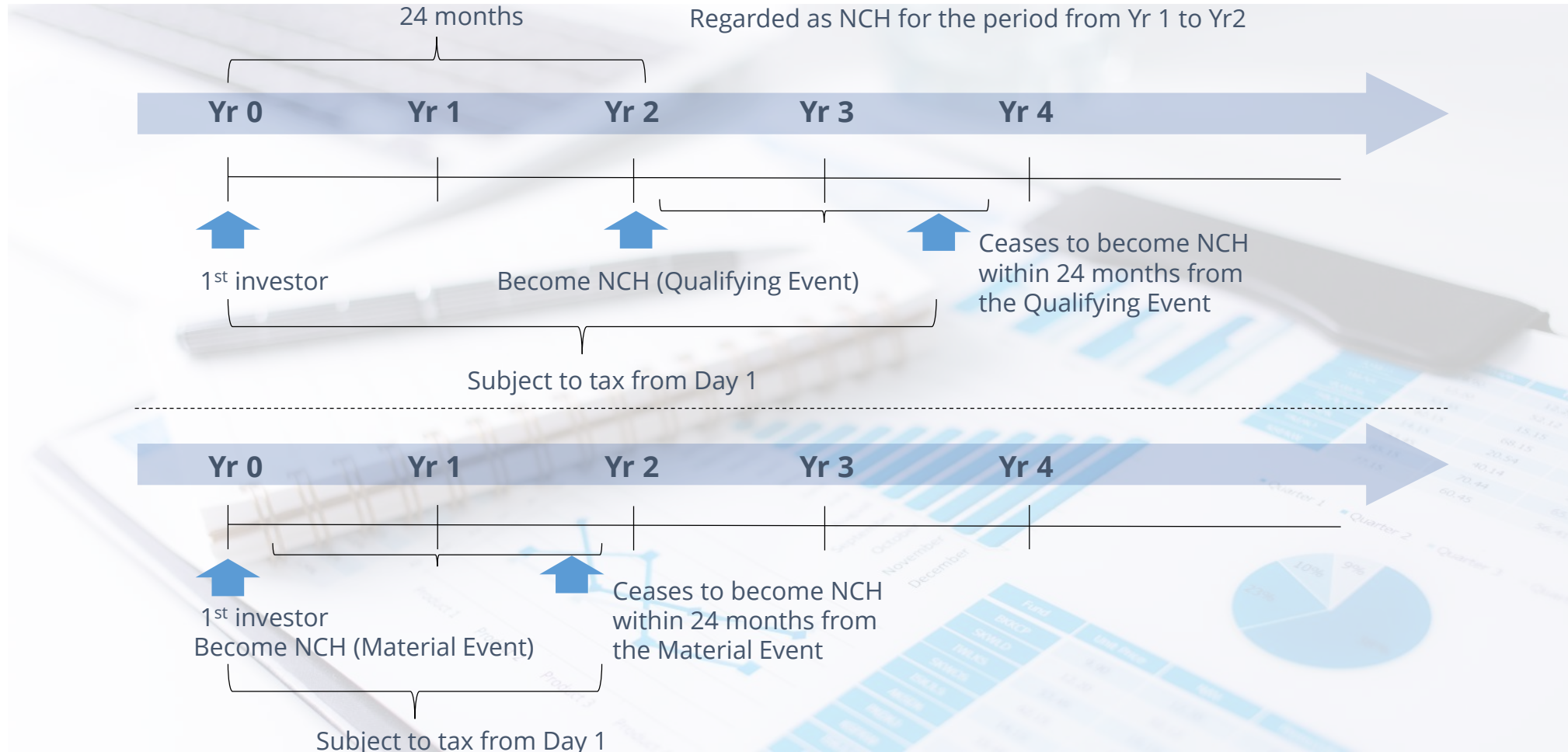
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The IRD aims to prevent individuals or entities from taking advantage of the tax exemption in the first 24-month period (e.g. by repeatedly opening and closing an OFC every 24 months)

But, really how likely?

- If the Fund does not become non-closely held within 24 months, it will be regarded as never having been exempt
- The IRD will “dis-apply” the tax exemption and the Fund will then be chargeable to tax for the entire 24-month start-up period
- If the Fund ceases business, or it doesn’t meet the non-closely held investor conditions within the following 24 months, the exemption will also be disapplied from day 1
- Hence, the “24 + 24 rule”

# Non-closely held – illustration



# Qualifying transactions – Schedule 16A class

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**Condition 3:**  
Profits from  
qualifying  
transactions  
are exempt -  
these include  
Schedule 16A  
and some  
non-Section  
16A  
transactions,  
as well as  
incidental  
transactions

- These are transactions in asset classes specified in Schedule 16A. Generally, these assets comprise:

✓ securities;	✓ bank deposits;
✓ shares of, or debentures issued by, a private company;	✓ foreign currencies;
✓ futures contracts;	✓ certificates of deposits;
✓ foreign exchange contracts;	✓ cash; and
	✓ OTC derivative products.
- Private companies refers to Hong Kong or offshore incorporated companies

# Excluded investments – non-qualifying transactions

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**What are the non-qualifying transactions?**

## **Non-qualifying transactions include:**

- Crypto currency
- Hong Kong property
- Hong Kong company that holds certain short term assets
- The OFC is involved in direct trading activities in Hong Kong

Profits from the above transactions may be taxable to the OFC, subject to ordinary rules applying, e.g. the source of profits would still need to be considered

# Specified person - qualifying conditions

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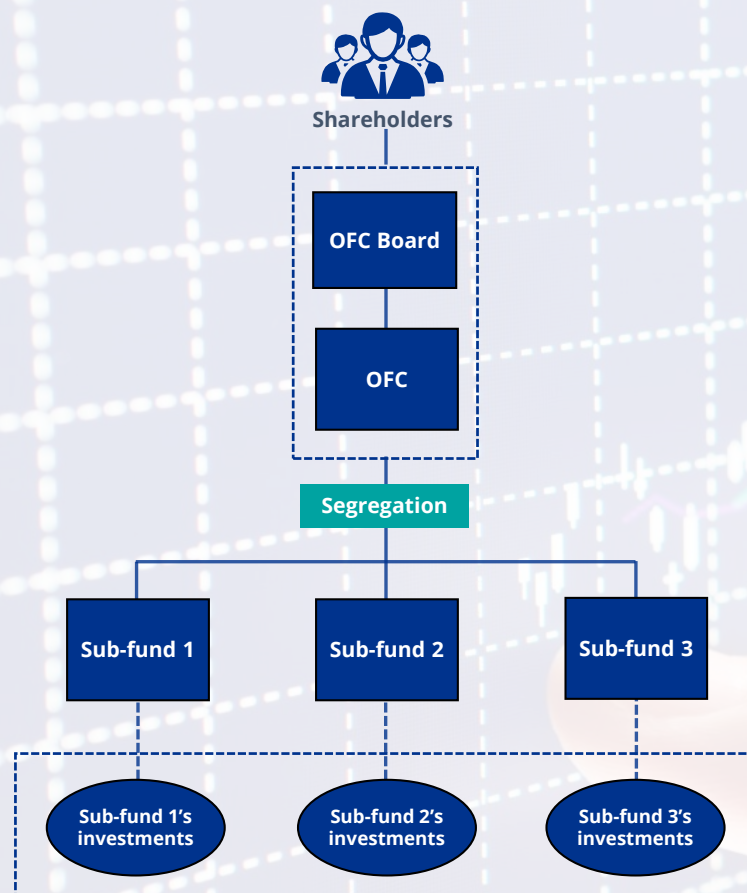
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**Condition 4:  
Transactions  
of the OFC  
must be  
carried out  
through or  
arranged by  
a specified  
person**

- A specific person is a company licensed by the SFC or an authorized financial institution to carry out Type 9 regulated activity



# Sub funds



## Taxation of sub funds

- Each sub-fund is to be regarded as an OFC (i.e. profits and losses are not consolidated or available to be offset with other sub-funds)
- If the conditions for profits tax exemption are met in respect of a sub-fund, the sub-fund is exempt even if the conditions are not met in respect of another sub-fund
- Losses of a sub-fund cannot be offset against profits from another sub-fund

Our views –  
challenges,  
concerns and  
will it be  
successful?



# Is the OFC dead on arrival?

The OFC regime is unlikely to receive mass adoption



The qualifying conditions are onerous, the investor and monitoring requirements are impractical, and non-compliance carries too much tax risk



The current OFC regime has gone through 3 rounds of consultation, and the Hong Kong government has taken on board only some of the feedback from the industry. However, there is an overemphasis on the potential loss in revenue and abuse, resulting in the overly restrictive qualifying conditions



# How would OFC's account for potential tax risks?

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**Tax liability –  
who bears the  
tax within the  
initial 4 year  
period or  
subsequently  
?**

- The incentive was conceived with good intention, but the final legislation has been burdened with too many onerous conditions
- There is too much tax risk within the regime:
  - Risk of the exemption being disappplied from day 1 if don't satisfy the non-closely held rule for up to 4 years

# Other areas of concern?



## Performance / Carried interest

- The deeming provision of performance is over simplistic and does not take into account genuine investment returns made by the relevant individuals
- This may have far ranging implications to offshore funds managed from Hong Kong



## Interest income

- Interest income from the “holding” of debt investments (instead of gains from the trading of debt instruments) is still regarded as non-qualifying – this is not addressed in the OFC regime

# Other areas of concern?



## Stamp duty

- The transfer of shares of an OFC would be subject to stamp duty. A blanket exemption from stamp duty for transfers of shares in OFCs should be introduced



## Short term asset conditions

- 3 year period and 50% of asset requirement quite onerous
- What is the apparent abuse?

# Contact

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