How Should Hong Kong Regulate Open-Ended Investment Companies?

Bryane Michael
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The Securities and Futures Commission (SFC) has begun its consultation on the legal framework for setting up open-ended investment companies. Yet, much of the advice it has received as been off the mark. In this small brief, we suggest planting the statutory basis for these companies in the Companies Ordinance.

Like the other well-wishers for Hong Kong as a leading international financial centre, we recommend the establishment of open-ended investment corporations in Hong Kong. Following the UK example, we recommend the establishment of open-ended investment companies in the Companies Ordinance – with subsidiary rulemaking by the SFC – for three reasons.¹ First, the legislature has clearly indicated in recent reforms of the Ordinance that the Companies Ordinance serves as the principle basis for regulating the establishment and function of Hong Kong’s companies.² The recent consultation documents produced during the last round of reforms sets out quite explicitly a list of companies which qualify as companies.³ Why would the Financial Services and Treasury Bureau help put together consultations about the types of companies that the Ordinance would regulate, only to decide later that investment companies should be treated separately? Even the long name of the Ordinance says it all as “the law relating to companies.”⁴ Second, the Securities and Futures Ordinance does not provide a sufficient basis for establishing investment companies. The SFC would need the competency to create companies. Yet, the current Securities and Futures Ordinance nowhere hints at such a competence. Figure 1 shows the regulatory objectives and functions/powers of the SFC – and the extent to which each provision might be interpreted as granting the authority to create open-ended investment companies. Again, the long title gives the clear intent of the Ordinance to provide “law relating to financial products, the securities and futures market and the securities and futures industry, the regulation of activities and other matters connected with financial products, the securities and futures market and the securities and futures industry” (underlining ours).⁵

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¹ Our recommendation runs counter to the FSDC’s recommendation that amendments to the Securities and Futures Ordinance establish the legal basis for Hong Kong’s mutual funds. Unlike the FSDC’s terse policy brief, we provide the rationale and support for our recommendation. For the FSDC’s telegraphic analysis of their recommendations, see FSDC, Proposals on Legal and Regulatory Framework for Open-ended Investment Companies in Hong Kong, FSDC RES. PAPER 5, available online.
² Given the wide range of reforms recently made to the Companies Ordinance in 2005, the Legislative Council – under advise from the Department of Justice and Financial Secretary’s Office – could have delegated many of these changes to subsidiary legislation or other Ordinances. In our opinion, the Legislature’s choice to keep these provisions “in one place” signals its intent to keep the Companies Ordinance as the regulating document for all kinds of companies – including investment companies.
³ See FSTB, Part 3 Second Consultation Draft at Part 3.3.1, available online.
⁴ Companies Ordinance, Chap. 32 at title.
⁵ Securities and Futures Ordinance, Chap 571 at title.
The UK method of legalising open-ended investment companies provides a useful model for Hong Kong legislators. The Financial Services and Markets Act 2000 provides the statutory basis for further rulemaking in the area of investment companies.\(^6\) The Act specifically defines them as a class or type of a “body corporate” which in essence manages the investment funds (property) of others.\(^7\) To boil the argument down (perhaps too much), when a UK “body corporate” (as established in their Companies Act) engages in open-ended investment activity, that company becomes an OEIC. The Financial Services and Markets Act then authorises the Treasury to make any necessary rules related to the government of these OEICs.\(^8\)

If the Financial Services and Markets Act provides the “statutory anchor” (speaking informally) for the establishment of OEICs and the Treasury’s regulatory role, the Open-Ended Investment Companies Regulations of 2001 provide the specific regulatory provisions.\(^9\) These include the Treasury’s regulation over the formation, supervision and

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\(^7\) Id at 236.2. As we do not want to turn this brief into a legal treatise, we do not discuss how meeting a property condition and investment condition in the Act qualifies a body corporate for status as an OEIC.
\(^8\) Id at 236(5), authorising the Treasury to “amend the definition of ‘an open-ended investment company’ for the purposes of this Part [of the Act].” Under art. 262, the Act provides that “the Treasury may by regulations make provision for” a long list of various regulatory functions.
\(^9\) The Open-Ended Investment Companies Regulations 2001, No. 1228, available online.
control of OEICs (in part II), corporate organisation and administration (part III), OEIC registration (part IV), and matters contained in various schedules – like the form of the instrument of incorporation, register of shareholders and so forth. As the Regulations make plain in their introduction “whereas a draft of these Regulations has been approved...pursuant to section 429(2) of the Financial Services and Markets Act 2000...now therefore, the Treasury, in exercise of the powers conferred on them by...that Act...hereby make[s] the following Regulations.”\(^\text{10}\) In a nutshell, once the relevant regulator (in this case the Treasury) had the brief statutory authorisation, it could regulate OEICs as needed.

Hong Kong – given the current set-up of its legislation – needs a similar “work around” given its own institutional structure. The Financial Services and Markets Act clearly gives the power to create (investment) companies. Such a creation power fits with the Act’s overall objectives and Parliament’s intent. Such creation power does not (as we explained above) fit with Hong Kong’s Securities and Futures Ordinance. We do not have a Financial Services and Markets Act. The only Act we have comes in the form of the Companies Ordinance. **Obviously, the Companies Ordinance should set the statutory basis of OEICs.**

What should the Companies Ordinance say and where should the provision allowing for OEICs sit in the Ordinance? Section 310 looks like the most reasonable place for such a provision.\(^\text{11}\) The section basically outlines how “other” kinds of companies can register. In theory – and under the existing law – any OEIC could register if the Registrar receives “a copy of any Ordinance…or other instrument constituting or regulating the company.”\(^\text{12}\) In theory, therefore, if the Legislative Council passes an Open-Ended Investment Companies Ordinance (providing the SFC with regulatory competencies), registration under the existing Companies Ordinance could proceed normally. However, such an Ordinance would be unlikely in the making.

**We propose to create a section 313A, 313B and 313C amendments to the Companies Ordinance creating OEICs.** The amendment title for 313A would read “definition of an open-ended investment company” (following in form the current section 311 defining joint stock companies). The text – which would (of course) change during the public consultation --would read “For the purposes of this Part, as far as relates to registration of companies as open-ended investment companies, an open-ended investment company means a company (as defined in this Ordinance) with property belonging beneficially to, and is managed by or on behalf of, the company having as its purpose the investment of

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\(^\text{10}\) Id at introduction.

\(^\text{11}\) The section appears in Cap. 32 under part IX “Companies Not Formed Under This Ordinance Authorized To Register Under This Ordinance.” Cap 32 s. 310 refers to “companies capable of being registered.” At present, the section provides for the definition of joint stock company (cap 32, s 311) and requirements for registration by joint stock companies (cap 32, s 312). For our purposes, the section dealing with requirements for registration by other joint stock companies (cap 32, sec. 313) concerns us most.

\(^\text{12}\) Id at s. 313(b).
its funds with the aim of the spreading of investment risk and giving its members the benefit of the results of the management of those funds by or on behalf of that body.\textsuperscript{13} As for section 313B, the title would read “requirements for the registration of an open-ended investment company.” The provision text would read “the Securities and Futures Commission shall decide on the requirements for registration.” Section 313C would read “regulation of open-ended investment companies.” The text would read “the Securities and Futures Commission shall have the authority to regulate all aspects related to open-ended investment companies, except as prohibited by other Acts.”

**Recommendation 1:** Add Sections 313A, 313B and 313C to the Companies Ordinance (as defined in this working paper) creating the statutory basis for open-ended investment companies.

Once the SFC has the authority to regulate open-ended investment companies, what kinds of regulations should appear in their rulebooks? We propose that the SFC create a Code on Open-Ended Investment Companies.\textsuperscript{14} Figure 7.27 shows the likely chapter topics for the Code.\textsuperscript{15} The Code basically repeats many of the provisions found in the US and EU -- omitting provisions already existing under Hong Kong law. In general, the SFC’s work regulating and supervising OEICs would not differ substantially from its current work regulating and supervising off-shore mutual funds operating in Hong Kong and Hong Kong domiciled unit trusts.

**Figure 2: Likely Sections for an SFC Code for Open-Ended Investment Companies**

<table>
<thead>
<tr>
<th>Chapter 1: General provisions related to OEICs</th>
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<tbody>
<tr>
<td>Section 1.1. Creation order for an open-ended investment company</td>
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<tr>
<td>Section 1.2. Registration procedures not in Companies Ordinance</td>
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<td>Section 1.3 Depository safekeeping of scheme property</td>
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<td>Section 1.4 Notices and warnings to OEICs</td>
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<tr>
<th>Chapter 2: Authorisation for Operation of an OEIC</th>
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<tbody>
<tr>
<td>Section 2.1. Procedures for applying for authorisation to conduct business</td>
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<tr>
<td>Section 2.2. Particulars about OEIC names (including naming and changing names)</td>
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<tr>
<td>Section 2.3. Particulars of directors</td>
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<tr>
<td>Section 2.4. Conditions for granting authorisations to conduct business</td>
</tr>
<tr>
<td>Section 2.5. Requirements for authorisation</td>
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\textsuperscript{13} Such a rendition omits the “investment condition” found in the UK Financial Services and Markets Act. We can not describe the many reasons why the UK definition would be practical for Hong Kong – and leave this to the public consultation/debate to decide if an investment condition is needed. The reader need not worry about changes to Registrar documents and other formalities, as sec. 2A of the Ordinance grants the Registrar the power to change forms as needed.

\textsuperscript{14} The Code would join the 13 codes (including one Handbook) on various aspects of securities law in Hong Kong. The Handbook has a brief section on mutual funds and unit trusts. Given the amount of rulemaking likely required, we recommend a separate Code rather than just an addition to the Handbook.

\textsuperscript{15} We do not have space to describe the way we have “filtered” OIEC regulations from various jurisdictions to identify the provisions best suited for Hong Kong. We also do not have space to describe how we matched these provisions with the Companies Ordinance, SFO and assumed subsidiary rulemaking by the SFC. We presume the SFC will repeat this exercise and report on their deliberations during the public consultation.
Section 2.5: Refusal of authorisation
Section 2.6: Handling of certificates
Section 2.7: Reasons for cancelling an OEIC authorisation
Section 2.8: Procedure for ending an OEIC authorisation
Section 2.9: Powers of issue orders to companies
Section 2.10: Powers to bring court cases
Section 2.11: Procedures for issuing orders
Section 2.12: Investigative powers unique for OEIC cases
Section 2.13: Power to wind-up OEICs

Chapter 3: Provisions Unique for the Operations of an OEIC
Section 3.1: Preparation of reports and accounts
Section 3.2: Revision of reports
Section 3.3: Provisions related to internal and external audit
Section 3.4: Regulations governing the merger, division, or acquisition of an OEIC
Section 3.5: Orderly resolution of insolvent OEIC

Chapter 4: SFC’s role in registering and tracking OEICs
Section 4.1: SFC register of open-ended investment companies (and information sharing with Registrar)
Section 4.2: Filings required by SFC unique to OEICs
Section 4.3: Procedures for receiving and keeping OEIC filings
Section 4.4: Inspection of OEICs’ filings to SFC
Section 4.5: Information disclosed to public
Section 4.6: Exemptions and exclusions

The SFC should not wait until the relevant amendments appear in the Companies Ordinance to begin drafting the Code for Open-Ended Investment Companies for three reasons. First, public consultation on the Code will help build public support and understanding for the statutory changes required to authorise the establishment and function of Hong Kong OEICs. Second, work on the Code now can help ensure that foreign regulators see and provide feedback on the any problems in the mutual recognition of Hong Kong’s OEIC regulations. Such mutual recognition will be particularly important for the proposed mutual recognition scheme between the Mainland and Hong Kong. 16 Third, current proposals for establishing OEICs usually also include establishing limited liability partnerships and modifying the existing unit trust framework governing Hong Kong’s mutual funds. By publishing a Draft Code on Open-Ended Investment Companies before the legislative basis for the Code appears in the Companies Ordinance, the SFC can help encourage public dialogue on legal changes needed (or not) for limited liability partnerships and unit trusts. 17

Recommendation 2: Once amendments from the previous recommendation appear in the

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16 We have described the mutual recognition scheme in a previous chapter. For a description specific to the proposed changes in the OEIC framework in Hong Kong and its effect on the cross-border mutual fund trade with the Mainland, see Rob Bond, Anne-Marie Godfrey, Jin Wang and Xiaowei Ye, *Hong Kong and Mainland China to Provide for Mutual Recognition of Retail Funds*, available online.

17 At the time we wrote this chapter, new rules on Trusts had just been announced.
Companies Ordinance, The SFC adopt a Code on Open-Ended Investment Companies based on the model provided in this working paper