Hong Kong

Regulation

FUNDS AND FUND MANAGEMENT 2010

2.1 Type of funds

Collective investment schemes (CISs) can be organized in Hong Kong either as unit trusts or as mutual funds, both open and closed ended. Unit trusts and mutual funds must be authorized by the Hong Kong Securities and Futures Commission (SFC) in order to be marketed to the public in Hong Kong. Authorized funds are classified as equities funds, bonds funds, unit portfolio management funds, money market/cash management funds, warrant funds, leveraged funds, futures and options funds, guaranteed funds, index funds hedge funds, index tracking exchange traded funds, and real estate investment trusts (REIT).

2.2 Laws and regulations

The laws and regulations governing authorized funds and fund managers licensed in Hong Kong are:

- Securities and Futures Ordinance (SFO)
- Securities and Futures (Client Money) Rules
- Securities and Futures (Client Securities) Rules
- Securities and Futures (Financial Resources) Rules
- Securities and Futures (Accounts and Audit) Rules
- Securities and Futures (Keeping of Records) Rules
- Code on Unit Trusts and Mutual Funds (the Unit Trust Code)
- Code on Real Estate Investment Trusts
- Code on Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the General Code)
- Rules Governing the Listing of Securities (Listing Rules) (if listed)

AUDIT ▪ TAX ▪ ADVISORY

- The Drug Trafficking (Recovery of Proceeds) Ordinance and the Organized and Serious Crime Ordinance (relevant to the operations of funds as funds might be used to launder money arising from criminal activities as specified in the ordinances)
- Code on Pooled Retirement Funds
- Fund Manager Code of Conduct
- Management Supervision and Internal Control Guidelines for persons licensed by or registered with the SFC
- Guidance Note on Internet Regulation
- Guidance Note on the Application of the Electronic Transactions Ordinance to Contract Notes
- Guidance Notes for Persons Advertising or Offering Collective Investment Schemes on the Internet
- Guidelines for Registered Persons Using the Internet to Collect Applications for Securities in an Initial Public Offering
- Mandatory Provident Funds Schemes Ordinance
- Code on MPF Investment Funds
- Code on Disclosure for MPF Investment Funds
- SFC Code on Mandatory Provident Fund (MPF) products
- Guidelines for Review of Internal Controls and Systems of trustees/custodians
- Fit and Proper Guidelines
- Guidelines on Competence
- Code on Investment-Linked Assurance Schemes
- Guidelines on marketing materials for listed structured products
- Registration Guidelines for intermediaries advising on securities incidental to the marketing of MPF schemes only.
- Code on Immigration-Linked Investment Schemes

Hong Kong has a well developed fund management sector with a sophisticated regulatory framework, which is internationally regarded as being of a high standard.

The SFC is empowered to authorize unit trusts and mutual funds under Section 104 of the SFO. The SFC has established the Committee on Unit Trusts, which considers every application for authorization of a trust or fund, administers the Unit Trust Code, and considers any matter relevant to the continued authorization of a trust or fund.

Advertisements and other invitations to the public in Hong Kong to invest in collective investment funds must be submitted for the SFC's approval under Section 105 of the SFO prior to their issue or publication in Hong Kong.

The Unit Trust Code applies to authorized funds and dealings in such funds. It establishes guidelines specifying the provisions of the constitutive documents (trust deeds in case of unit trusts and articles of association in case of mutual funds) and explanatory memoranda of unit trusts and mutual funds, the contents of annual reports, and financial statements and requirements applying to the trustee, the management company and other parties concerned. The Unit Trust Code was substantially revised in April 2003 and the latest amendment was made in August 2008.

Although the Unit Trust Code does not have the force of law, in practice compliance with the Unit Trust Code is essential if a unit trust or mutual fund is to obtain the SFC's authorization. The major advantages resulting from authorization are:

- advertising and marketing to the general public in Hong Kong is permitted;
- exemption is given from Hong Kong profits tax; and
- listing on the Hong Kong Stock Exchange is greatly facilitated.

There are 46 mutual funds or unit trusts which are listed on the Hong Kong Stock Exchange as of 19 February 2010.

The General Code, which sets out general principles for the conduct of business, applies to fund managers of unauthorized funds and discretionary funds.

The SFC has issued Guidance Notes and Money Laundering: Revised Guidance Notes which require registrants to develop a level of awareness and vigilance to guard against money laundering. The Guidance Notes address the following areas:

- Client identification
- Record keeping

- Period of retention of records
- Recognition and reporting of suspicious transactions
- Procedures for disclosure
- Education and training

As of 31 March 2009, 2,093 unit trusts or mutual funds had been authorized by the SFC, with a net-asset value of USD 628 billion (as of 31 December 2008) under management. Authorized funds in Hong Kong continue to be predominantly equity in fund type.

2.3 Managers, trustees, and custodians

Every mutual fund or unit trust for which authorization is required must appoint a management company (except for self-managed funds) which must:

- be acceptable to the SFC;
- have sufficient financial resources at its disposal to enable it to conduct its business effectively and to meet its liabilities – in particular, it must have minimum paid up capital and capital reserves of HKD 1 million or its equivalent in foreign currency;
- be engaged primarily in the business of fund management;
- not lend to a material extent;
- maintain at all times a positive net asset position; and
- have directors (and employees) of good repute and with the necessary fund management experience (in the opinion of the SFC).

If the management company is not incorporated and does not have a place of business in Hong Kong, it must appoint a representative in Hong Kong to carry out certain administrative functions.

Every authorized fund must appoint a trustee/custodian acceptable to the SFC. The trustee/custodian should either:

- on an ongoing basis, be subject to regulatory supervision; or
- appoint an independent auditor to periodically review its internal control systems on terms of reference agreed with the SFC and should file such report with the SFC.

The trustee/custodian must also be one of the following:

- Hong Kong licensed bank or its trust subsidiary

- Registered trust company
- Foreign bank or trust company approved by the SFC for the purpose

A trustee/custodian must have an issued and paid up share capital and non-distributable reserves of at least HKD 10 million or its equivalent in foreign currency, but may have less than HKD 10 million if it is a wholly owned subsidiary of a substantial financial institution and the latter provides undertakings to the SFC.

There is no legal limit on fees payable from the fund's assets to the management company or trustee/custodian. However these must be clearly stated in the offering document as an annual percentage. Payments of certain fees and charges out of the fund's assets are prohibited, for example expenses arising out of any advertising or promotional activities in connection with the fund.

2.4 Investment restrictions

The principal restrictions on the investment powers of authorized funds in Hong Kong, other than specialized schemes, such as warrant funds, leveraged funds, futures, and options funds and REITs are:

- prohibition on investment in real estate except for shares in real estate companies and interests in REITs;
- holding of securities issued by any single issuer may not exceed 10 percent of fund's net asset value, except that this rule is relaxed in the case of government and other public securities;
- the fund may not hold more than 10 percent of any class of security issued by any single issuer, except that this rule is relaxed in the case of government and other public securities;
- the fund may not have more than 15 percent of net asset value invested in unquoted or unlisted securities;
- options, warrants, and financial futures can be bought for hedging purposes, but the following restrictions apply to other activities involving these financial instruments:
    - no more than 15 percent (options and warrants) or 20 percent (financial futures) of net asset value can be invested in such instruments for purposes other than hedging;
    - writing of call options on portfolio investments may not exceed 25 percent of a fund's total net asset value in terms of exercise price;

- holdings of units or shares in other collective investment funds cannot exceed in aggregate 10 percent of net asset value but this is relaxed in the case of a feeder fund or a unit portfolio management fund;
- there are also restrictions on short selling, investment in nil or partly-paid shares and in securities in which directors or officers of the management company have an interest; and
- separate restrictions apply to specialized funds, such as unit portfolio management funds, money market/cash management funds, warrant funds, leveraged funds, futures and options funds, guaranteed funds, index funds, hedge funds, index tracking exchange traded funds, and REITs.

2.5 Borrowing

The maximum borrowing of a fund must not exceed 25 percent of its net asset value, except that for a capital markets scheme (as defined in the Unit Trust Code), borrowing must not exceed 10 percent of its net asset value.

2.6 Accounts and prospectus

A mutual fund or unit trust is obliged to provide shareholders or unitholders with annual audited accounts within four months of the financial year end date, and an interim report within two months of the end of the period covered. If it is listed, it must send 10 copies of its reports and accounts to the exchange. A fund may select any accounting date. An authorized fund must issue an offering document containing the information specified in Appendix C of the Unit Trust Code. The offering document must be approved in advance by the SFC.

2.7 Supervision

The supervisory authority is:

Investment Products Department
The Securities and Futures Commission
8/F Chater House
8 Connaught Road Central
Hong Kong

2.8 Fund ownership

There are no restrictions on the percentage of units in a fund which may be held by one person or by a group of persons.

2.9 Fund structure

A fund that invests all its assets in other collective investment funds may be authorized as a unit portfolio management fund. Umbrella funds are also permitted and are specifically dealt with in the Unit Trust Code.

2.10 Stock exchange

Authorized funds can readily obtain a listing under Chapter 20 of the Listing Rules of the Hong Kong Stock Exchange, with the contents of the listing document being based closely on the prospectus/offering document already prepared under the Unit Trust Code.

Unauthorized Hong Kong funds can obtain a listing on the Hong Kong Stock Exchange under Chapter 21 of the Listing Rules. A track record is not required but the managers must prove to the Hong Kong Stock Exchange that they have the necessary expertise and experience. Such funds are often listed on the basis that they will be marketed only to professional investors. A comprehensive prospectus is nonetheless required.

2.11 Money laundering

In line with the Guideline on Money Laundering issued by the Hong Kong Monetary Authority authorized institutions are expected to have a system in place to minimize the chances to launder money earned from criminal activities and to finance terrorist activities. In particular institutions should verify the true identity of all customers requesting the institution’s services.

2.12 Fund set-up

The creation of a fund in Hong Kong, including approval by the SFC depends on complexity of the fund structure, the level of compliance of the applicant fund with the Unit Trust Code and the quality of fund documentation. However, as a general guide, the SFC will take up an application within two working days upon receipt of the application and the necessary fees, and provide preliminary response to applications after take-up within seven working days. Under the SFO, a mutual fund corporation or unit trust has to pay, on application for authorization, an initial fee of HKD 20,000 (USD 2,564). A further fee of HKD 10,000 (USD 1,282) will be charged upon authorization and an annual fee of HKD 6,000 (USD 769) will be levied at the same time. Higher fees apply to umbrella funds. Costs, including professional fees to setting up a fund, would be in the range of USD 50,000 to USD 150,000 depending on complexity.

2.13 Foreign funds

Foreign funds may be marketed in Hong Kong only if authorized to do so by the SFC. However approval is not required where they are being offered only to professional investors. The SFO includes types of investors which can be treated as professional investors.

2.14 Bearer shares

There are no legal restrictions on offering/issuing bearer shares under the laws of Hong Kong.

2.15 Use of the internet

The SFC has stated its approach to the marketing of authorized funds over the internet in its Guidance Note on Internet Regulation, Guidance Note for Persons Advertising or Offering Collective Investment Schemes on the Internet, and Guidelines for Registered Persons Using the Internet to Collect Applications for Securities in an Initial Public Offering.

In addition, the SFC has stated in its Guidance Note on the Application of the Electronic Transactions Ordinance to Contract Notes that contract notes are acceptable in electronic form for most transactions in securities, futures, and leveraged foreign exchange trading.

As a general principle, the SFC will not seek to extend its supervision of the activities which it regulates if carried out in Hong Kong to such activities which are conducted from outside Hong Kong and over the internet, provided these activities are not detrimental to the interests of the investing public in Hong Kong.

The SFC has provided detailed guidance on the issuing of advertisements on documents relating to regulated services or products over the internet. It considers that where such advertisements or documents are dispatched over the Internet they may trigger registration requirements if targeted at people residing in Hong Kong. The SFC has listed various factors it will consider in determining whether such forms of marketing are targeted at Hong Kong residents.

The SFC has also discussed its stance on the issue of electronic prospectuses in the Guideline. It expects that the current requirements for filing application forms and prospectuses with the SFC for approval will continue to apply to the distribution of electronic prospectuses; that is, the application forms and prospectuses must be filed in paper form. It will also require issuers of electronic prospectuses to make paper prospectuses available to would be investors. Both forms should be identical. If electronic application forms are issued they should be accompanied by an electronic prospectus.

With regard to dealings in CISs (including mutual funds and unit trusts authorized by the SFC) via the internet, the SFC is of the view that an intermediary or fund manager should only accept an electronic application for CISs from investors who already maintain an account with them. Intermediaries or fund managers, who allow such aforesaid investors to deal in CISs over the internet, should ensure that proper account opening procedures have been followed to establish the client's full identity and, where appropriate, the client's financial situation, investment experience, and investment objectives. They should also ensure that their computer systems have sufficient operational integrity and, in particular, address issues of security and reliability.

The SFC also requires registered persons using the internet to conduct their business to include adequate risk disclosure statements in their Internet pages which contain references to the special risks of internet transactions such as transmission blackouts.

2.16 Future development

Consultation Paper on the Proposal to extend the application of the Codes to authorized REITs and SFO to listed CISs was issued by the SFC in January 2010.

The first part of the paper proposes changes to the REIT Code to require takeover and merger activities to be conducted in compliance with the Codes on Takeovers and Mergers and Shares Repurchases; to require the appointment and removal of management companies on a par with those applicable to directors of listed companies; and to clarify the regulatory requirements applicable to delisting of REITs. The second part of the paper proposes to extend the application of SFO to all listed CISs whatever form they take, with an exemption for listed open-ended CISs regarding disclosure of interests.

Another consultation Paper on Proposals to Enhance Protection for the Investing Public was issued by SFC in September 2009.

The paper proposes a number of enhancements to the regulation of the sale of retail investment products in response to issues highlighted by the early termination of Lehman products. The key enhancement proposals in the paper are listed out below.

Pre-sale disclosures

There is a proposed SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Products, which contains a revised Code on Unit Trusts and Mutual Funds, a revised Code on Investment-Linked Assurance Schemes; and a new Code on Unlisted Structured Products. Some of the proposed changes are as follows:

First, in order to further mitigate against conflicts of interest and to enhance transparency, there is a requirement for disclosures to customers at the pre-sale stage of commissions, fees, and other benefits receivable from product issuers for the sale of the products.

Second, to enable investors to better monitor their investments in a volatile market, it proposes to require additional ongoing disclosure to investors of material information in relation to unlisted structured products. Distributors of these products are also reminded of their obligations to pass on to ultimate investors the information they receive from the issuers.

Last, to provide a uniform statement of key facts to investors at the point of sale, it proposes to specify the minimum content to be provided in a sales disclosure document.

Regulation of intermediary conduct and selling practices

There are proposed amendments to Code of Conduct and Professional Investors Rules, such as restricting the use of gift offered to investors and audio recording of the sales process, etc.

Post-sale arrangements

To allow investors to change the mind within a short period after the initial investment decision, cooling-off period after sale is proposed for long-term investment products, provided that there is no ready and realistic secondary market. In these circumstances, the investors shall be refunded of their investment capital and corresponding sales commission less a reasonable administration charge and any legitimate market value adjustment.

The above are only some highlights of the changes. Please refer to the consultation paper for details:
http://www.sfc.hk/sfc/html/EN/speeches/consult/consult.html

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