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Securities and Futures Commission
35/F Cheung Kong Center
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Sent via email

5 September 2017

Dear Sirs

Consultation Paper on the Securities and Futures (Open-ended Fund Companies) Rules and the Code on Open-Ended Fund Companies

The Alternative Investment Management Association[1] ("**AIMA**") welcomes the opportunity to provide comments on the draft Securities and Futures (Open-ended Fund Companies) Rules ("**OFC Rules**") and the draft Code on Open-Ended Fund Companies ("**OFC Code**") contained in the consultation paper issued by the Securities and Futures Commission (the "**Commission**") on 28 June 2017. AIMA has been working for some years to promote the introduction of open-ended fund company ("**OFC**") legislation to establish Hong Kong as a successful domicile for private funds.

We appreciate the efforts of the Financial Services and Treasury Bureau and the Commission in working with AIMA on this ground-breaking initiative (as well as across a range of other matters). We are pleased to note that the draft OFC Rules and draft OFC Code take into account earlier feedback on, amongst others, a streamlined filing process, the ability to appoint overseas custodians and the ability to create multiple share classes.

However, we believe fundamental issues remain that will significantly limit the attractiveness of OFCs as a choice for private funds. Also additionally, whilst not within the remit of the Commission, the proposed exemption from profits tax contain a number of challenges and uncertainties that are likely to weigh against establishing a private fund in Hong Kong. We enclose for the Commission's reference a separate comment letter we have submitted

[1] AIMA is the global representative of the alternative investment industry, with more than 1,800 corporate members in over 50 countries. AIMA's fund manager members collectively manage more than US$1.8 trillion in assets. AIMA draws upon the expertise and diversity of its membership to provide leadership in industry initiatives such as advocacy, policy and regulatory engagement, educational programmes and sound practice guides. AIMA works to raise media and public awareness of the value of the industry. AIMA set up the Alternative Credit Council (ACC) to help firms focused in the private credit and direct lending space. References to AIMA in this letter incorporate the ACC. The ACC is the sole global trade association representing the interests of the private credit and non-bank finance participants in asset management. The ACC currently represents over 80 members that manage US$300 billion of private credit assets globally. AIMA is committed to developing skills and education standards and is a co-founder of the Chartered Alternative Investment Analyst designation (CAIA) – the first and only specialised educational standard for alternative investment specialists. For further information, please visit AIMA's website www.aima.org.

concurrently to the FSTB (copying the Inland Revenue Department) on this issue, and offering our views and perspectives on the tax matters relating to privately offered OFCs.

General comments

Our comments are offered primarily on behalf of our fund manager members who generally run private funds only, whose investors are institutions and professionals rather than retail investors.

In that regard, AIMA is concerned that the regime as proposed for private OFCs in Hong Kong will have extremely limited appeal to private fund managers and in turn will be hugely detrimental to Hong Kong's potential as a regional hub for privately offered funds.

The proposed requirements, taken as a whole, mean establishment and ongoing operation of a private OFC is likely to be more time consuming and more expensive than for fund vehicles in other domiciles that are typically used for private funds, whilst having less flexibility. In particular:

- The permitted investment scope for private OFCs is narrower than for fund vehicles in other domiciles that are typically used for private funds, such as the Cayman Islands (the jurisdiction most frequently used by Asian private fund managers for the domicile of their funds) and various other Caribbean jurisdictions, Luxembourg, Dublin, Malta, the Channel Islands, Bermuda, Gibraltar, Mauritius and Cyprus;
- The requirements for regulatory approval of the directors, the investment manager and the custodian, over and above satisfying minimum eligibility requirements, and for approval of various changes to a private OFC add an additional level of uncertainty, time and cost that compares unfavourably with other domiciles that are typically used for private funds; counterintuitively, some of the approval requirements are more onerous than for existing authorised funds under the Code on Unit Trusts and Mutual Funds;
- Timeliness to market is an important consideration for private fund managers, and the uncertainty about the time needed for regulatory approvals and the nature and extent of the review process compares unfavourably with other domiciles that are typically used for private funds;
- The requirement that the investment manager be licensed with the Commission for Type 9 regulated activity will decrease the attractiveness of OFCs to global fund management groups;
- The requirement for a single custodian does not reflect the common hedge fund model where 2 or more prime brokers may be appointed; in addition, requiring a custodian of a private OFC to meet the same eligibility requirements as under the Code on Unit Trusts and Mutual Funds will exclude the significant number of prime brokers that are not banks (even though they may be part of a wider banking group); and
- The proposed requirements for OFCs are significantly more onerous than for private unit trusts - a fund structured as a unit trust can be established in Hong Kong and marketed to professional investors without any registration, approval or other regulatory requirements (other than complying with the general offering restrictions for private funds).

The Hong Kong and Asian private fund sector is served predominantly by Cayman structures, which are valued for their speed and efficiency of establishment; their cost-effectiveness; their flexibility both in operation and investment scope; and their tax neutrality. The vast majority of Asian private fund managers are for the most part small businesses, for which cost, timeliness to market and flexibility are all critical considerations. Fund sizes in Asia tend to be on average considerably smaller than other regions.

AIMA feels strongly that the OFC regime as proposed creates unnecessary and costly impediments which would strongly deter Hong Kong and other Asian private fund managers from structuring their funds as OFCs.

It is instructive that few Asian fund managers have established European structures, even with the potential distribution benefits of the AIFMD passport, in large part because the perceived benefit is not considered justified by the additional cost, delay, and increased regulatory and compliance burden associated with an EU fund.

Responses to Questions in Consultation Paper

1. ***Do you have any comments on the suggested one-stop process for the establishment of an OFC? Please explain your view.***

   We welcome this approach. We note that timeliness to market is an important consideration for private fund managers. It is important that the one-stop process facilitates timeliness to market.

2. ***With regards to the suggested factors as to whether a proposed OFC name is "misleading or otherwise undesirable", are there other factors which you think should be taken into account? Please explain your view.***

   We agree with proposed paragraphs (a), (b) and (c) of chapter 4.5 of the OFC Code.

   For paragraph (a), "inconsistent with the nature, investment objectives or policy of the OFC", we would appreciate the Commission's confirmation that it is not the intention to require the name of an OFC to include its nature, investment objective or policy, and accordingly a name that is generic in nature and does not indicate any particular investment objective (e.g. the "Zebra Fund") would be acceptable.

   For paragraph (b), "substantially similar to the name of another OFC", we would appreciate the Commission's confirmation that the following common naming arrangements for private funds would be permissible:

   - XYZ Fund, XYZ Fund II, XYZ Fund II
   - XYZ Non-US Feeder Fund, XYZ US Feeder Fund, XYZ Master Fund

   Paragraphs (d) and (e) are unusual and we are unclear of the intent behind them. Most private funds would normally include the name of the sponsoring group / investment manager in the name. We would appreciate the Commission's confirmation that doing so would not be in breach of paragraphs (d) and (e).

3. ***Do you have any views on the proposals regarding the instrument of incorporation and the legal capacity of an OFC?***

   We agree with these proposals regarding the content of the instrument of incorporation and the legal capacity of an OFC.

   We disagree with the requirements of proposed chapter 13.1 of the OFC Code. The instrument of incorporation should be a "framework" document that sets out the broad powers of an OFC. Detailed provisions relating to pricing, dealing, valuation, distribution policy, use of leverage, fees and charges should only need to be set out in an OFC's offering documents.

   We believe it is sufficient that any alteration of a private OFC's instrument of incorporation is made in accordance with proposed Rule 14(2) of the OFC Rules. We believe including an additional requirement for approval by the Commission (as set out in proposed Rule 14(4) of the OFC Rules and chapter 12.2 of the OFC Code) will add an additional burden in time and cost that appears unnecessary where the requirements of proposed Rule 14(2) have already been met. We also note that this additional requirement compares unfavourably with other domiciles that are typically used for private funds.

4. ***What are your views on the proposed General Principles in the draft OFC Code as outlined above? Are there any other areas which you think the General Principles should cover?***

We note that:

(i) the directors of an OFC will be subject to statutory duties of care under s.122U of the Securities and Futures Ordinance (the "**SFO**");

(ii) the investment manager of an OFC, as a type 9 licensed entity, will be subject to the Code of Conduct and the Fund Manager Code of Conduct; and

(iii) the custodian of an OFC will be subject to statutory duties of care under s.112ZA of the SFO.

We are concerned that including the General Principles in addition to the above (and, in particular, the existing requirements imposed on the investment manager) creates the potential for confusion and conflict. We believe a better approach would be to remove the General Principles and instead (to the extent not already addressed by the above requirements) include provisions specific to the directors, the investment manager and the custodian in the other chapters of the draft OFC Code.

We also have the following specific comments and queries:

GP1 – Does the reference to "professionally" mean that the Commission expects individual directors to be professional directors?

GP3, GP4 – We propose the phrases "properly protected" (GP 3) and "properly disclosed" (GP 4) are replaced with "protected" and "disclosed", respectively. Addition of "properly" adds an element of subjectivity and uncertainty. It appears unnecessary given the duties of care to which the directors, the investment manager and the custodian are subject.

GP5 – The obligation to provide ongoing disclosure should be qualified to disclosure of information that is necessary for investors to be able to make an informed decision in relation to their continued investment in the OFC.

GP6 – It should be clarified that a key operator should only be responsible for compliance with regulatory requirements within its authority. The custodian will have a more limited role than the investment manager, which will in turn have a more limited role than the directors of an OFC. It is not practical to expect a custodian to ensure an OFC's compliance with all applicable regulatory requirements.

GP7 – This general principle may be problematic for custodians. A custodian of a private fund will typically be responsible for acting in accordance with the terms of the custodian agreement, but would not be subject to compliance with the constitutive or offering documents of the private fund.

5. ***Do you have any comments on the proposed requirements as to the eligibility, appointment and removal, and duties of the key operators of an OFC? Please explain your view.***

For private OFCs, whose investors are institutions and professionals rather than retail investors, we believe it is sufficient that a key operator fulfil minimum eligibility requirements, without an additional qualitative requirement for approval by the Commission. The requirements for the Commission's approval of the directors, the investment manager and the custodian, over and above satisfying minimum eligibility requirements, add an additional level of uncertainty, time and cost that compares unfavourably with other domiciles that are typically used for private funds.

Timeliness to market is an important consideration for private fund managers. The uncertainty about the time needed for regulatory approvals and the nature and extent of the review process compares unfavourably with other domiciles that are typically used for private funds

Private fund investors are able to independently determine whether they are comfortable with an OFC's corporate governance and board composition, and will have their own due diligence process which they will use to assess their investments. We fully support strong standards of corporate governance but believe that the existing common law framework provides sufficient protection to professional investors of the private funds space.

There is also the question of a level playing field with private unit trusts. We note that a fund structured as a unit trust can be established in Hong Kong and marketed to professional investors without any registration, approval or other regulatory requirements (other than complying with the general offering restrictions for private funds).

Directors

As stated above, we believe it is sufficient that the directors fulfil minimum eligibility requirements, without an additional qualitative requirement for approval by the Commission. We note that the Cayman Islands, for example, requires registration of directors but does not require that they be approved by the Cayman Islands Monetary Authority.

To the extent the Commission does make a qualitative assessment of the directors of an OFC, including the factors identified in the note to chapter 5.1 of the OFC Code, we recommend that a materiality threshold is included in relation to any breach of company, securities or financial markets laws or regulations.

We are uncertain how proposed Rule 100 of the OFC Rules will operate in practice and how an OFC would be able to demonstrate compliance. An OFC will act through its board of directors. Proposed Rule 100 appears to be saying, in effect, that the board of directors of an OFC must ensure that the board of directors is appropriate for the purposes of carrying on the business of the OFC.

It is not uncommon for private funds to be structured with different voting rights so that, for example, one class has the right to vote on the appointment and removal of directors, whilst the other classes have the right to vote on all matters other than the appointment and removal of directors. We note that proposed Rule 103(6) of the OFC Rules will prohibit such structures.

We note the register of directors will include information on the residential addresses of the directors and that shareholders in an OFC will be entitled to inspect the register and so obtain information on the residential addresses of directors. Whilst we acknowledge it is necessary for the Commission to have access to this information, we believe the potential loss of privacy of the individual directors that could result from making this information available to shareholders outweighs any benefit from doing so. It should be sufficient that shareholders can view information on who the directors are. If a shareholder wishes to correspond with a director, the shareholder can do so by sending correspondence to the registered office of the OFC, marked for the attention of the relevant director.

Investment manager

As stated above, we believe it is sufficient that an investment manager fulfil minimum eligibility requirements, without an additional qualitative requirement for approval by the Commission.

We note that the requirement that the investment manager be licensed with the Commission for Type 9 regulated activity will decrease the attractiveness of OFCs to global management groups.

We understand there is no restriction on the ability of the investment manager to delegate to third parties, either within or outside Hong Kong. We would appreciate the Commission's confirmation on this point.

We note that proposed chapter 5.3 of the OFC Code requires that the investment management functions of the investment manager should include valuation and pricing of the scheme property of the OFC. This proposal is inconsistent with the typical arrangements for private funds and with the requirements of institutional investors. Valuation and pricing is ultimately the responsibility of the board of directors. It is typically delegated to the fund's administrator. There is an inherent conflict in having the investment manager responsible for valuation and pricing, given that both its management and performance fees will depend on the fund's valuation. Accordingly, whilst the investment manager may have input into valuations, it will not be responsible for valuation and pricing.

Custodian

As stated above, we believe it is sufficient that a custodian fulfil minimum eligibility requirements, without an additional qualitative requirement for approval by the Commission.

The requirement for a single custodian does not reflect the common hedge fund model where, in order to reduce counterparty risk, 2 or more prime brokers may be appointed. The requirement for a single custodian also unnecessarily restricts the flexibility to appoint different custodians for different sub-funds of an umbrella OFC, and so reduces the attractiveness of establishing an umbrella OFC.

Typically, a custodian or prime broker would not take responsibility for assets of a private OFC that are entrusted to another custodian or prime broker. The requirement in proposed chapter 7.3 of the OFC Code that a custodian be responsible for "all" the assets of the OFC may have the consequence of forcing hedge funds to limit themselves to only one prime broker (if a prime broker is indeed presumed to be a custodian in this instance) or may increase custody fees for investors to the extent that one of the custodians will need to accept liability for the totality of the assets of a private OFC.

We do not agree with the proposed eligibility requirements for a custodian of a private OFC. Requiring a custodian of a private OFC to meet the same eligibility requirements as under the Code on Unit Trusts and Mutual Funds will exclude the significant number of prime brokers that are not banks (even though they may be part of a wider banking group).

We note that the requirements in proposed chapter 7.3 of the OFC Code go beyond what is required under the Code on Unit Trusts and Mutual Funds for authorised funds. In particular, the requirements under paragraphs (c) and (f) of chapter 7.3 of the OFC Code for a custodian to put in place "appropriate measures" for the verification of ownership of the assets of an OFC and to put in place "adequate risk management measures" to ensure it can properly carry out its functions are vague and unclear.

The requirement in proposed Rule 117 of the OFC Rules that a sub-custodian take reasonable care, skill and diligence to ensure the safe keeping of the property of an OFC entrusted to it is likely to be inconsistent with a number of global sub-custody arrangements and as a result is likely to narrow the range of custodians willing to act for, and increase the cost of custody for, private OFCs.

6. ***What are your views on the proposed persons and entities which may serve as the process agent of an overseas director and overseas custodian of an OFC?***

We agree with these proposals.

7. ***Do you have any views on the proposals concerning the shares, meetings and resolutions of an OFC discussed above?***

We believe that the proposals set out in Part 5 of the OFC Rules should apply in the absence of any provisions to the contrary in an OFC's instrument of incorporation, rather than overriding the OFC instrument of incorporation as currently set out in Rule 95. Private fund investors are able to independently determine whether they are comfortable with an OFC's corporate governance, including voting rights and shareholder meetings, and will have their own due diligence process (including with reference to AIMA's industry standard investor due diligence questionnaires) which they will use to assess their investments.

8. ***Do you agree with the proposed approach with regards to the filings with the CR? Please explain your view.***

We appreciate the Commission's proposals to streamline filings for OFCs. For simplicity of operation, we believe it would be preferable if all filings for OFCs are made with the Commission.

9. ***Do you have any views on the proposed eligibility, appointment and removal, and rights and powers of the auditors in the draft OFC Rules?***

We agree with these proposals.

10. ***Do you agree with the proposed requirements regarding the financial reports of an OFC? Please explain your view.***

We agree with these proposals.

We recommend that proposed chapter 9.2 of the OFC Code is amended to include US GAAP, in addition to HKFRS and IFRS.

We also recommend that the OFC Rules retain the flexibility for an umbrella OFC to adopt different accounting standards for different sub-funds.

11. ***Do you have any comments on the proposed provisions for the segregated liability of sub-funds and cross sub-fund investments? Please explain your view.***

We welcome these provisions.

12. ***Do you have any comments on the proposed draft OFC Rules regarding arrangements and compromises? Please explain your view.***

We query whether it is necessary for court approval of arrangements approved by shareholders of a solvent private OFC. Such court approval would appear to add significant additional time and cost, without material benefit for shareholders.

There is also the question of a level playing field with private unit trusts. We note that a unit trust established in Hong Kong can enter into a scheme of arrangement in accordance with the terms of its trust deed, without the need for court approval.

The definition of "arrangement" in Rule 160 of the OFC Rules would appear to include common structures used to ensure greater equity in allocating performance fees amongst shareholders, such as the consolidation of series shares following payment of a performance fee. Any decision to issue shares in series, and the intention to consolidate series shares following payment of a performance fee, would be with the intention of ensuring greater equity in allocating performance fees amongst shareholders and would disclosed to

shareholders in the offering documents of the OFC. Accordingly, we believe such arrangements should be carved out from the definition of "arrangement".

13. ***What are your views on the proposed requirements and steps for termination by application to the SFC?***

The proposed requirements in chapter 10 of the OFC Code indicate a qualitative review by the Commission of the board of directors' decision to terminate an OFC or a sub-fund. We disagree with the need for the Commission's prior approval of the solvent termination of a private OFC. It will add unnecessary time and expense. Investors in a private OFC will have assessed and agreed to the termination process offered by fund documentation. The proposed additional regulatory requirements will make the termination process more cumbersome, lengthy and expensive, to the ultimate detriment of shareholders.

14. ***Do you agree with the proposed approach to applying the C(WUMP)O's winding up regime to OFCs and the modifications suggested in the draft OFC Rules when applying the winding-up regime? Are there any other modifications which you think should be included? Please explain your view.***

We do not have any comments on the proposed approach.

15. ***Do you have any comments on the wording in the proposed OFC Code in respect of the investment scope of private OFCs? Please explain your view.***

We disagree with the proposed investment restrictions for private OFCs in chapter 11 of the OFC Code and believe that such restrictions will mean OFCs have extremely limited appeal to private fund managers.

Private OFCs must offer sufficient flexibility for investment into any asset class, subject only to the restrictions contained in their instrument of incorporation or offering documents. Many hedge funds and hedge/private equity hybrid funds may originate and/or invest in private companies, cash and currency forwards, contracts for differences; loan participations; asset-based lending, and other assets (or asset classes) which go beyond the narrow scope of securities, futures and OTC derivatives. Some of our members have originated and/or invest in timber funds, art funds, wine funds and crypto-currency funds. A 10% de minimis limit on investment in other assets is wholly inadequate.

If the investment restrictions as proposed are included in the OFC Code, a further provision should be included to permit temporary breaches due to events outside the control of the investment manager, such as market movements, large redemptions and the like.

16. ***Do you agree with the proposed approach and basic requirements concerning fund operations and disclosure by a private OFC? Do you think that there are other requirements that should be included in the proposed OFC Code? Please explain your view.***

We disagree with the requirements of proposed chapter 13.1 of the OFC Code. The instrument of incorporation should be a "framework" document that sets out the broad powers of an OFC. Detailed provisions relating to pricing, dealing, valuation, distribution policy, use of leverage, fees and charges should only need to be set out in an OFC's offering documents.

We recommend that the time period for filing changes to an OFC's offering document in chapter 13.4 of the OFC Code be change from "one week" to "seven business days". Doing so accommodates public holidays and is consistent with the time period within which a licensed corporation must file changes under s.4 of the Securities and Futures (Licensing and Registration) (Information) Rules.

17. Do you have any views on the proposed approach to the different types of scheme changes of a private OFC?

We believe it is sufficient that any alteration of a private OFC's instrument of incorporation is made in accordance with proposed Rule 14(2) of the OFC Rules. We believe including an additional requirement for approval by the Commission (as set out in proposed Rule 14(4) of the OFC Rules and chapter 12.2 of the OFC Code) will add an additional burden in time and cost that appears unnecessary where the requirements of proposed Rule 14(2) have already been met. We also note that this additional requirement compares unfavourably with other domiciles that are typically used for private funds.

We note the proposed requirement for shareholder approval of material changes to a private OFC (including its investment objectives and policy and its maximum leverage limit) imposes a higher standard on private OFCs than applies to authorised funds under the Code on Unit Trusts and Mutual Funds (which requires prior notice to investors, rather than approval).

We do not see any reason to impose a higher standard on private OFCs. We believe it is sufficient that an OFC give affected shareholders prior notice of any material changes and an opportunity to redeem prior to the changes taking effect.

We are grateful for the opportunity to comment on the draft OFC Rules and OFC Code and would be pleased to discuss our comments in further detail.

Yours faithfully,