

Issued on: 19 March 2016

Securities and Futures (Amendment) Bill 2016

Legislative Amendments to introduce an Open-ended Fund Company Regime in Hong Kong

We at HKIoD have pleasure in submitting views to the Bills Committee on the Securities and Futures (Amendment) Bill 2016. The Bill concerns legislative amendments to introduce an open-ended fund company regime in Hong Kong and related matters.

HKIoD previously commented on the subject matter in our 15 December 2015 submission in response to an invitation by the FSTB to comment on certain legislative proposals that precede the Bill, and in our 19 June 2014 submission in response to the Open-ended Fund Companies Consultation Paper (March 2014). We stand by the views presented in those submissions.

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To enable OFCs will enhance fund manufacturing capabilities

HKIoD supports the further development of Hong Kong as international financial centre. A stronger more diversified asset management industry is one key component to this direction. HKIoD agrees Hong Kong can benefit from more choices of legal forms of investment funds.

Hong Kong is currently already a major destination for fund distribution. To permit open-ended fund companies, or OFCs, should indeed enhance Hong Kong's fund manufacturing capabilities. This should mean more jobs for fund administration and fund servicing work, to add more variety to the sales and marketing job functions that now make up the asset management workforce.

The role of OFC directors

OFCs are like ordinary companies in that they have boards of directors. The fund directors oversee the management and operations of the company being the fund and have a fiduciary duty to represent the interest of the shareholders of the fund. Unlike ordinary companies, however, OFCs do not have operations in the ordinary sense. There are no employees and there are no assets other than the cash and investments it holds. A fund is typically externally managed. Fund directors oversee these service providers, most notably the investment adviser.

The differences between ordinary companies and that of OFCs define the role of fund directors. They are the watch dogs for the fund and its shareholders, to police conflicts of interests and compliance with rules and regulations.

There are some general eligibility requirements for appointment as director (e.g., body corporate not to act as director, minimum age to be director, undischarged bankrupt not to act as director except with leave, embodied in Section 112V, 112W and 112X, respectively). We concur with these requirements.

Should require majority independent out of a minimum of three directors

The Bill merely require a minimum of two directors. Section 112U refers. We take issue with this requirement.

The March 2014 Consultation Paper did require the “independence” of at least one director. Consultation Paper Para 44 refers. Director’s independence, however, appears to have not been mentioned in the present Bill. That may be because the issue of directors’ independence is considered a subject matter for the OFC Rules and/or OFC Code. The present Bill appears to be gearing towards a primary, enabling legislation with detailed operational and procedural matters to be set out in subsidiary legislation(s) (or OFC Rules) and an OFC Code to be published by the SFC. March 2014 Consultation Paper para 46, and Section 112ZL and 112ZR refers.

HKIoD believes the present Bill should put more focus on the role of OFC directors, and there are good grounds to require majority independent out of a minimum of three directors. Some key decisions to be taken by an OFC board should require majority independent vote. In our formulation, independence is key. The independent directors should have a control over the process for identifying and nominating OFC directors to ensure true independence. Independent directors should also set their own compensation, in order to ensure the independence.

Nonetheless, HKIoD recognises the utility of having interested directors on an OFC board. For an OFC to have at least one interested director who is employed or otherwise affiliated with the fund’s adviser may actually enhance the board’s effectiveness. The interested directors would have knowledge of the adviser’s operations. They could help foster open communication with the adviser and in turn, more direct accountability on the adviser’s part.

We believe “majority independent out of a minimum of three directors” is appropriate, suitable and ultimately beneficial to shareholders of an OFC.

Tools to perform, shields to protect

The Bill would stipulate that a director of an OFC owes the same fiduciary and other duties (e.g., the duty of reasonable care, skill and diligence) that are owed by a director of an ordinary company. Section 112U refers. We concur.

Yet, OFC directors should have the benefits of proper shields of liability in performing their duties. OFC directors need rules that will protect them when they make good faith business judgment and decisions. They should have the right to be indemnified from fund assets for liabilities (including legal expenses) incurred by them as defendants or witnesses in fund-related actions.

Funds tend to have a lesser likelihood for becoming insolvent, so indemnification generally affords good protection. But still, to cover situations where indemnity is not available or has become worthless, OFC directors should have available to them proper insurance coverage to protect themselves from liabilities.

OFC directorship involves complex and technical subject matters. Candidates should have a good measure of competence before taking office. They should be expected to continually upgrade and improve their skills and knowledge. There should also be widely-accepted and recognised reference guides to their conduct and behavior. HKIoD will be happy to work with the Administration, the SFC and other professional groups or organizations in these aspects.

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