Launching **Innovative Retail Investment Funds** in Hong Kong without SFC Authorization

It is commonly believed that an asset manager who wishes to offer an investment fund to the investing public in Hong Kong must seek authorization from the SFC. In this article, we challenge this belief and explore a possible new approach that may avoid SFC authorization altogether and open up new possibilities for asset managers to offer innovative investment funds that fall outside categories recognized by the SFC.

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Recent Articles

Asset managers and their legal advisers generally assume that investment funds (*e.g.* unit trusts) that are intended to be marketed to the investing retail public in Hong Kong must be authorized by the Securities and Futures Commission ("**SFC**") pursuant to one of the applicable codes issued by the SFC. Our research shows that this may not be so.

The Law

The Securities and Futures Ordinance ("**SFO**") expressly exempts "securities" from authorization by the SFC if the securities are listed on the Stock Exchange of Hong Kong ("**SEHK**") under the Rules Governing the Listing of Securities on the SEHK ("**SEHK Listing Rules**"). Interests in investment funds are securities. Accordingly, if interests in an investment fund are listed on the SEHK, SFC authorization is not required even if it is intended that those interests will be marketed to the investing retail public in Hong Kong.

SEHK Listing Rules

The SEHK Listing Rules in turn contemplate (and indeed for many years have contemplated) the listing of interests in investment funds on the SEHK without SFC authorization. However, the SEHK has not actively promoted itself as a destination for fund listings.

SEHK Listing Jurisdiction

The SEHK's passivity may arise in part because the SEHK power to list an investment fund in the absence of SFC authorization is limited. Under the Companies Ordinance ("**CO**"), the public offer of shares of a company requires SFC authorization. Pursuant to the Securities and Futures (Transfer of Functions – Stock Exchange Company) Order ("**SFTO**"), the SFC has delegated its power of authorization under the CO to the SEHK, meaning that if the SEHK grants a listing to shares of company, the SEHK may at the same time authorize the offer of the shares for the purposes of the CO.

However, the delegation arrangement specifically provides that the SEHK will have no authority to authorize the offer of shares of an investment fund. Thus, the SEHK may grant a listing of shares of an investment fund but cannot at the same time authorize the offer of the shares to the public as it would do in the case of other types of publicly listed companies. This only the SFC can do.

In our view, what is perhaps widely unrecognized is that the limitation under the SFTO on the power of the SEHK to authorize an offer to the public of shares of an investment fund applies only to offers where the interests of the investment fund being offered are shares of a company. Where the interests of the investment fund being offered are not shares of a company, SFC authorization of the offer is not required under the CO and hence, there is no need to have regard to the delegation arrangements under the SFTO. In the result, only the SFO applies to the offer and the SEHK should be able, by virtue of a grant of listing, to exempt the offer from SFC authorization requirements.

Advantages of Listing

In a normal application for SFC authorization of an investment fund, the SFC will require the investment fund to comply with one of its codes, such as the Code on Unit Trusts and Mutual Funds ("**Mutual Fund Code**").

SFC Authorization

A difficulty with complying with the SFC codes is that the codes are prescriptive. They establish specific requirements for specific fund categories. By definition however, innovative investment funds may not fall within these fund categories or may not substantially comply with the requirements of these categories. As a result, they may not be eligible for SFC authorization.

Whilst the SFC has announced that it is reviewing at least the Mutual Fund Code, it is not clear when the review will complete and what changes may arise from the review.

Listing Rules More Flexible

Thus, for the time being, a primary advantage of listing on the SEHK is that the SEHK Listing Rules are far less prescriptive than the SFC codes. The SEHK Listing Rules do not prescribe specific requirements for specific fund categories and indeed, do not contemplate specific fund categories at all. Instead, the SEHK Listing Rules are substantially disclosure based, placing greater emphasis than the SFC codes on disclosing material characteristics of a fund rather than prescribing particular characteristics of a fund.

Assuming therefore that the SEHK does not exercise its listing discretion narrowly, a listing on the SEHK may allow for the public sale of investment funds which otherwise would not qualify for authorization by the SFC under the Mutual Fund Code. Such a listing

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Basic Requirements

A successful listing of interests in an investment fund should meet 4 basic requirements.

Legal Form

As set out above, the first basic requirement is that the investment fund should be structured otherwise than as an investment company. This generally will mean that it should take the form of a unit trust.

A listing on the SEHK is most suitable where it is unlikely that the SFC would grant authorization of the fund and it is expected that there will be strong investor demand.

Key Parties

The second basic requirement is that the investment fund should have a suitable trustee and auditor and an investment manager that meets prescribed standards including as to corporate governance. Otherwise, the SEHK Listing Rules do not prescribe in detail the requirements for suitability. Thus, for example, unlike the SFC codes, they do not require the investment manager to be domiciled and regulated in pre-defined acceptable inspection regime jurisdictions.

Sponsor

The third basic requirement is that the investment product should be sponsored and supported, following listing, by a compliance adviser. In contrast, investment funds which are authorized by the SFC are not normally sponsored by a corporate finance house and do not require a compliance adviser to advise on their regulatory obligations following their launch.

A key role of the sponsor is to ensure that the investment product is suitable for listing. This is particularly important given the flexibility afforded in structuring the investment product.

Minimum Public Float

The fourth and final basic requirement is that the investment should generate strong investor interest. Under SEHK Listing Rules, a unit trust should have a minimum of 300 unit holders and no more than 50 per cent. of the units should be held by the 3 largest public shareholders.

Investment Objectives and Policies

As noted above, the SEHK Listing Rules require that all applicants for listing be suitable. Otherwise, they prescribe very few investment restrictions.

Types of Portfolio Assets

The SEHK Listing Rules provide considerable latitude in the composition of the investment portfolio of a listed unit trust. The rules expressly permit a listed unit trust to invest in:

- securities, whether listed or unlisted, including money market instruments, warrants and options,
- bank deposits,
- currencies, and
- commodities and futures contracts.

It is possible, though not clear, that a listed unit trust may invest in other property, such as real property. However, the SEHK Listing Rules restrict the unit trust from taking effective management control of underlying investments and in particular, prohibit the unit trust from controlling more than 30 per cent. of the voting rights in any one company.

Other Investment Restrictions

The SEHK Listing Rules require a reasonable spread of investments, which is generally interpreted to mean that the value of investments held by a listed unit trust in any one issuer should not exceed 20 per cent. of the net asset value of the unit trust at the time when the investment is made. The rules do not prescribe limits on leverage though they do require that the listed unit trust establish and disclose a ceiling on borrowings.

Marketing

The SEHK Listing Rules require that listed investment funds be marketed in compliance with the Mutual Fund Code. In light of recent changes to the Mutual Fund Code on advertising, it is not clear what effect this provision will have. This is particularly so given that the new advertising guidelines applicable under the Mutual Fund Code expressly apply only to investment funds authorized by the SFC.

Practical Challenges

The listing of a unit trust on the SEHK is likely to be most suitable where (i) it is unlikely that the SFC would grant authorization of the fund, and (ii) it is expected that there will be large existing investor base or strong investor demand for the fund both at the outset and over the longer term.

Cost

The cost of listing units of a unit trust on the SEHK are likely to be higher than the cost of obtaining SFC authorization both as a result of the requirement for a sponsor and the requirement for minimum public float.

Limited Regulatory Precedent

It is unclear to what degree the SEHK will be receptive or unreceptive to particular proposals for innovation and how the SEHK will construe its jurisdiction and interpret the relevant provisions of the SEHK Listing Rules. Equally, it is unclear how the SFC will respond to applications for listing of unit trusts which bear material similarities to products governed by one of its codes. ■

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