Chapter 21 Listings

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Introduction

Issue

- Whether there would be real interest in listing funds under Chapter 21
- If the Exchange were to implement relevant changes

What we will touch on:

- The background to Ch.21
- Possible changes to the current regime to attract more funds to list under the Ch.21 regime
- Comparable requirements in other fund jurisdictions
- The issues for discussion

Current Routes to Listing

- Ch.20 & Ch.21 Main Board Listing Rules

Chapter 20 Listings

- Listing of funds authorized by the Securities and Futures Commission (**SFC**)
- Subject to restrictions in the SFC's Code on Unit Trusts and Mutual Funds (the **UT Code**)
  - ***Investment restrictions***
    a) fund's holding of securities of any single issuer cannot exceed 10% of its total net assets (by value)
    b) a cap of 10% on the number of ordinary shares a fund can hold in any single issuer
    c) a cap of 15% of a fund's total net asset value on the value of its holding of securities that are not listed, quoted or dealt in on a market
  - ***Restriction on borrowing***
    a) a fund cannot borrow more than 25% of its total net asset value
- Excluding Real Estate Investment Trusts (REITS), all Ch.20-listed funds except one are open-ended, including many Exchange Trade Funds (ETFs) in Hong Kong

Chapter 21 Listings

- Not authorized by the SFC
- Not subject to the UT Code
- Cannot be marketed or offered to the public in Hong Kong
- Can be offered offshore or to “professional investors” in Hong Kong
- Securities and Futures Ordinances (SFO) definition of “professional investors” includes:
  - ***Institutional investors***
    - including banks, regulated intermediaries, pension funds, insurance companies, authorized funds etc.
  - ***High net worth investors***
    - individuals with a portfolio of at least HK$8 mln (or the foreign currency equivalent)
    - companies with a portfolio of at least HK$8 mln (or the foreign currency equivalent) or total assets of at least HK$40 mln (or its equivalent)

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Reasons for Listing under Chapter 21

Permanent Capital

- Closed to new capital
- Raised capital is not redeemable by investors

Increased Liquidity

- Tradable on secondary market in the Exchange
- But subject to restriction on board lot size

Transparency

- Ch.21 contains comprehensive disclosure requirements
- Scrutiny of the Exchange gives a stamp of respectability to funds from unregulated jurisdictions

Less Stringent Regulatory Requirements

- No need to be SFC-authorized or to comply with UT Code

Reasons for Listing under Chapter 21 (cont'd)

Less Restrictions on Investments

- 2 key restrictions
  a) reasonable spread of investments: value of investment in any one body must not exceed 20% of the fund's NAV at the date of investment (LR21.04(3)(b))
  b) a fund cannot, either alone or with any connected person, take legal, or effective, management control of its underlying investments and, in any event, must not own or control more than 30% of the voting rights in any single company or body (LR21.04(3)(a))

- Other Restrictions
  - no change in the investment objectives, policies and additional restrictions without prior shareholders' consent for 3 years after the initial listing (LR21.04(5))
  - a person cannot control more than 30% of the votes exercisable at any general meeting of the fund (LR21.04(4))
  - funds are allowed to adopt additional restrictions (eg. borrowing powers)

Reasons for Listing under Chapter 21 (cont'd)

Attraction of a Chapter 21 Listing

- "Technical listings" – for funds to be marketed outside Hong Kong
- Ch.21 listing will attract institutional investors whose investment mandates only permit investment in listed securities
- Some jurisdictions offer favourable tax treatment to investments in listed funds e.g. Japan

Restrictive Regime

- As at 5 February 2016, 165 ETFs were listed on the Exchange under Ch. 20
- Only 26 funds were listed under Ch.21 by the end of 2015
  - all but one are closed-ended
  - 1 listing under Ch.21 in the last decade
  - total turnover of HK$5.03 billion (0.04% of the market's) in 2013
  - total market capitalization of HK$12.57 billion (0.05% of the market's) in 2013
- Lack of interest due to restrictions imposed by Exchange Guidance Letter (HKEx-GL17-10) on Ch.21 Listings

Restrictive Regime (cont'd)

- Exchange's Guidance Letter HKEx-GL17-10 imposes restrictions to ensure Ch.21 funds marketed only to professional investors

	Restrictions imposed by Guidance Letter
Minimum Board Lot and Subscription Size	1) Funds must have a board lot size and minimum subscription size of at least HK$500,000 (subject to adjustment for special circumstances) 2) Intermediaries selling interests in Ch.21 funds must satisfy themselves that buyers are "professional investors" within SFO definition *A principles-based approach is allowed for intermediaries' determination of whether customers meet the qualification thresholds under the Professional Investor Rules* 3) The offering structure must be generally acceptable to the Exchange
Minimum Number of Shareholders	Ch. 21 fund must have at least 300 shareholders, unless a waiver is obtained. No waiver for a listed Chapter 21 company has been granted since 2004 (when required minimum no. of shareholders was increased to 300).

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Restrictive Regime (cont'd)

	Restrictions imposed by Guidance Letter
Minimum Market Cap.	Although Ch.21 funds not subject to market cap. requirement under Rule 8.09, in practice minimum market cap. must be HK$150 mln (because of required subscription size of HK$500,000 per placee and required minimum of 300 placees).
Prospectus Registration	Prospectus registration is not required, but where a fund proposes to register a prospectus, it must provide the Exchange with a submission from its sponsor & legal adviser on why the offering document is a prospectus Note: An offer of shares in a fund to the public requires both the fund and its listing documents to be authorized by the SFC and comply with Ch.20 of the Listing Rules
Conflicts of Interest	Where the executive director is involved in the management of other funds at the same time Internal control mechanism must demonstrate: ○ Directors have enough time and resources to manage the company ○ Confidentiality maintenance in accordance with professional standard ○ Disclosure of fair process of allocating investment opportunities between the company and other funds in a timely and equitable manner in the listing document

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Restrictive Regime (cont'd)

Criticism

- Regime remained more or less unchanged since introduction in 1989
- Unfavourable listing environment for funds compared to foreign exchanges, especially the Irish Stock Exchange (ISE) and Luxembourg Stock Exchange (LuxSE)

Minimum of 300 Shareholders Requirement

- Virtually impossible to achieve
- Questionable co-existence with Listing Rule 21.04 which exempts Ch.21-listed funds from compliance with minimum public float requirement set out in LR8.08(1)
- Guidance Letter contemplates possibility of derogation

Restrictive Regime (cont'd)

Share Price

- Trade at a discount to net asset value
    - reflects the fund's operational costs (often including the fund manager's annual fee and performance fee which are deducted before dividend payment)

Tax Treatment

<u>Profits Tax</u>

- Non-offshore Ch.21-listed fund has to pay HK profits tax
- SFC authorized funds are exempted from profits tax

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Restrictive Regime (cont'd)

Profits Tax (cont'd)

- Offshore fund may be exempt for:
  - specified transactions, including transactions from which the trading receipts do not exceed 5% of the total trading receipts from the specified transactions and incidental transactions combined; and
  - transactions conducted through or arranged by a specified person
- "Specified transactions": include transactions in securities (other than the shares or debentures of a private company)
- "Specified person": an entity licensed by the SFC as a licensed corporation, or an authorised financial institution registered as a registered corporation, to conduct regulated activities under Part V SFO

Stamp Duty

- Unlike ETFs listed under Ch.20, trades of Ch.21-listed shares are subject to stamp duty

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Restrictive Regime (cont'd)

Listing Process

- No streamlined application process in place - can be slow and costly
- Lack of recent listings - considerable uncertainty in application approval

Conflicts of Interest

- Often exist between the investment manager and the board of the investment company and between the investment company and the companies in which it invests
- Principal requirements under the existing regime:
  - at least 1/3 of a listed investment company's board must be made up of independent non-executive directors (INEDs);
  - the investment manager who must be licensed to conduct regulated activities Types 4 and 9 (advising on securities and asset management, respectively) must comply with the conflict of interest requirements of the SFC's Fund Manager Code of Conduct and the Code for Persons Licensed by or Registered with the SFC.

Disclosure Requirements

- The requirement to disclose investments only annually is considered to be insufficient

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Jurisdictional Comparison

Major competitors

- ISE and LuxSE – facilitate technical listings
- LSE, Euronext Amsterdam, NASDAQ and NYSE – popular with hedge funds

General Comparison

- LSE is the only exchange that operates a separate market segment – “Specialist Fund Market”
  - allows funds to be marketed only to “institutional, highly knowledgeable investors or professionally advised investors”
  - listing of large hedge funds, private equity funds and certain emerging market and specialist property funds
- ISE and LuxSE have listing regimes for funds marketed to professionals
  - ISE: “Qualified Investor Funds” (QIFs) regime
  - LuxSE: “Specialized Investment Funds” (SIFs) regime

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Comparison of HKEx, LuSE and ISE

	HKEx Ch. 21	LuxSE	ISE
Number of listed funds	26	13 listed SIFs	35 listed QIFs
Minimum number of shareholders	300	No required minimum	No minimum requirement
Minimum subscription amount	Minimum board lot size and subscription amount is HK$500,000	Minimum investment in SIFs is EUR 125,000 (HK$1.2 mln) if the investor is not an institution or professional	QIFs can only be marketed to Qualifying Investors who make the minimum subscription of EUR 100,000

Jurisdictional Comparison

	HKEx Ch. 21	LuxSE	ISE
Restricted marketing requirements	Ch.21 funds can only be marketed to "professional investors"	Open only to qualified investors: a) Institutional investors b) Professional investors c) Others who declare in writing that they're informed investors and either of the following: 1) Minimum investment of EUR 125,000, even in case of co-investment; 2) Appraisal from bank, investment firm/ management co. with an EU passport, certifying that they have the appropriate expertise, experience & knowledge to adequately understand the investment made in the fund	QIFs can only be marketed to "Qualifying Investors" (Annex II of MiFID) who must: a) be a professional client in accordance with MiFID; or b) receive an appraisal from an EU credit institution, MiFID firm or UCITS management company that he/she has appropriate expertise, experience and knowledge; or c) self-certifies that he/she has sufficient knowledge and experience to enable him/her to properly evaluate the investment or his/her business involves the management, acquisition or disposal of property of the same kind as the property of the QIF.

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Jurisdictional Comparison

	HKEx Ch. 21	LuxSE	ISE
Restricted marketing requirements (cont'd)		SIF must publish a prospectus which must comply with the EU Prospectus and Transparency Directives	Although QIF may only be marketed to professional investors as defined in the AIFMD, EU Member States can permit AIF to be sold to other categories of investors under domestic law
Minimum market capitalization	Minimum market cap. of HK$150 million because of the requirements for a subscription size of HK$500,000 per placee and a minimum of 300 shareholders	Minimum market cap. of EUR1,250,000 must be achieved within 12 months following approval by the CSSF (but only 5% of the subscribed share capital must be paid-in)	
Investment Manager conflicts	INEDs to comprise 1/3 of board and must be minimum of 3 INEDs	Required to comply or explain against conflict of interest provisions in corporate governance code	Minimum of 2 INEDs for funds domiciled offshore and all directors to be conflict free

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Jurisdictional Comparison

	HKEx Ch. 21	LuxSE	ISE
Investment Restrictions **Note: Exchanges in EU member states usually impose fewer additional requirements coz many rely on the robust regime created by various EU directives, e.g. Admission Directive, Market Abuse Directive, Transparency Directive**	Ch. 21 funds' restrictions: - a fund's holding of securities of any single issuer must not exceed 20% of its total net assets (by value) – although a waiver may be sought for a fund tracking an index with constituent stocks exceeding 10%; - cannot hold >30% of ordinary shares in any single issuer; and	No significant restrictions Risk diversification requirements (Circular CSSF 07/309): - SIFs cannot invest >30% of their net assets in securities issued by the same issuer, with exceptions - Short-selling is allowed but cannot result in SIF holding >30% of their net assets issued by the same issuer Derogation on a case-by-case basis	QIF local restrictions - minimal investment restrictions QIFs can invest in instruments traded on and off exchanges No significant investment restrictions AIFMD restrictions: - Funds cannot invest >50% of net assets in unregulated investment funds unless it has a min. subscription of EUR500,000 and prospectus identifies item-by-item QIF and AIFM obligations not applicable to underlying funds.

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Jurisdictional Comparison

	HKEx Ch. 21	LuxSE	ISE
Tax treatment		SIFs must pay an annual subscription tax 0.01% per year of the fund's NAV. The following are exempt from annual subscription tax: - The value of the assets represented by units held in other UCIs provided such units have already been subject to the subscription tax - Special institutional money market funds - Pension funds - SIFs investing in microfinance Management services provided to SIFs are exempt from VAT. No withholding tax and resident investors are only subject to Luxembourg income tax for capital gains and distribution of dividends.	

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Jurisdictional Comparison

	HKEx Ch. 21	LuxSE	ISE
Tax treatment (cont'd)		Non-resident investors are not subject to Luxembourg income tax when investing in Luxembourg UCIs. However, a withholding tax may be levied if the Savings Directive on taxation of savings income in the form of interest payments applies. Non-resident investors are not subject to Luxembourg income tax for gains derived from a substantial shareholder (>10%) & such transfer/liquidation takes place within 6 months of acquisition.	For investors, Irish tax at the rate of 41% must be deducted from all distributions, redemptions and proceeds of transfers paid to individuals who are Irish resident. Exemptions from this withholding tax are available for certain categories of Irish investors such as pension funds, life assurance companies and other Irish domiciled funds. Non-resident investors are exempted from both.

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Comparison of LSE's Main Market & SFM and NYSE

	NYSE	London Stock Exchange's Main Market and SFM
Application Time	12 – 16 weeks	12 – 24 weeks
Subscription Size	No significant restrictions NYSE has imposed rules on odd lot, with a board lot size of 100 units trading	No significant restrictions
Investment Restrictions	Maximum of 5% of first 75% of assets can be held in a single issuer	Spread of investments required for a premium listing No restrictions for SFM
Restricted Marketing	No restrictions	Premium listing: no restrictions SFM: Professional investors only

Jurisdictional Comparison

	NYSE	London Stock Exchange's Main Market and SFM
Minimum number of shareholders	No required minimum	Premium listing: 25% of issued shares must be publicly held SFM: no required minimum
Minimum market cap./asset size	None – unless meeting the global market cap. test of US$200 mln	Premium listing: GBP700,000 (HK$8.7 mln) SFM: no requirement
Board independence from investment manager	At least 40% of board must be independent	Premium listing: majority of board must be independent SFM: no requirement
Other Requirements for SFM		• currently, 40 funds listed on SFM • SFM funds must be closed-end • funds listed on the SFM must be transferable securities: • published prospectus valid for 12 months to allow for follow-on funding • no requirement (though good practice) for shareholder consent for material change to investment policy • annual report and accounts must be provided • must publish annual information update, ½ year report and interim management statements

Hong Kong Shanghai and Shenzhen Stock Connect

- mutual access to share trading on the Shanghai and Hong Kong stock exchanges commenced in November 2014 while mutual access between the Shenzhen and Hong Kong stock exchanges launched in December 2016
- the scheme is expected to be expanded in due course
- a framework for the mutual recognition of publicly offered funds between Hong Kong and the Mainland was launched in July 2015
- the number of Hong Kong-domiciled SFC-authorised funds has increased from less than 400 in 2011 to 700 in November 2016

Recent Developments

- Hong Kong is trying to position itself as the leading fund management centre in Asia:
  - In June 2016, the Securities and Futures (Amendment) Ordinance 2016 was gazetted which provides the legislative framework for the establishment of open-ended fund companies (OFCs) under a new Part IVA of the Securities and Futures Ordinance.
  - The aim of the new legislation is to attract more mutual funds and private funds to domicile in Hong Kong
  - In order to list under Ch. 20, these would however require SFC authorisation
- ***Key features of an Open-ended Fund Company***
- OFCs are investment vehicles and thus have greater flexibility than conventional companies. They are entitled to:
  - vary their share capital to meet investor subscription and redemption requests;
  - distribute assets out of share capital subject to solvency and disclosure requirements;
  - adopt an umbrella fund structure, allowing for sub-funds, where the assets of each sub-fund are managed in accordance with the investment objectives and policies specific to that sub-fund; and
  - take the form of a publicly or privately offered fund

Recent Developments

- ***Consultation on new OFC Rules and OFC Code***
- On 28 June 2017, the SFC launched a 2-month consultation on the detailed legal and regulatory requirements for OFCs
- The consultation sets out the SFC's proposed Securities and Futures (Open-ended Fund Companies) Rules and Code on Open-ended Fund Companies which include requirements relating to an OFC's formation, its key operators, ongoing maintenance, termination and winding-up
- Implementation of the new OFC regime is envisaged in 2018 following the conclusion of the consultation and completion of the legislative process

- Charltons' extensive experience in corporate finance makes us uniquely qualified to provide a first class legal service
- Charltons have representative offices in Shanghai, Beijing and Yangon
- Charltons was named the "**Corporate Finance Law Firm of the Year in Hong Kong** " in the Corporate Intl Magazine Global Award 2014
- "**Boutique Firm of the Year**" was awarded to Charltons by Asian Legal Business for the years 2002, 2003, 2006, 2007, 2008, 2009, 2010, 2011, 2012, 2013, 2014, 2015 and 2016
- "**Hong Kong's Top Independent Law Firm**" was awarded to Charltons in the Euromoney Legal Media Group Asia Women in Business Law Awards 2012 and 2013
- "**Equity Market Deal of the Year**" was awarded to Charltons in 2011 by Asian Legal Business for advising on the AIA IPO

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