

BRIEFING

Termination of Open-ended Fund Companies: Practical Issues and Considerations

The open-ended fund company (“**OFC**”) regime was introduced in Hong Kong in 2018 and has reached a stage of evolution where more OFCs have reached the point of termination, whether due to the expiry of the term of the fund or due to other reasons. This article seeks to explore the issues that arise when terminating a private OFC and offer practical guidance on the termination process. Whilst some requirements are set out in the relevant legislation as well as documents issued by the Securities and Futures Commission (“**SFC**”) (such as the Code on Open-Ended Fund Companies (the “**Code on OFCs**”), Frequently Asked Questions relating to Open-ended Fund Companies and the relevant Information Checklist), others are not set out explicitly and are encountered through our experience in handling termination of OFCs. It should be noted, although this article primarily describes termination of an OFC, termination of a sub-fund within an umbrella OFC (and not the entire umbrella OFC) is largely similar to termination of an OFC itself.

Procedures For the Termination of an OFC

Terminating an OFC involves two separate SFC procedures. Firstly, a termination proposal (the “**Proposal**”) must be submitted to the SFC. Under Chapter 10 of the Code on OFCs and the relevant Information Checklist, the Proposal must address several key matters: the rationale for terminating the OFC, an overview of the proposed procedures and expected timeline, and an explanation of the consequences of the OFC’s termination and how this will affect all investors (assuming there are still investors at the time of the submission of the Proposal to the SFC – see paragraph below). The Proposal must demonstrate that the procedures will be undertaken in an orderly manner. The OFC’s directors are required to conduct a full enquiry into the OFC’s affairs and provide a solvency statement confirming that the OFC can meet all its liabilities within 12 months from the date of the confirmation. They must also make a confirmation that the termination of the OFC is in the investors’ best interests and that an investor notice has been duly issued (once again assuming that there are still investors at the time of the submission of the Proposal to the SFC), and further that the Proposal complies with the OFC’s instrument of incorporation and offering documents. The SFC may raise requisitions and require amendments to the Proposal before approving the Proposal, after which the termination of the OFC may proceed according to the Proposal.

After the Proposal has been approved by the SFC, the procedures and timeline as stated in the Proposal can be carried out for the purposes of terminating the OFC. Thereafter, a termination

application should be submitted to the SFC for formal regulatory approval and termination and de-registration of the OFC (or termination of a sub-fund without cancellation of registration of the OFC in cases where the umbrella OFC and the other sub-funds are to remain registered). When the SFC is satisfied with the termination application, it will issue a formal letter of approval that specifies the effective date of (i) cancellation of registration of the entire OFC; or (ii) termination of the sub-fund, as the case may be.

Key Issue – Whether There are Investors in the Terminating OFC

A key question when submitting the Proposal to the SFC is whether there are investors in the terminating OFC. Several scenarios can arise:

1. There are no investors at the time the directors of the OFC determine to terminate the OFC;
2. There are investors at the time the directors determine to terminate the OFC, but at some point thereafter, there are no longer any investors in the OFC. Under this scenario, there is then a further question as to how the investors exit the OFC – whether their shares are compulsorily redeemed, or whether they redeem their shares voluntarily.

It is interesting to note that, based on the SFC's published materials on terminating an OFC, the overriding presumption is that the OFC still has investors at the time the directors of the OFC determine to terminate the OFC. This is perhaps based on the thinking that OFCs are mostly used as evergreen open-ended funds. Hence, for example, there is a requirement that the Proposal be submitted to and be approved by the SFC before the OFC's last trading date or operation date (the "**Last Date of Activity**"). However, it is not always the case that there are still investors at the time the directors of the OFC determine to terminate the OFC because (i) the OFC is a closed-end fund with a fixed life, and after the end of the life of the fund there are no longer any investors, with all investors having been compulsorily redeemed; (ii) the OFC never had any investors from the beginning due to failure to raise any capital; (iii) the investors all redeemed their shares voluntarily at some point; or (iv) due to other reasons.

Expectedly, the procedure through the SFC under scenario (1) is simpler than scenario (2) as described above. Understandably, where the directors of the OFC determine to terminate the OFC whilst there are still investors, the SFC would be concerned with a number of issues relating to how those investors are treated in the termination process, e.g. whether the investors are treated fairly, whether adequate notice has been given to them, whether the termination is in the investors' best interests or materially prejudicial to them, whether any potential conflicts of interest and risks are adequately managed and disclosed, etc. Relevant documentation or records may need to be provided at the SFC's request, such as investor notices, consents, and board resolutions authorising the termination.

Under scenario (2), in the event investors of the OFC are compulsorily redeemed and the OFC then proceeds to termination, the question arises as to whether compulsory redemption is a part of the termination process or whether compulsory redemption and termination of the OFC are two distinctive processes. If compulsory redemption is presented as a part of the termination process, then the SFC, once again understandably, would raise questions regarding the compulsory redemption procedures, for example, how those investors are treated, as noted in the paragraph above. If compulsory redemption is presented to the SFC as not being a part of the termination process and instead as a separate, earlier process, with the determination by the directors of the OFC to terminate the OFC being a separate decision occurring subsequent to the investors having all been redeemed, then those questions regarding how those investors are treated can be largely avoided on the basis that compulsory redemption is not a part of the termination process.

Practical Issues and Considerations in Terminating an OFC

Terminating an OFC involves several practical and regulatory considerations that require careful planning. Let us delve into some of the critical components of the termination process:

1. **Key milestone dates and proposed timeline:** When preparing the Proposal, a number of key milestone dates up to the termination application must be decided, such as the expected date of completion of the final audited accounts, the anticipated timeframe for the Inland Revenue Department (the “**IRD**”) to provide tax clearance, and the projected date of submission of the termination application to the SFC. To formulate a realistic timeline, the OFC’s accountants/auditors should be consulted in advance regarding the timeline and scope of preparation of management accounts and auditors’ report for the purposes of termination. It may also be useful to discuss with the OFC’s case officer at the IRD to facilitate obtaining tax clearance within the proposed timeframe.
2. **Audited final accounts:** The general principle is that the audited final accounts of the OFC must be prepared up to the OFC’s Last Date of Activity. When terminating an OFC, if its Last Date of Activity coincides with its financial year-end date, only the annual report of the OFC needs to be prepared; if this date does not coincide with the OFC’s financial year-end date, an additional set of audited accounts to cover the period from the last financial year-end date to the Last Date of Activity for the purposes of termination needs to be prepared. This similarly applies in the case of terminating a sub-fund where the sub-fund’s Last Date of Activity falls on a date other than the OFC’s financial year-end date — this means that an additional set of audited accounts of the sub-fund for the purposes of termination needs to be prepared to cover the period from the last financial year-end date to the Last Date of Activity.

3. **Tax clearance:** After the final audited accounts have been prepared, the OFC should submit to the IRD Form IR1263^[1] (or, in the case of terminating a sub-fund, write a letter to the IRD requesting a tax clearance letter). The submission should be accompanied by relevant financial documentation, including the OFC's final audited accounts and profits tax computation. If the OFC has conducted business and is a private fund, the IRD may issue a requisition within one month regarding the nature of assets held and certain information of investors (e.g. tax residence) for the purpose of assessing tax exemption eligibility and any round-tripping risks. A fund structure chart showing the OFC's share classes and service providers and profits tax return (if not already submitted for that year) may also be requested by the IRD. If the IRD is satisfied with the responses and no tax liabilities remain, it will issue a Notice of No Objection or a tax clearance letter.
4. **Costs and expenses:** In the Proposal, how the costs and expenses associated with terminating an OFC are allocated, say between the OFC and its investment manager, should also be addressed, taking into account the requirements set out in the OFC's instrument of incorporation and offering documents.

Concluding Remarks

Terminating an OFC is a relatively simple process and takes a shorter time to complete when compared to some other jurisdictions commonly used for funds. Increasing complexities and longer timeframes involved in some jurisdictions for the fund termination process are factors that should be considered when choosing a jurisdiction to domicile a fund at the fund formation stage. Although these considerations are often overlooked, these are additional compelling reasons to choose OFCs over funds domiciled in other jurisdictions.

For further details on how we can assist you, please contact us at: info@wbylawyers.com.hk.

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Ben Wong, Principal
Kimberly Yeung, Trainee Solicitor

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[1] Request under section 88B of the Inland Revenue Ordinance (Cap. 112) for a Notice of No Objection to a Company / Limited Partnership Fund being Deregistered