Chapter XX

HONG KONG

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I OVERVIEW OF RECENT ACTIVITY

At the end of a volatile year for global financial markets, amid asset market corrections and weak investment sentiment, Hong Kong's asset management and fund advisory business recorded a year-on-year decrease of 6 per cent to HK$16.447 trillion at the end of 2018. Similarly, looking at the industry on a wider level, Hong Kong's asset and wealth management business fell from HK$24.270 trillion to HK$23.955 trillion.[2]

Nonetheless, asset management continues to be a growing industry in Hong Kong. The number of corporations licensed for asset management (i.e., Type 9 regulated activity) grew 11 per cent in 2018, and the number of individuals licensed for asset management also increased 11 per cent in the same time frame.

Hong Kong continues to be the pre-eminent offshore renminbi centre, offering a range of renminbi financial products. Total outstanding renminbi deposits and certificates of deposit increased from 618 billion at the end 2017 to 658 billion at the end of 2018, although this figure still remains significantly below the record 1.16 trillion at the end of 2014. The number of licensed corporations and registered institutions established by Mainland-related groups in Hong Kong also increased 8 per cent from 334 as at 31 December 2017 to 362 as at 31 December 2018.[3]

The Securities and Futures Commission (SFC) has been pursuing initiatives to facilitate the development of Hong Kong as a competitive full-service asset and wealth management centre and a preferred place of fund domicile. Following the implementation of mutual recognition of funds (MRF) arrangements with the Mainland and five other markets, the SFC further expanded its MRF network to include the UK in October 2018, Luxembourg in January 2019 and the Netherlands in May 2019. The new open-ended fund companies regime took effect in July 2018. The SFC also relaxed the leverage cap for inverse products to a factor of two-times negative (-2x) and introduced active exchange traded funds via a revised Code on Unit Trusts and Mutual Funds. Enhanced conduct requirements were introduced

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2 All figures are taken from the Asset and Wealth Management Activities Survey 2018 issued by the SFC in July 2019 (Asset and Wealth Management Survey), where 'asset and wealth management business' comprises asset management, fund advisory business, private banking and private wealth management business, and SFC-authorised real estate investment trusts management business, each as defined in the Asset and Wealth Management Survey.

3 Asset and Wealth Management Survey.

in key areas such as securities lending and repurchase agreements, custody of fund assets, liquidity risk management and disclosure of leverage by fund managers. These took effect in November 2018.[4]

The number of Hong Kong-domiciled funds increased 4.1 per cent to 789 between 31 March 2018 and 31 March 2019.[5] However, the number of authorised collective investment schemes fell from 2,799 on 31 March 2018 to 2,797 on 31 March 2019. At the end of 2018 the total net asset value of SFC-authorised unit trusts and mutual funds stood at US$1.433 trillion.[6]

Going forward, Hong Kong looks set to continue to develop as a leading centre for the asset management industry for a number of reasons, including its rigorous but flexible and accommodating regulatory regime, its proximity to the mainland markets, its flexible tax regime and its world-class financial infrastructure.

II GENERAL INTRODUCTION TO THE REGULATORY FRAMEWORK

The principal source of regulation of the asset management industry in Hong Kong is the Securities and Futures Ordinance (SFO) and its subsidiary codes, guidelines and circulars, and the principal regulator is the SFC.

Retail funds in Hong Kong (funds offered to the Hong Kong public) must be authorised by the SFC, whereas non-retail funds generally structure and conduct themselves in such a manner as to avoid the need to be authorised, and thereby regulated, by the SFC. Unauthorised funds, whose investors are predominantly institutions, have an aggregate net asset value thought to be in excess of the figure for authorised funds, although this is hard to quantify in the absence of any obligation to file accounts.

Even where non-retail funds are able to avoid the requirement to be authorised, the regulatory regime generally requires their Hong Kong-based fund managers to be licensed by the SFC, whether they manage retail funds or non-retail funds.

The principal source of regulation in respect of both authorisation and licensing is the SFO, and the key codes are the SFC Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products, and the SFC's Fund Manager Code of Conduct.

i Authorisation by the SFC

The asset management structures utilised in Hong Kong and discussed below are collective investment schemes for the purposes of the SFO.[7] Under Section 103(1) of the SFO, it is an offence for a person to issue any advertisement, invitation or document that to his or her knowledge is or contains an invitation to the public to acquire an interest in or participate in any collective investment scheme unless the issue is authorised by the SFC under Section 105(1) of the SFO, or is exempted by any other relevant provision.

4 Asset and Wealth Management Survey.
5 Securities and Futures Commission, Annual Report 2018–2019.
6 These figures are taken from Table D3, SFC Market & Industry statistics.
7 As defined in Part 1 of Schedule 1 to the SFO.

A common way to structure a fund to avoid the requirement to be authorised by the SFC is by ensuring that the offer and marketing is not regarded as being made to the public.[8]

The meaning of 'to be given to the public' in the context of Hong Kong securities law has been the subject of much debate. Following previous market practice, the general consensus is that 50 persons (or fewer) in Hong Kong would not constitute the public. In 1991, an SFC working group also informally stipulated that, in order for a document or invitation not to be regarded as made to the public:

a not more than 50 copies of the offering document or invitation should be issued;
b each copy should be serially numbered;
c each copy should be individually addressed to a named person; and
d each copy should make clear that only the named addressee is entitled to take up the offer or invitation, and that he or she is not entitled to transfer his or her acceptance to any other person.[9]

Another common way to structure a fund so as to avoid the requirement to be authorised by the SFC is by offering and marketing the fund only to professional investors, for which Section 103(3)(k) of the SFO provides a specific exemption. The definition of professional investors includes:

a intermediaries (i.e., licensed corporations and registered institutions);
b authorised institutions or overseas banks;
c authorised insurers;
d governments;
e trust corporations with total trust assets of not less than HK$40 million (or its equivalent in foreign currency);
f corporations or partnerships with a portfolio of not less than HK$8 million (or its equivalent in foreign currency) or total assets of not less than HK$40 million (or its equivalent in foreign currency);
g high net worth individuals with a portfolio of not less than HK$8 million (or its equivalent in foreign currency);
h corporations that have as their principal business the holding of investments and are wholly owned by one or more professional investors; and
i holding companies that wholly own another corporation that is itself a qualified professional investor.

ii Licensing by the SFC

The requirement for a fund manager to be licensed under the SFO arises because the fund manager will be carrying on a business[10] in one or more of the following specified regulated activities:[11]

a Type 1: dealing in securities;
b Type 2: dealing in futures contracts;
c Type 3: leveraged foreign exchange trading;

8 As noted in an SFC Working Group report on offers of securities and other investments issued in December 1991.
9 ibid.
10 Section 114(1) of the SFO.
11 Part 1 of Schedule 5 to the SFO.

d Type 4: advising on securities;
e Type 5: advising on futures contracts;
f Type 6: advising on corporate finance;
g Type 7: providing automated trading services;
h Type 8: securities margin financing;
i Type 9: asset management;
j Type 10: providing credit rating services;
k Type 11: dealing in over-the-counter (OTC) derivative products or advising on OTC derivative products;[12] and
l Type 12: providing client clearing services for OTC derivative transactions.[13]

The general position under Hong Kong law is that if the fund manager is not performing any activities in Hong Kong it will not need to be licensed. However, the licensing provisions of the SFO can have extraterritorial effect where a person actively markets, to the public of Hong Kong, services falling within one of the regulated activities listed above.[14] Again, following previous market practice, the general consensus is that 50 persons (or fewer) in Hong Kong would not constitute the public for these purposes.

Given the diversity of activities that fund managers conduct, the type of licence required will vary from case to case and, for each regulated activity, there are exemptions from licensing that need to be looked at on a case-by-case basis. For example, a typical hedge fund manager will hold a licence only in respect of Type 9 (asset management) regulated activity.

In considering a licensing application, the SFC seeks, among other criteria, to ensure that managers are fit and proper and have adequate resources. Licensed persons are subject to, inter alia, continuing reporting obligations, restrictions on unsolicited calls, and obligations to pay annual fees, to submit annual returns and to manage risks prudently. Substantial shareholders, officers and any other person who is or is to be employed by, or associated with, a licensed corporation for the purposes of the regulated activity for which the application is made must also satisfy the fit and proper test.[15]

iii Other regimes

In addition to the SFO regime, other statutes, subsidiary codes, guidelines and circulars apply to specific sectors of asset management. For example, investment-linked assurance schemes (ILAS), which are discussed below, are life insurance policies issued by an insurance company, and are subject to both the SFO and the Insurance Ordinance.

A fund established in Hong Kong will also be subject to the rules and regulations applicable to its structure: for example, the Companies Ordinance, the Partnership Ordinance, the Limited Partnership Ordinance or the Trustee Ordinance.

12 Type 11 was added by the Securities and Futures (Amendment Ordinance) 2014. Type 11 has not yet come into operation. The SFC has recently issued a consultation to refine the scope of the regulated activity (see further Section VIII.ii).

13 Type 12 was added by the Securities and Futures (Amendment) Ordinance 2014. It came into partial operation on 1 September 2016. As with Type 11, the SFC has recently issued a consultation to refine the scope of the regulated activity.

14 Section 115(1) of the SFO.

15 Section 129 of the SFO.

Specific sectors of asset management also fall under the ambit of other regulators, in addition to being under the regulation of the SFC. For example, mandatory provident fund schemes (MPF schemes), which are discussed below, are regulated by both the Mandatory Provident Fund Schemes Authority (MPFA) and the SFC. Both regulators issue their own codes, and MPF schemes are expected to comply with both codes.

Funds listed on the Stock Exchange of Hong Kong Limited (SEHK) are also subject to the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited (Hong Kong Listing Rules).

III COMMON ASSET MANAGEMENT STRUCTURES

Various legal structures are used for the different sectors of asset management in Hong Kong.

Hedge funds managed from Hong Kong are commonly structured as companies or limited partnerships domiciled offshore in a tax-neutral jurisdiction such as the Cayman Islands. Far less often, they are structured as unit trusts constituted under trust deeds governed by Hong Kong law.

Most private equity funds managed from Hong Kong are also established in offshore tax-neutral jurisdictions such as the Cayman Islands, commonly as limited partnerships.

The majority of pension funds available to Hong Kong residents are in the form of MPF schemes (which are generally master trust schemes consisting of multiple constituent funds that are themselves invested in either feeder funds or portfolio managed funds) or Occupational Retirement Schemes Ordinance (ORSO) schemes, each of which is discussed below.

ILAS, which are utilised in insurance fund management in Hong Kong, are life insurance policies whose premiums are invested in underlying funds that can be offshore or onshore and of varying legal structure.

Real estate investment trusts (REITs) managed from Hong Kong are required to be structured in the form of a trust.

The SFC has developed a new framework for open-ended fund companies that offers the industry an additional choice of investment fund vehicle. This framework came into operation on 30 July 2018. Further information can be found in Section VII.iii.

IV MAIN SOURCES OF INVESTMENT

Hong Kong continues to be a preferred location for international investors. Contributions from non-Hong Kong investors accounted for 62 per cent of the non-REIT asset and wealth management business[16] in 2018.

Despite a significant fall from 2015 levels, the yuan currency remains a major source of investment in Hong Kong's asset management industry, with total outstanding yuan customer deposits and certificates of deposit of 658 billion yuan as at the end of 2018.[17]

16 Asset and Wealth Management Survey.

17 ibid.

V KEY TRENDS

The global financial crisis and subsequent market events have led to significant regulatory reform, with profound implications for the asset management industry in relation to issues such as:

a systemic risks;
b liquidity and risk management;
c enhanced custody requirements;
d securities lending and repos;
e conflicts of interest; and
f product design.

The SFC is looking at some of these issues closely with a view to further enhancing the regulation of the Hong Kong asset management industry and, in particular, is now focusing on the conduct of asset managers and intermediaries in relation to:

a commissions and independent advice;
b securities lending and repurchase agreements;
c safe custody of fund assets;
d liquidity management;
e disclosure of leverage by fund managers; and
f conflicts of interest in the selling of investment products.

The SFC is also focused on ensuring that the regulations governing public funds in Hong Kong align with international standards and market developments. For example, amendments to the Hong Kong Code on Unit Trusts and Mutual Funds (UT Code) took effect on 1 January 2019. The revised UT Code strengthens the requirements for key operators, providing greater flexibility and enhanced safeguards for funds' investment activities. These include enhanced risk management and collateral requirements as well as a 50 per cent limit for the net derivative exposure of 'plain vanilla' funds. Furthermore, the updates allow additional types of funds, including active ETFs, which is expected to significantly increase the number of ETFs registered in Hong Kong.

The market has seen the SFC taking a more robust approach in its inspection and enforcement actions. The SFC's regulatory reach has been extended by the *Tiger Asia* case,[18] which established that Hong Kong's High Court may (for remedial or protective purposes) determine market misconduct and make orders against persons located outside Hong Kong, allowing for the swift sanction of asset managers engaged in market misconduct. This enforcement avenue is in addition to the other enforcement mechanics set out in Parts XIII and XIV of the SFO.

VI SECTORAL REGULATION

i Insurance

Formerly, any company wishing to carry on insurance business in or from Hong Kong had to apply to the Office of the Commissioner of Insurance (OCI) for authorisation to do so under

18 *Securities and Futures Commission v. Tiger Asia Management LLC and others* [2013] 3 HKC 600; FACV 10/2012.

the Insurance Companies Ordinance. With the coming into effect of parts of the Insurance Companies (Amendment) Ordinance 2015 on 26 June 2017 the Insurance Authority (IA) took over the statutory functions of the OCI. The policy objectives of the establishment of the IA were to modernise the insurance industry's regulatory infrastructure to facilitate stable development of the industry, provide better protection for policyholders, and comply with the requirement of the International Association of Insurance Supervisors that insurance regulators should be financially and operationally independent of government and industry. Under the new regime, the requirements for authorisation include capital and solvency requirements, adequacy of reinsurance arrangements, as well as fit and proper requirements in relation to the directors and key persons (such as officers responsible for risk management, compliance, financial control, audit and actuarial functions) of the insurer. Once authorised, insurers remain subject to various requirements, including in relation to their investment in and the holding of assets.

The IA plans to take over the regulation of insurance intermediaries from the three self-regulatory organisations that currently exist in Hong Kong[19] and administer a statutory licensing regime by mid-2019.

ILAS

One of the key products used by insurance companies in Hong Kong are ILAS, which fall within the definition of Class C of Long-Term Business under the Insurance Ordinance[20] and are also classified as collective investment schemes under the SFO.

ILAS are life insurance policies whose premiums are invested in funds chosen by the policyholder, the benefits of the ILAS policy then being linked to the performance of those investment options. As of March 2019, there were 300 SFC-authorised ILAS.[21]

As noted in Section II, collective investment schemes, including ILAS, must fall within a relevant exemption under Section 103 of the SFO if it is to avoid the requirement to be authorised by the SFC. As ILAS will generally be marketed to the public in Hong Kong, it is unlikely that any of the exemptions will apply, and accordingly, insurers are generally required to seek authorisation for the marketing of ILAS.

The requirements for SFC authorisation of ILAS include the requirement that the insurer has obtained authorisation to carry on Class C of Long-Term Business;[22] detailed disclosure requirements for scheme documentation;[23] and requirements in relation to fees and charges.[24]

Ongoing requirements for authorised ILAS include reporting obligations and the requirement to seek prior authorisation from the SFC for any changes to the scheme materials, unless an exemption applies.[25]

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19 The three existing self-regulatory organisations are the Hong Kong Confederation of Insurance Brokers, the Professional Insurance Brokers Association and the Insurance Agents Registration Board established by the Hong Kong Federation of Insurers.

20 See Part 2 of the First Schedule of the Insurance Ordinance.

21 These figures are taken from Table D1, SFC Market and Industry statistics.

22 Paragraph 1.8 of the Code on ILAS.

23 Paragraphs 5.1 to 5.11 and Appendix A of the Code on ILAS.

24 Paragraphs 5.14 to 5.17 of the Code on ILAS.

25 Chapter 7 of the Code on ILAS.

The SFC has published guidance stating that insurers, corporate insurance brokers and insurance intermediaries engaging in promoting, offering or selling ILAS to the public, or who advise members of the public concerning ILAS, are not, by virtue of those particular activities, required to be licensed under the SFO for the purpose of advising on securities (i.e., Type 4 regulated activity) or dealing in securities (i.e., Type 1 regulated activity).[26]

ii Pensions

Retirement schemes in Hong Kong are governed primarily by ORSO and the Mandatory Provident Fund Schemes Ordinance (MPFSO). The MPFA is the primary regulator.

ORSO

ORSO, which became effective in 1993, does not impose a requirement on employers to provide a retirement scheme, but rather aims to ensure that occupational retirement schemes established voluntarily are properly regulated.

Schemes that are covered by ORSO are required to apply for either registration or exemption under ORSO. ORSO exemptions may be allowed for offshore schemes that are registered or approved by a recognised overseas authority, or for schemes with not more than either 10 per cent or 50 of their members, whichever is less, who are holders of a Hong Kong permanent identity card.

Whether registered or exempted under ORSO, such schemes are subject to certain ongoing requirements.

MPFSO

MPFSO, which became effective in 2000, imposes a requirement on employers to ensure that all relevant employees are members of a registered provident fund scheme, as well as ongoing requirements for such schemes.

When MPFSO was introduced, pre-existing ORSO schemes (whether registered or exempted under ORSO) were permitted to apply for an exemption from certain provisions of MPFSO.

Owing to the interaction of the ORSO and MPFSO regimes, retirement schemes in Hong Kong are usually ORSO schemes that are neither MPF-exempted nor MPF-registered (acting as a top-up or supplement to MPF); ORSO schemes that are MPF-exempted; or MPF-registered schemes.

iii Real property

Real property funds in Hong Kong are commonly in the form of REITs, which are considered collective investment schemes for the purposes of the SFO. As noted in Section II, a collective investment scheme, including a REIT, must fall within a relevant exemption under Section 103 of the SFO if it is to avoid the requirement to be authorised by the SFC. As REITs will generally be marketed to the public in Hong Kong, it is unlikely that any of the exemptions will apply.

26 SFC Circular Clarifying the Licensing Requirements arising out of the Promotion, Offering or Sale of Investment-Linked Assurance Schemes to the Public, 13 August 2009.

The SFC has issued a Code on Real Estate Investment Trusts (REIT Code) establishing authorisation and ongoing requirements for REITs. The REIT Code provides that an authorised REIT must have a trustee, a management company and a principal valuer to value the real estate held under the scheme, which are, in each case, acceptable to the SFC. It is also a condition for a REIT to be authorised that it will be listed on the SEHK within a period acceptable to the SFC. Once listed, a REIT is subject to the Hong Kong Listing Rules.

An SFC-authorised REIT may hold real estate located in Hong Kong or overseas, directly or indirectly, through special purpose vehicles that are legally and beneficially owned by the REIT.

The REIT Code imposes various ongoing requirements, including that at least 75 per cent of the gross asset value of the scheme must be invested in real estate generating recurrent rental income;[27] and the REIT is obliged to distribute to unitholders as dividends each year an amount not less than 90 per cent of its audited annual net income after tax.[28]

As of March 2019, there were 11 authorised REITs.[29]

iv Hedge funds

Hong Kong's regulatory regime does not provide a clear definition of a hedge fund, but the SFC takes the view that non-traditional funds that possess characteristics and utilise investment strategies that are different from traditional funds will generally be regarded as hedge funds.

As noted in Section II, a collective investment scheme, including a hedge fund, must fall within a relevant exemption under Section 103 of the SFO if it is to avoid the requirement to be authorised by the SFC. Most non-retail hedge funds structure and conduct themselves in such a manner as to avoid the need to be authorised by relying on these exemptions.

Authorisation of hedge funds

The UT Code is the applicable SFC code for authorised hedge funds, and contains a special section[30] that deals with collective investment schemes that are hedge funds. As well as ongoing requirements, the UT Code sets out the factors the SFC will consider in determining whether to authorise a hedge fund.

SFC-authorised hedge funds (whether local or foreign) can be marketed to the public in Hong Kong subject to a minimum subscription of US$50,000, or for funds of hedge funds, US$10,000.[31]

27 Paragraph 7.1 of the REIT Code.

28 Paragraph 7.12 of the REIT Code.

29 These figures are taken from Table D1, SFC Market & industry statistics.

30 Section 8.7 of the UT Code.

31 ibid.

Regulation of typical hedge fund activities

Certain activities typically carried out by hedge funds, whether authorised or not, are regulated, such as follows:

a there is a prohibition on on-exchange naked short-selling, unless exempted;[32]

b subject to certain limited exemptions contained in the Hong Kong Listing Rules, on-exchange covered short sales may only be effected in certain securities designated by the SEHK, and all such short-selling activities must be executed at or through the SEHK;

c the Securities and Futures (Contracts Limits and Reportable Positions) Rules prescribe limits and reporting positions applicable to futures contracts and stock options contracts traded on the SEHK or the Hong Kong Futures Exchange Limited;

d if a hedge fund is interested in more than 5 per cent of voting shares in a corporation listed on the SEHK, it has an obligation to make a disclosure that arises upon the occurrence of certain relevant events, including the crossing of certain percentage threshold positions and a change in the nature of their interest in the shares. Short positions also need to be disclosed; and

e the Securities and Futures (Short-Position Reporting) Rules set out additional short-position disclosure requirements. A short-seller will need to compute his or her short position in certain listed shares on the SEHK at the end of the last trading day of each week to determine whether it amounts to, or exceeds, 0.02 per cent of the issued share capital of that particular listed company, or the value of the short position amounts to or exceeds HK$30 million, whichever is lower. If the short position amounts to or exceeds such threshold, then the gross short position must be reported to the SFC.

Following a consultation on the scope of the short-position disclosure regime, the SFC extended disclosure requirements to all securities that can be short sold under the rules of the SEHK in March 2017.

Listing

It is possible for a hedge fund to be listed on the SEHK. An authorised hedge fund's listing on the SEHK would follow Chapter 20 of the Hong Kong Listing Rules. An unauthorised hedge fund's listing on the SEHK would follow Chapter 21 of the Hong Kong Listing Rules.

v Private equity

Private equity funds are generally not regulated as a specific class of investment. However, as noted in Section II, the SFO regulates the authorisation and operation of collective investment schemes, which are broadly defined and can include private equity funds. However, private equity funds will generally structure and conduct themselves so as to avoid the need to be authorised, and so regulated, by the SFC, by relying on the exemption for offers made only to professional investors.

Under the SFO, a private equity fund's promoter, principals and manager need to be licensed if they carry out a regulated activity in Hong Kong. The most relevant regulated activity for private equity fund managers is dealing in securities (Type 1), advising on

32 Unless exempted under Section 170(3) of the SFO, naked short selling is prohibited under Section 170(1) of the SFO.

securities (Type 4) and asset management (Type 9). In practice, the licensing requirements mainly concern the fund manager who manages and carries out investment activities for the fund.

Acquisitions by private equity funds of companies listed on the SEHK or stakes in such companies are fairly common, and are governed by various laws, regulations, or both, including the Companies Ordinance, the Hong Kong Codes on Takeovers and Mergers and Share Buy-backs and the Hong Kong Listing Rules.

As described in Section VII.i, the government has introduced extensions to the profits tax exemptions that are expected to attract more private equity funds to Hong Kong.

vi Other sectors

Retail unit trusts and mutual funds

A large part of the retail asset management market in Hong Kong is in the form of non-specialised unit trusts and mutual funds (both of which fall within the meaning of collective investment scheme under the SFO) authorised by the SFC. The majority of such retail funds (by both number and net asset value) are equity funds and bond funds (there being 1,005 and 474 respectively as at 31 March 2019).[33]

Retail funds that are mutual funds or unit trusts are subject to the general regulatory framework noted in Section II, and to the provisions of the UT Code.

ETFs

The ETF segment is one of the fastest-growing segments in the asset management industry in Asia, and Hong Kong is at the forefront of this trend, with 115 ETFs listed on the SEHK as of 31 March 2019.[34]

As noted in Section II, a collective investment scheme (including index funds such as ETFs) that is offered to the Hong Kong public must be authorised by the SFC unless a relevant exemption under Section 103 of the SFO can be relied upon. To be authorised, ETFs are expected to comply with the relevant provisions of the UT Code,[35] which also provides ongoing requirements for authorised schemes.

The SEHK provides a listing avenue for authorised ETFs under Chapter 20 of the Hong Kong Listing Rules, and is responsible for overseeing their compliance with the Hong Kong Listing Rules.

Streamlined process for certain ETFs listed overseas and waiver of stamp duty

Overseas ETFs that meet the core structural and operational requirements set out in the UT Code, and that are regulated in an acceptable ETF regime that has comparable or similar regulatory principles as those set out in the UT Code, may seek SFC authorisation by way of a streamlined recognition process.[36]

33 These figures are taken from Table D2, SFC Market and Industry statistics.

34 These figures are taken from the Securities and Derivatives Markets Quarterly Report (first quarter 2019), issued by Hong Kong Exchanges and Clearing Ltd.

35 Being the Guidelines for regulating index tracking exchange traded funds at Appendix I, and the requirements set out in Chapter 8.6, of the UT Code.

36 Guidelines for regulating index tracking exchange traded funds at Appendix I to the UT Code.

Since February 2015, a stamp duty waiver has been in effect for trading in ETF shares or units that are listed or traded on the SEHK, as a means to lower transaction costs and further promote the growth of the ETF market.

Leveraged and inverse products, crude oil futures ETFs

Adding to the diversity of the products in Hong Kong's ETF market, in June 2016 the SFC authorised the first batch of leveraged and inverse products structured as ETFs. From 9 January 2017, the SFC accepts applications for the authorisation of leveraged and inverse products that track liquid and broadly based Hong Kong and non-mainland foreign equity indices. The SFC has also stated that it is willing to consider, on a case-by-case basis, the authorisation of funds tracking non-equity indices, provided that they meet the relevant requirements of the UT Code. As of March 2019, 22 leveraged and inverse products were listed on the SEHK.[37] In 2016, the SFC also authorised the first crude oil futures ETF and the first ETFs with multiple trading counters. In 2019, the SFC relaxed the leverage cap for inverse products to a factor of two-times negative.

VII TAX LAW

Hong Kong has three separate types of income tax: property tax, salaries tax and profits tax. Of the three income taxes, profits tax is the most relevant to asset management funds, their investment managers and their investors. Unlike many other jurisdictions, Hong Kong does not have a separate capital gains tax regime.

Hong Kong stamp duty is chargeable on certain transactions.

i Profits tax – funds

Hong Kong adopts a territorial source principle of taxation.

Under the Inland Revenue Ordinance, profits tax is charged on people carrying on a trade, profession or business in Hong Kong; and in respect of income profits (and excluding capital gains profits) arising in or derived from Hong Kong from that trade, profession or business.

On 29 March 2018, the Inland Revenue (Amendment) (No. 3) Ordinance was gazetted, introducing a two-tier tax regime. For the years of assessment from 2018–2019 onwards, the applicable rate of profit tax for corporations is 8.25 per cent for the first HK$2million of profits and 16.5 per cent for profits over HK$2million. The application of the two-tiered rates is restricted to only one enterprise nominated among connected entities.

Carrying on a trade, profession or business in Hong Kong

A low threshold is required to fall within the scope of carrying on a trade, profession or business in Hong Kong.

In some cases, a non-Hong Kong resident fund, by using a Hong Kong investment manager, may be regarded as falling within that scope. The non-Hong Kong resident funds exemption referred to below was introduced to alleviate this concern.

37 These figures are taken from the Securities and Derivatives Markets Quarterly Report (first quarter 2019), issued by Hong Kong Exchanges and Clearing Ltd.

Note that the locality of a fund's central management and control is not a determinative factor when considering whether it carries on a trade, profession or business in Hong Kong.

Income arising in or derived from Hong Kong

If the above test of carrying on a trade, profession or business in Hong Kong is satisfied, profits tax will (subject to exemptions) be chargeable if the income arises in or is derived from Hong Kong. This is a factual question that is determined by looking to see what the taxpayer has done to earn the relevant profit. A test often applied in difficult cases is where the operations take place from which the profits in substance arise. Note that the place where a taxpayer's profits arise is not necessarily the place where he or she carries on business.

Inland Revenue Department guidelines and case law assist in determining the locality where income arises or is derived from. Two principles relevant to funds are as follows:

a listed shares and other securities: profits from the sale of listed shares and other securities arise at the location of the stock exchange where those shares and other securities in question are traded; and

b unlisted shares and other securities: profits from the sale of unlisted shares and securities arise at the place where the contracts of sale and purchase are effected (regardless of where the relevant issuer is incorporated or carries on business).

Exemptions to profits tax

Publicly offered or authorised and regulated funds

The following types of fund are exempt from profits tax:

a mutual funds, unit trusts and similar investment schemes that are SFC-authorised (and thus available for general distribution to the Hong Kong public); and

b other mutual funds, unit trusts and similar investment schemes where the Commissioner of Inland Revenue is satisfied that the relevant fund is (1) bona fide widely held and (2) complies with the requirements of an acceptable non-Hong Kong supervisory authority. Further details on how the Commissioner of Inland Revenue applies (1) and (2) are set out in the Inland Revenue Departmental Interpretation and Practice Notes.[38]

Privately offered funds

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 came into effect on 1 April 2019, unifying the profits tax exemptions for privately offered funds so that they apply (for transactions in specified assets and subject to meeting certain conditions) equally to onshore and offshore funds, irrespective of their structure, location of central management and control, size or the purpose they serve, and to investments in both local and overseas private companies.[39]

38 Practice Note No. 20 (Revised) – Mutual Funds, Unit Trusts and Similar Investment Schemes.

39 The unifying changes therefore include the repeal of the recently introduced profits tax exemption for Hong Kong incorporated open-ended fund companies (OFCs), as well as amending the existing profits tax exemption for non-residents to carve out entities falling within the new definition of 'fund' in the Inland Revenue Ordinance (which is largely similar to the definition of 'collective investment scheme' in the SFO).

If an entity falls within the new definition of 'fund' in the Inland Revenue Ordinance, then its 'qualifying transactions' and transactions incidental thereto ('incidental transactions'), or in the case of Hong Kong incorporated open-ended fund companies (OFCs) all of its transactions, will be exempt from profits tax, provided:

a the fund is a 'qualified investment fund';[40] or

b the qualifying transactions are carried out in Hong Kong by a 'specified person' (being a corporation licensed by or a financial institution registered with the SFC), or arranged in Hong Kong by a specified person.

The above exemption does not apply to assessable profits earned from incidental transactions if the fund's trading receipts from incidental transactions in a given tax year exceed 5 per cent of the total of the fund's trading receipts from qualifying transactions and incidental transactions in such tax year.

'Qualifying transactions' include:

a shares, stocks, debentures, loan stocks, funds, bonds or notes of, or issued by, a company (whether public or private);

b futures contracts;

c foreign exchange contracts under which the parties to the contracts agree to exchange different currencies on a particular date;

d deposits other than those made by way of a money-lending business, deposits made with a bank and certificates of deposit;

e exchange-traded commodities;

f foreign currencies;

g OTC derivative products; and

h an investee company's shares co-invested by a partner fund and the Innovation and Technology Venture Fund Corporation (ITVFC) under the Innovation and Technology Venture Fund (ITVF) Scheme.[41]

A key feature of the new profits tax exemption is the removal of the tainting features of the previous regime, such that the tax-exempt profits of a fund are not tainted even if such fund is taxed on its non-qualifying transactions.

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40 A 'qualified investment fund' means a fund that falls within the following descriptions:
(a) at all times after the final closing of sale of interests:
(i) the number of investors exceeds four; and
(ii) the capital commitments made by investors exceed 90 per cent of the aggregate capital commitments; and
(b) the portion of the net proceeds arising out of the transactions of the fund to be received by the originator and the originator's associates, after deducting the portion attributable to their capital contributions (which is proportionate to that attributable to the investors' capital contributions), is agreed under an agreement governing the operation of the fund to be an amount not exceeding 30 per cent of the net proceeds.

41 The ITVF aims to stimulate private investment in local innovation and technology (I&T) start-ups in Hong Kong. The ITVFC has been set up to serve as a special-purpose vehicle for co-investing with venture capital funds selected as co-investment partners (CP) in local I&T start-ups at a matching investment ratio of approximately 1:2. ITVFC acts as a passive investor, making direct investment in the start-ups concurrently with the CPs upon invitation of the CP.

The new exemption is available not only at the fund level, but also to special purpose entities (SPEs) set up by the fund for the sole purpose of holding and administering investments in private investee companies, to such extent as corresponds to the percentage of shares or interests that the fund holds in the SPE.

Certain measures have also been introduced to minimise the risk of tax evasion, including:[42]

a in respect of any private company in which a fund invests (other than a private company which directly or indirectly holds immovable property in Hong Kong, or share capital in another private company that directly or indirectly holds immovable property in Hong Kong), the profits tax exemption will not be available to the fund in respect of its investment in the company unless one of the tests below is satisfied:
- the fund holds its investment in the company for at least two years (the holding period test);
- the fund does not have control over the company (the control test); or
- the company holds (directly or indirectly) short-term assets the aggregate value of which does not exceed 50 per cent of the value of the company's assets (the short-term assets test); and

b in respect of any private company in which a fund invests which directly or indirectly holds immovable property in Hong Kong, or share capital in another private company that directly or indirectly holds immovable property in Hong Kong:
- if the aggregate value of such immovable property and share capital held by the private company exceeds 10 per cent of the value of its assets, then the profits tax exemption is not available to the fund in respect of its investment in the company; and
- if the aggregate value of such immovable property and share capital held by the private company is equal to or less than 10 per cent of the value of its assets, then the profits tax exemption will not be available to the fund in respect of its investment in the company unless the holding period test, the control test or the short-term assets test is met.

ii Profits tax – investors

The same general principles of profits tax discussed above in respect of funds also apply to the taxation of investors.

An investor, however, typically holds investments for investment purposes (rather than as part of a trade, profession or business). In such a case, profits or income derived from his or her investments fall outside the charge to profits tax. In addition to the above, specific exclusions may also apply, in particular, an investor's gain from disposing of shares or units in a fund will usually be a capital gain (and therefore fall outside the charge to profits tax); and dividends received by an investor are not chargeable to profits tax.[43]

42 The anti-round tripping provisions relating to the existing profits tax exemption for non-residents (which continues to apply to entities that do not fall within the new definition of 'fund' in the Inland Revenue Ordinance, as described in footnote 39) have also been retained to prevent a person resident in Hong Kong from using the exemption to shelter otherwise taxable profits through such a non-resident entity that is not bona fide widely held.

43 Encyclopedia of Hong Kong Taxation, Volume 3, II 5811–5850.

iii Profits tax – fund managers

The same general principles of profits tax discussed above in respect of funds and investors also apply to the taxation of fund managers.

iv Double taxation agreements

As of 12 July 2019, Hong Kong had comprehensive double taxation agreements with Austria, Belarus, Belgium, Brunei, Canada, China, the Czech Republic, Finland, France, Guernsey, Hungary, India, Indonesia, Ireland, Italy, Japan, Jersey, Kuwait, Latvia, Liechtenstein, Luxembourg, Malaysia, Malta, Mexico, the Netherlands, New Zealand, Pakistan, Portugal, Qatar, Romania, Russia, Saudi Arabia, South Africa, South Korea, Spain, Switzerland, Thailand, the United Arab Emirates, the United Kingdom and Vietnam. Hong Kong had also signed such an agreement with Cambodia, but it had not entered into force. The terms set out in double taxation agreements take precedence over the other provisions of the Inland Revenue Ordinance.[44]

v Stamp duty

Stamp duty is chargeable on transfers of real property, the issue of certain bearer instruments and the transfer of Hong Kong stock. In practice, stamp duty on Hong Kong stock is usually chargeable with respect to shares in Hong Kong incorporated companies or companies listed on the SEHK.

Although stamp duty may be chargeable on unit trusts, bonds and bearer instruments, these are often structured so as to fall outside the charge of stamp duty. Stamp duty is not chargeable on redemptions of shares. Stamp duty is also not chargeable on trading in ETF shares or units that are listed or traded on the SEHK.

The current rate of stamp duty chargeable on the transfer of shares in a Hong Kong incorporated or an SEHK-listed company is 0.2 per cent of the consideration for (or, in the case of gifts, the value of) the shares.

VIII OUTLOOK

i Cooperation arrangements with the mainland and other jurisdictions

Hong Kong is expected to develop further its role as an offshore yuan business centre, with the SFC continuing to promote offshore yuan-denominated investment products in Hong Kong. There is widespread mainland governmental support for using Hong Kong as a platform to further the liberalisation of the yuan, evidenced by recent policy initiatives, including the formation of a working group with the SFC to study the implementation of mutual recognition and cross-border offering of funds between Hong Kong and the mainland aiming to bring about a wider investment platform for both jurisdictions in terms of more product offerings and a bigger investor base. The Shanghai–Hong Kong Stock Connect was launched in 2014 as a two-way arrangement under which Hong Kong and international investors can directly access the mainland A-share market, and mainland investors can directly access Hong Kong's stock market. The Shenzhen–Hong Kong Stock Connect was established in December 2016. Its structure and rules mirror that of the Shanghai–Hong Kong Stock Connect. The CSRC and SEHK announced that from May 2018 the daily quota under the Stock Connect

44 Section 49 of the Inland Revenue Ordinance.

would be quadrupled. As of 31 March 2019, Stock Connect covered 1,321 mainland stocks and 479 Hong Kong stocks. The stock exchanges have also announced that, from July 2019, dual-class shares will be included on Stock Connect.

Under the Mainland–Hong Kong MRF initiative, the CSRC and the SFC allow mainland and Hong Kong funds that meet the relevant eligibility requirements to follow streamlined procedures to obtain authorisation or approval for offering to retail investors in each other's market. The CSRC and the SFC have respectively prepared the 'Provisional Rules for Recognised Hong Kong Funds' and 'Circular on Mutual Recognition of Funds between the mainland and Hong Kong', which set out the eligibility requirements, application procedures, operational requirements and regulatory arrangements of the MRF. It is envisaged that this initiative will further promote Hong Kong's development as a fund management hub and fund domicile. As of 31 March 2019, the SFC has authorised 50 mainland funds and the CRSC has approved 19 Hong Kong funds under the MRF scheme.[45]

Mainland-related licensed firms are expected to play an even more significant role in Hong Kong, and it is predicted that the range of yuan-denominated retail investment products managed by mainland-related licensed firms will grow significantly in future years.

Following the successful implementation of the MRF, the SFC announced it would further explore cooperation arrangements in asset management with other overseas authorities. Since October 2018, the SFC has signed memorandums of understanding with the UK Financial Conduct Authority, the Luxembourg Commission de Surveillance du Secteur Financier and the Netherlands Authority for the Financial Markets. The agreements allow eligible Hong Kong public funds and the respective foreign funds to be distributed in the other's markets through a streamlined process. The SFC is continuing to explore MRF arrangements with other overseas jurisdictions.

ii Regulation of OTC derivatives

In April 2014, the Securities and Futures (Amendment) Ordinance was enacted, introducing a new regulatory regime for OTC derivatives in Hong Kong. The regime provides a framework for mandatory reporting, clearing, trading and record-keeping obligations in respect of OTC derivative transactions, and introduces the new regulated activities of dealing in and advising on OTC derivative products (Type 11 regulated activity), and providing client clearing services for OTC derivative transactions (Type 12 regulated activity), and also expands Type 9 (asset management) and Type 7 (providing automated trading services) to cover OTC derivative transactions.

The regime is being implemented in phases. In July 2015, the Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules (OTC Rules) brought into effect mandatory reporting and related record-keeping obligations for certain interest rate swaps and non-deliverable forwards. The first phase of mandatory clearing came into effect in September 2016. In July 2017, the second phase extended mandatory reporting obligations to all five key asset classes, namely interest rates, foreign exchange, equities, credit and commodities. It is not expected that the OTC Rules will impact on asset managers that only trade as a disclosed agent to an unaffiliated named principal (i.e., the fund that it manages).[46]

45 Securities and Futures Commission, Annual Report 2018–2019.

46 See FAQ, Q26.

The SFC has published a number of consultations and conclusions in relation to the OTC derivatives regime:

a in July 2017, it published consultation conclusions on capital and other prudential requirements for activities involving OTC derivatives engaged in by licensed corporations under the Securities and Futures (Financial Resources) Rules;

b in June 2018, it published consultation conclusions on mandating the use of Legal Entity Identifiers for the mandatory reporting obligation, expanding the clearing obligation and adopting a trading determination process, with consultation conclusions to be published later in 2019;

c in June 2018, it also launched a consultation on proposals to implement margin requirements for non-centrally cleared OTC derivatives, which are set out in the 'Margin requirements for non-centrally cleared derivatives' report published in March 2015 by the Working Group on Margining Requirements, with consultation conclusions to be published later in 2019;

d in December 2018, it published consultation conclusions on amendments to the Code of Conduct for Persons Licensed By or Registered with the SFC (Code of Conduct) to (1) introduce new requirements on OTC derivatives in relation to derivative risk mitigation and client clearing; (2) impose conduct requirements to address risks posed by group affiliates; and (3) make a consequential amendment on client agreement requirements; and

e in April 2019, it launched a consultation paper on mandating the use of unique transaction identifiers for the reporting obligation, revising the list of designated jurisdictions for the masking relief of the reporting obligation and updating the list of financial services providers under the clearing obligation.

In relation to the SFC's proposal to enhance the investor compensation regime by increasing the compensation limit from HK$150,000 to HK$500,000 per investor per default, the SFC intends to publish consultation conclusions in the second half of 2019 and implement the proposals subject to completion of the legislative process.

iii Open-ended fund companies

On 30 July 2018, the Securities and Futures (Amendment) Ordinance 2016 came into operation, and introduced an OFC framework in Hong Kong as an additional investment fund vehicle option. Previously, an open-ended investment fund could be established in the form of a unit trust, but not in corporate form owing to various restrictions on capital reduction under Hong Kong company law. The new regime for OFCs is established under the SFO and supervised by the SFC, with detailed operation and procedural requirements contained in the Securities and Futures (Open-ended Fund Companies) Rules, Securities and Futures (Open-ended Fund Companies) (Fees) Regulation and Code on Open-ended Fund Companies.

iv Professional investor regime and client agreement requirements

On 25 March 2016, amendments to the Code of Conduct came into effect, providing that specified categories of professional investors who previously were not covered by a number of the Code of Conduct's protections will be covered from this date. The amendments provide that intermediaries are, among other obligations, bound by the Code of Conduct's suitability requirement in relation to these clients, and need to enter into a written client agreement and provide relevant risk disclosure treatments.

On 13 July 2018, the SFC adopted amendments to the Securities and Futures (Professional Investor) Rules. The amendments include allowing joint accounts and investments to be counted towards meeting the monetary threshold for the purpose of determining individuals' qualification as professional investors as well as accepting alternative forms of evidence. The amendments also expand the categories of corporations that qualify as professional investors, including certain holdings companies. See Section II.i.

Separately, as of 9 June 2017, intermediaries must comply with new Code of Conduct requirements governing the contents of all client agreements.

v Online trading and diversification of fund distribution channels

The SFC published a consultation paper in March 2018 on proposed guidelines on online distribution and advisory platforms, which considered the alignment of online and offline requirements applicable to complex products. The consultation conclusions were published in October 2018. The SFC decided to proceed with the proposed amendments to the Code of Conduct, which require intermediaries to have to ensure the suitability of complex products and provide product information and warning statements to clients when the complex products are sold on an unsolicited basis.

The SFC has also set out various core principles concerning governance and controls with which all platform operators should comply. They further aim to clarify how the suitability requirement set out in the Code of Conduct would operate in the context of online platforms. The SFC hopes that the new guidelines will facilitate the growth of online platforms to give investors greater choice and better access to investment advice.

Following a consultation, in October 2017 the SFC published guidelines aimed at mitigating hacking risks associated with internet trading. The guidelines cover preventive and detective controls for the protection of client trading accounts, infrastructure security management, and cybersecurity management and supervision. A requirement for two-factor authentication took effect on 27 April 2018.

vi Enhancement of asset management regulation and point-of-sale transparency

Following an SFC consultation and a 12-month transition period, a revised Fund Manager Code of Conduct came into force on 17 November 2018. The reach of the revised Fund Manager Code of Conduct has been extended so that it applies to businesses that involve the management of collective investment schemes, discretionary accounts, or both. The changes made to the Fund Manager Code of Conduct relate to, among other topics, securities lending and repurchase agreements, safe custody of fund assets, liquidity risk management and disclosure of leverage. There are certain provisions that only apply to a fund manager who is responsible for the overall operation of a fund.

A revised Code of Conduct came into force on 17 August 2018 to enhance point-of-sale transparency and to better address potential conflicts of interests. The Code of Conduct adopts a two-pronged approach and covers restrictions on the ability of intermediaries to represent themselves as 'independent' or as providing 'independent advice', and the disclosure of monetary benefits that are not quantifiable at the point of entering into a transaction. The revised Code of Conduct applies to all Hong Kong licensed fund managers.

The SFC launched further consultations on the disclosure requirements for point-of-sale transparency in relation to discretionary accounts, and published its conclusions in May 2018. The changes, which came into effect in December 2018, introduce specific disclosure requirements for monetary benefits under an explicit remuneration arrangement, and generic disclosures for monetary benefits under non-explicit remuneration arrangement and non-monetary benefits.

vii Senior management accountability

On 17 October 2017 the manager in charge (MIC) regime was fully implemented. It aims to enhance the obligations of licensed corporations in relation to their senior management. There are eight core functions for which licensed corporations must identify an MIC. These are:

a overall management oversight;
b key business line;
c operational control and review;
d risk management;
e finance and accounting;
f information and technology;
g compliance; and
h anti-money laundering and counterterrorist financing.

Licensed corporations are required to submit up-to-date information regarding their management structure to the SFC, and to ensure that MICs are aware of their regulatory obligations. The SFC has noted that since the launch of the MIC regime, many firms have taken measures to enhance their governance structures, including strengthening the composition of their boards, clearly delineating the job responsibilities and reporting lines of individual senior managers, and better aligning senior management accountability with the responsible officer regime.[47]

viii Paperless securities market

In January 2019, the SFC, Hong Kong Exchanges and Clearing Limited and the Federation of Share Registers Limited released a joint consultation paper on a new mechanism for implementing an uncertificated securities market regime in Hong Kong. The consultation paper proposes a framework to modernise the existing securities market regime in Hong Kong that is still reliant on the use of paper documents, such as documents to evidence or transfer legal title of securities, including shares. The current regime means that investors hold and transfer only the beneficial interest in securities, but not the legal title to the securities. The proposed revised model will give the investors the option of holding securities in their own name in electronic form.

The aim is for a conclusions paper to be issued in the second half of 2019, with implementation in early 2022.

47 Securities and Futures Commission, Annual Report 2018–2019.

ix Cryptocurrencies and security token offerings (STOs)

The offer of cryptocurrencies to investors in Hong Kong (typically as part of an initial coin offering) may, depending on the features of the offering, be subject to Hong Kong's existing securities law. In addition, intermediaries providing services to Hong Kong investors in relation to investments in cryptocurrency-related investment products are likely to be regulated by the existing regulatory regime.

On 28 March 2019, the SFC issued a Statement on Security Token Offerings, reminding market participants about the regulatory requirements applicable to STOs. The SFC also reiterated its earlier warning (contained in the SFC's Statement on Regulatory Framework for Virtual Asset Portfolios Managers, Fund Distributors and Trading Platform Operators, published in November 2018) to investors to be wary of the risks associated with virtual assets, including tokens that are the subject of STOs (security tokens). The SFC's statement highlighted that, in Hong Kong, security tokens are likely to be 'securities' under the SFO and so subject to the securities laws of Hong Kong. Anyone who markets and distributes security tokens (whether in Hong Kong or targeting Hong Kong investors) must be licensed or registered for Type 1 regulated activity (dealing in securities) under the SFO. It is a criminal offence for any person to engage in regulated activities without a licence unless an exemption applies.

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Jason Webber is a partner at Slaughter and May, and is involved in a wide range of corporate, commercial and financing work, advising companies, financial institutions and fund management groups. He regularly advises in relation to complex matters involving the Hong Kong regulatory authorities and governmental bodies. Mr Webber has also worked in the London office of Slaughter and May. Other projects include advising MTR Corporation Limited, Hong Kong's mass-transit railway operator, in relation to its privatisation, being Hong Kong's first (and to date only) privatisation of its kind; the merger with the Kowloon–Canton Railway Corporation; and the construction of various railway lines including the Disney Resort Line, the West Island Line, the Shatin to Central Line, the South Island (East) Line and the Express Rail Line. Mr Webber has advised JP Morgan JF Asset Management Group on the launch of various retail funds, Oxford Asset Management Group on the launch of the OxAM Quant Fund, as well as numerous international hedge fund groups on their establishment and operations in Hong Kong. Mr Webber is qualified in England and Wales and in Hong Kong.

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