The Asset Management Review

Ninth Edition

Editor
Paul Dickson

The LawReviews

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THE ASSET MANAGEMENT REVIEW

NINTH EDITION

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This article was first published in September 2020
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THE LAWREVIEWS

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Published in the United Kingdom
by Law Business Research Ltd, London
Meridian House, 34–35 Farringdon Street, London, EC4A 4HL, UK
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Enquiries concerning reproduction should be sent to Law Business Research, at the address above.
Enquiries concerning editorial content should be directed
to the Publisher – tom.barnes@lbresearch.com

ISBN 978-1-83862-433-0

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

ABOU JAOUDE & ASSOCIATES LAW FIRM

ADVOKATFIRMAET BAHR AS

ARTHUR COX

BONELLIEREDE

CHRYSSES DEMETRIADES & CO LLC

CORRS CHAMBERS WESTGARTH

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HAN KUN LAW OFFICES

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CONTENTS

PREFACE.. vii
Paul Dickson

Chapter 1 EUROPEAN OVERVIEW.. 1
Nick Bonsall

Chapter 2 ARGENTINA.. 48
Pablo Gayol

Chapter 3 AUSTRALIA.. 59
Fadi C Khoury, Kon Mellos and Michael Chaaya

Chapter 4 BRAZIL.. 71
Fernando J Prado Ferreira, João Pedro Ribeiro Taveira and Arthur Gonçalves Camargo

Chapter 5 CAYMAN ISLANDS.. 85
Tim Coak, Luke Stockdale and Michael Richardson

Chapter 6 CHINA.. 99
Huaying (Daisy) Qi and Lin Zhou

Chapter 7 CYPRUS.. 112
Demosthenes Mavrellis, Sonia Varnava and Christos Heracleous

Chapter 8 GERMANY.. 125
Carl-Philipp Eberlein, Markus Ernst and Christian Schmies

Chapter 9 HONG KONG.. 137
Jason Webber, Peter Lake, Ben Heron and Mike Ringer

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Chapter 10 INDIA 161
Ganesh Rao, Aditya Jha and Yash Bansal

Chapter 11 IRELAND 173
Kevin Murphy, Jennifer McCarthy, David O'Shea, David Kilty, Sarah McCague, Michael Shovlin and Niall Guinan

Chapter 12 ITALY 191
Giuseppe Rumi, Riccardo Ubaldini, Michele Dimonte, Cristiana Ferrari and Giulio Vece

Chapter 13 JAPAN 212
Yasuzo Takeno and Fumiharu Hiromoto

Chapter 14 LEBANON 230
Rita Papadopoulou

Chapter 15 LUXEMBOURG 243
Pierre de Backer and Emmanuelle Bauer

Chapter 16 NORWAY 258
Peter Hammerich and Markus Heistad

Chapter 17 PORTUGAL 274
Carlos Costa Andrade, Marta Pontes, Gerard Everaert, Duarte Araújo Martins and Domingos Braga

Chapter 18 SAUDI ARABIA 287
Nabil A Issa, James R Stull, Macky O'Sullivan and Sayf Shuqair

Chapter 19 SPAIN 303
Juan Carlos Machuca Siguero and Anna Viñas Miquel

Chapter 20 SWITZERLAND 326
Shelby R du Pasquier and Maria Chiriaeva

Chapter 21 UNITED ARAB EMIRATES 339
Nabil A Issa, James R Stull, Macky O'Sullivan and Sayf Shuqair

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Chapter 22 UNITED KINGDOM 351
Paul Dickson

Appendix 1 ABOUT THE AUTHORS 401
Appendix 2 CONTRIBUTORS' CONTACT DETAILS 419

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PREFACE

What a difference a year makes! Last year we were reflecting on the uncertain global macroeconomic outlook brought about by geopolitical factors including political uncertainty and the rise of populist movements. In the UK and Europe, we were focusing on the uncertain future of the political and regulatory relationship with the EU. We had no idea that a more wide ranging event was soon to occur . . .

One imagines that 2020 will be primarily remembered in history as the year of the novel coronavirus pandemic, and all that the inescapable event has brought. The pandemic, far from being under control globally, is distracting from other developments and causing increased fear in the financial markets of the future strength of historically safe investments.

But what about those other events that the pandemic has masked? The UK has now left the EU and seems likely to fail to reach a 'deal' with EU on the long-term relationship at the end of the implementation period in 2021. This has had, and is likely to continue to have, a potentially destabilising effect on the UK asset management sector and its clients.

Sources of global uncertainty for financial markets are on the rise, with only increasing tensions on the global political stage. There are multiple examples of foreign investment controls being tightened, sometimes for political reasons and sometimes for understandable economic ones.

Leaving all of of this aside though, the importance of the asset management industry continues to grow. Nowhere is this truer than in the context of pensions, as the global population becomes larger, older and richer, and government initiatives to encourage independent pension provision continue. Both industry bodies and legislators are also increasingly interested in pursuing environmental, social and governance (ESG) goals through private sector finance. For example, the European Commission has proposed a package of measures seeking to introduce sustainable finance into current regulations to make it easier for investors to identify and invest in such projects.

This should not be a surprise: lack of shareholder engagement has been identified as one of the key issues contributing to the governance shortcomings during the financial crisis. Given the importance of the asset management industry in investing vast amounts on behalf of clients, the sector is the natural focus of regulatory and governmental initiatives to promote effective stewardship and take the lead in instilling a corporate cultural focus on sustainability and ESG initiatives.

The activities of the financial services industry remain squarely in the public and regulatory eye, and the consequences of this focus are manifest in ongoing regulatory attention around the globe. Regulators are continuing to seek to address perceived systemic risks and preserve market stability through regulation. Operational resilience – a concept

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focused on ensuring asset managers' holistic preparedness against any risk event, particularly significant operational risks – has become a significant focus point for global regulators.

It is not only regulators who continue to place additional demands on the financial services industry in the wake of the financial crisis: the need to rebuild trust has led investors to call for greater transparency around investments and risk management from those managing their funds. Senior managers at investment firms are, through changes to regulatory requirements and expectations as to firm culture, increasingly being seen as individually accountable within their spheres of responsibility. Industry bodies have also noted further moves away from active management into passive strategies, illustrating the ongoing pressure on management costs. This may, in itself, be storing up issues for years to come.

The rise of fintech and other technological developments, including cryptocurrencies, data analytics and automated (or 'robo') advice services, is also starting to have an impact on the sector, with asset managers looking to invest in new technologies, seeking strategies to minimise disruption by new entrants, or both. While regulators are open to the development of fintech in the asset management sector, they also want to ensure that consumers do not suffer harm as a consequence of innovations. Regulators across various jurisdictions are working together to develop a global sandbox in which firms can test their new technologies.

This continues to be a period of change and uncertainty for the asset management industry, as funds and managers act to comply with regulatory developments and investor requirements, and adapt to the changing geopolitical landscape. Although the challenges of regulatory scrutiny and difficult market conditions remain, a return of risk appetite has also evidenced itself and the global value of assets under management continues to increase year on year. The industry is not in the clear but, prone as it is to innovation and ingenuity, it seems well placed to navigate this challenging and rapidly shifting environment.

The publication of the ninth edition of *The Asset Management Review* is a significant achievement, which would not have been possible without the involvement of the many lawyers and law firms who have contributed their time, knowledge and experience to the book. I would also like to thank the team at Law Business Research for all their efforts in bringing this edition into being.

The world of asset management is increasingly complex, but it is hoped that this edition of *The Asset Management Review* will be a useful and practical companion as we face the challenges and opportunities of the coming year.

Paul Dickson
Slaughter and May
London
August 2020

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Chapter 9

HONG KONG

Jason Webber, Peter Lake, Ben Heron and Mike Ringer[1]

I OVERVIEW OF RECENT ACTIVITY

The global covid-19 pandemic presents unprecedented challenges for financial markets generally, including the asset and wealth management industry. Nonetheless, Hong Kong is well placed to remain, and indeed strengthen its position as, a competitive full-service asset and wealth management centre and a preferred place of fund domicile, and as the pre-eminent offshore renminbi centre.

The Securities and Futures Commission (SFC) has been pursuing a number of initiatives in this regard. 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 (OFC) regime, which provides a corporate vehicle for use by open-ended funds (including hedge funds), took effect in July 2018. The new limited partnership fund (LPF) regime, which is aimed primarily at the private equity industry, will take effect on 31 August 2020. Alongside the introduction of these new fund vehicles, recent legislative changes have unified 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 and to investments in both local and overseas private companies. 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 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.

The number of Hong Kong-domiciled funds decreased 3.4 per cent to 762 between 31 March 2019 and 31 March 2020.[2] In addition, the number of authorised collective investment schemes fell from 2,797 on 31 March 2019 to 2,728 on 31 March 2020.

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 new fund vehicle options and unified profits tax exemption for privately offered funds, its proximity to the mainland markets, its flexible tax regime and its world-class financial infrastructure. Hong Kong also looks set to benefit from

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1 Jason Webber, Peter Lake and Ben Heron are partners and Mike Ringer is a counsel at Slaughter and May. The authors would like to thank Benedict Tang, associate at Slaughter and May, for his help in updating this chapter.

2 Securities and Futures Commission, Annual Report 2019–2020.

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traditionally popular offshore fund domicile jurisdictions such as the Cayman Islands facing ever more burdensome regulatory requirements driven by pressure from the OECD, such as economic substance requirements and more stringent reporting requirements.

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.[3] 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.

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.[4]

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;

3 As defined in Part 1 of Schedule 1 to the SFO.
4 As noted in an SFC Working Group report on offers of securities and other investments issued in December 1991.

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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.[5]

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[6] in one or more of the following[7] specified regulated activities:
a Type 1: dealing in securities;
b Type 2: dealing in futures contracts;
c Type 3: leveraged foreign exchange trading;
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;

5 ibid.
6 Section 114(1) of the SFO.
7 Part 1 of Schedule 5 to the SFO.

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k Type 11: dealing in over-the-counter (OTC) derivative products or advising on OTC derivative products;[8] and
l Type 12: providing client clearing services for OTC derivative transactions.[9]

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.[10] 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.[11]

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, the Limited Partnership Fund Ordinance (once it becomes effective – see Section VII.iv) or the Trustee Ordinance.

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.

8 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 consultation conclusions to refine the scope of the regulated activity (see Section VIII.ii).

9 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 consultation conclusions to refine the scope of the regulated activity.

10 Section 115(1) of the SFO.

11 Section 129 of the SFO.

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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 have commonly been structured as companies or limited partnerships domiciled offshore in a tax-neutral jurisdiction such as the Cayman Islands. Far less often, they have been structured as unit trusts constituted under trust deeds governed by Hong Kong law. However, the SFC has recently developed a new OFC regime that offers the hedge fund industry (as well as the open-ended funds industry more broadly) an additional choice of Hong Kong-domiciled investment fund vehicle. This regime came into operation on 30 July 2018. Further information can be found in Section VII.iii.

Most private equity funds managed from Hong Kong have also historically been established in offshore tax-neutral jurisdictions such as the Cayman Islands, commonly as limited partnerships. However, the SFC has recently developed a new LPF regime that offers the private equity industry (as well as other funds traditionally structured as limited partnerships) an additional choice of Hong Kong-domiciled investment fund vehicle. This regime will come into operation on 31 August 2020. Further information can be found in Section VII.iv.

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.

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[12] 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.[13]

12 Asset and Wealth Management Activities Survey 2018, published by the SFC in July 2019. The 2019 survey has not been published at the time of writing, due to delays resulting from the global covid-19 pandemic.

13 ibid.

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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,[14] 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.

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

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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 the Insurance Companies Ordinance (now the Insurance 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 also took over the regulation of insurance intermediaries (i.e., agents and brokers) from the three self-regulatory organisations that previously existed in Hong Kong[15] under a new statutory licensing regime that came into operation on 23 September 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[16] 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 2020, there were 299 SFC-authorised ILAS.[17]

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;[18] detailed disclosure requirements for scheme documentation;[19] and requirements in relation to fees and charges.[20]

15 The previously existing self-regulatory organisations were 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.

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

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

18 Paragraph 1.8 of the Code on ILAS.

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

20 Paragraphs 5.14 to 5.17 of the Code on ILAS.

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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.[21]

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).[22]

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

21 Chapter 7 of the Code on ILAS.

22 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.

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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.

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;[23] 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.[24]

On 9 June 2020 the SFC began a two-month consultation on proposals to amend the REIT Code to provide Hong Kong REITs with more flexibility in making investments. The proposed changes include allowing REITs to make investments in minority-owned properties and in property development projects in excess of the existing limit of 10 per cent of gross asset value (GAV) subject to unitholders' approval, as well as increasing the borrowing limit for REITs from 45 per cent to 50 per cent of GAV.

As of March 2020, there were 12 authorised REITs.[25]

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[26] 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.

23 Paragraph 7.1 of the REIT Code.
24 Paragraph 7.12 of the REIT Code.
25 These figures are taken from Table D1, SFC Market & industry statistics.
26 Section 8.7 of the UT Code.

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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.[27]

Regulation of typical hedge fund activities

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

a there is a prohibition on on-exchange naked short selling, unless exempted;[28]

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

27 ibid.

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

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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 activities for private equity fund managers are dealing in securities (Type 1), advising on 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.

The SFC issued a circular on 7 January 2020 to clarify licensing obligations of private equity firms that conduct business in Hong Kong, including licensing requirements for private equity firms' general partners, investment committee members and fund marketing activities. The circular also clarifies how the SFC assesses private equity firms' discretionary investment authority and investments in securities of private companies, as well as the industry experience requirement for their responsible officers.

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.

In addition, the new legislative framework for limited partnership funds, which will come into operation on 31 August 2020, is intended to encourage more private equity funds to choose Hong Kong as their domicile of choice. See Section VII.iv for further details.

vi Family offices

On 7 January 2020, alongside its issuance of a circular to clarify licensing obligations of private equity firms that conduct business in Hong Kong, the SFC also issued a circular addressing how the SFC's licensing regime applies to family offices intending to carry out asset management or other services in Hong Kong. The SFC's Chief Executive Officer, Ashley Alder, commented at the time of the issuance of the two circulars that private equity firms and family offices are two key building blocks of any leading asset and wealth management centre, highlighting the importance of these two sectors to the Hong Kong asset management industry.

The family offices circular explains the potential licensing implications for both single and multi-family offices, and that licensing exemptions or carve-outs may be available depending on how a family office operates.

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vii 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 these retail funds (by both number and net asset value) are equity funds and bond funds (there being 945 and 465 respectively as at 31 March 2020).[29]

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 107 ETFs listed on the SEHK as at 31 March 2020.[30]

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,[31] 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.[32]

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

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

30 These figures are taken from the Securities and Derivatives Markets Quarterly Report (first quarter 2020), issued by Hong Kong Exchanges and Clearing Ltd.

31 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.

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

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authorisation of funds tracking non-equity indices, provided that they meet the relevant requirements of the UT Code. As at March 2020, 24 leveraged and inverse products were listed on the SEHK.[33]

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 (-2x).

On 23 June 2020, the SFC issued a supplemental circular confirming that the SFC will accept applications for authorisation of leveraged and inverse products tracking mainland equity indices. A leveraged product tracking a mainland equity index may have a leverage factor up to two-times (2x), but the leverage factor cap of a mainland equity index inverse product is limited to negative one-times (-1x). Currently only a swap-based replication structure is accepted for leveraged and inverse products tracking mainland equity indices – a futures-based replication structure is not yet acceptable. However, the SFC has indicated that it will continue to review the eligible replication structures for leveraged and inverse products for public sale in Hong Kong.

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.

33 These figures are taken from the Securities and Derivatives Markets Quarterly Report (first quarter 2020), issued by Hong Kong Exchanges and Clearing Ltd.

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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.[34]

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.[35]

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

35 The unifying changes therefore include the repeal of the specific profits tax exemption introduced for Hong Kong incorporated 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).

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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 a Hong Kong incorporated OFC all of its transactions, will be exempt from profits tax, provided:

a the fund is a 'qualified investment fund';[36] 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.[37]

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.

36 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.

37 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.

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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:

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.[38]

On 30 June 2020, the Inland Revenue Department (IRD) published Departmental Interpretation and Practice Note No. 61 – Profits Tax Exemption for Funds (DIPN 61), which clarifies the IRD's interpretation and application of the new unified profits tax exemption.

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

38 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.

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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.[39]

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.

The Hong Kong Financial Secretary noted in his budget speech in February 2020 that with a view to attracting more private equity funds to domicile and operate in Hong Kong, the government plans to provide tax concessions for carried interest issued by private equity funds operating in Hong Kong subject to the fulfilment of certain conditions. The government will consult the industry on the proposal, and the relevant arrangement will be applicable starting from 2020–21 upon completion of the legislative exercise.

iv Double taxation agreements

As of 10 July 2020, Hong Kong had comprehensive double taxation agreements with Austria, Belarus, Belgium, Brunei, Cambodia, Canada, China, the Czech Republic, Estonia, 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 Macao SAR, 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.[40]

v Stamp duty

Stamp duty is chargeable on transfers of real property, the issue of certain bearer instruments and the transfer (but not the issue or redemption) 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. An interest in the newly introduced Hong Kong limited partnership fund vehicle is not 'Hong Kong stock' for these purposes, and so transfers (and issuances and redemptions) of limited partnership fund interests should not be subject to Hong Kong stamp duty.

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. For example, for Hong Kong unit trust schemes (other than those traded on the SEHK), most transfers are do not incur stamp duty because they are effected through issuance of new units and cancellation of existing units by the manager of the scheme instead of sale and purchase between investors.

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

40 Section 49 of the Inland Revenue Ordinance.

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Allotments, transfers and redemptions of shares in open-ended fund companies are treated for stamp duty purposes as if they were units under a unit trust scheme.[41] 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 would be quadrupled. As at 31 March 2020, Stock Connect covered 1,288 mainland stocks and 477 Hong Kong stocks.[42] From July 2019, dual-class shares have also been included on Stock Connect.

On 29 June 2020 the People's Bank of China, the Hong Kong Monetary Authority and the Monetary Authority of Macau jointly announced the launch of the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong–Hong Kong–Macao Greater Bay Area. The purpose of Wealth Management Connect is to allow individual residents in the Greater Bay Area to carry out cross-boundary investment in wealth management products distributed by banks in the Greater Bay Area. The scheme has a southbound and a northbound components, depending on the residency of the investors. The date of formal launch of Wealth Management Connect and implementation details will be separately specified.

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

41 Section 37B of the Stamp Duty Ordinance. See also Stamp Office Stamping Procedures and Explanatory Note 'Stamp Duty Exemption Instruments of Transfer relating to Indirect Allotment or Redemption of (1) Units under Unit Trust Schemes and (2) Shares under Open-ended Fund Companies' – January 2019.

42 Securities and Futures Commission, Annual Report 2019–2020.

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that this initiative will further promote Hong Kong's development as a fund management hub and fund domicile. As of 31 March 2020, a total of 79 funds were approved under the regime.[43]

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).[44]

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;

c 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

43 Securities and Futures Commission, Annual Report 2019–2020.

44 See FAQ, Q26.

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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. The corresponding amendments to the Code of Conduct were made on 1 January 2020;

d 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;

e in December 2019, it published consultation conclusions on proposals to implement margin requirements for non-centrally cleared OTC derivatives, confirming that the initial margin requirements will be phased in starting from 1 September 2020 and the variation margin requirements will become effective on 1 September 2020; and

f in June 2020, it published consultation conclusions on proposals to refine the scope of regulated activities under the OTC derivatives licensing regime, so that the corporate treasury activities of non-financial groups and certain portfolio compression services will not be captured. The conclusions also set out the competence and continuous professional training requirements which will apply to those licensed or applying to be licensed under the regime.

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 operational and procedural requirements contained in the Securities and Futures (Open-ended Fund Companies) Rules (the OFC Rules), Securities and Futures (Open-ended Fund Companies) (Fees) Regulation and Code on Open-ended Fund Companies (the OFC Code).

On 20 December 2019, the SFC published a consultation paper on proposed enhancements to the OFC regime. The consultation paper proposes enhancements in the following areas: (1) custodian eligibility requirements for private OFCs – to allow intermediaries licensed or registered for Type 1 regulated activity (dealing in securities) to act as custodians of private OFCs provided that the intermediary meets certain requirements as set out in the paper; (2) expansion of investment scope for private OFCs – to include loans as well as Hong Kong private company shares and debentures; (3) redomiciliation of overseas corporate funds to Hong Kong – using the OFC structure; and (4) significant controllers register requirements – to require OFCs to keep a register of beneficial shareholders similar to the requirements under the Companies Ordinance.

iv Limited partnership funds

Following extensive consultation by the government with the asset management industry in Hong Kong, the Limited Partnership Fund Bill was gazetted on 20 March 2020 and will come into operation on 31 August 2020. The new LPF vehicle is aimed at the private equity industry, with private equity funds often taking the form of limited partnerships.

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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 and the guidelines published in July 2019. Corresponding changes to offline distribution and advisory were implemented by way of amendments made to the Code of Conduct in July 2019. Subject to certain exemptions, intermediaries are now required to ensure the suitability of complex products and provide product information and warning statements to clients when the complex products are sold (including sales made 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:

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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.[45]

viii Paperless securities market

On 8 April 2020 the SFC, Hong Kong Exchanges and Clearing Limited (HKEX) and the Federation of Share Registers Limited (FSR) released joint consultation conclusions on a proposed operational model for implementing an uncertificated securities market (USM) in Hong Kong. The consultation was triggered by market concerns that the operational model proposed in 2010 would compromise some of the settlement efficiencies enjoyed by the market and have a significant impact on participants' funding needs. The model put forward in the new consultation paper published on 28 January 2019 aims to address these concerns while still offering investors an option to hold securities in their own names and without paper.

The proposed operational model as outlined in the consultation paper and the conclusions will: (1) enable securities to be moved into and out of the clearing and settlement system much more efficiently and cost-effectively than today; (2) address concerns about settlement efficiencies being compromised, and the potential impact on market participants' funding needs; and (3) result in less market disruption and costs as it builds on existing processes, operational flows and infrastructure.

The SFC, HKEX and FSR will further develop the model and the regulatory framework to support it with a view to implementing the USM regime from 2022.

ix Cryptocurrencies and other virtual assets

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 security token offerings

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

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(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.

On 6 November 2019, the SFC issued a warning to investors about the risks associated with the purchase of virtual asset futures contracts in Hong Kong. The warning notes that the SFC has repeatedly reminded investors that investing in virtual assets may expose them to significant risks – in particular, insufficient liquidity, high price volatility and potential market manipulation – and that these risks may be further magnified when investing in virtual asset futures contracts. In addition, investors should be wary that platforms offering or trading virtual asset futures contracts may potentially be operating illegally in Hong Kong. In particular, any trading platforms or persons that offer or provide trading services in virtual asset futures contracts in Hong Kong without a proper licence or authorisation may be in contravention of the SFO or the Gambling Ordinance. The SFC has not licensed or authorised any person in Hong Kong to offer or trade virtual asset futures contracts, and given the current risks associated with these contracts and in order to protect the investing public, the SFC would be unlikely to grant a licence or authorisation to carry on a business in such contracts.

At the same time as it issued the above warning in relation to virtual asset futures contracts, the SFC issued a position paper setting out a new regulatory framework for virtual asset trading platforms. Under the new framework, platforms that operate in Hong Kong and offer trading of at least one security token (being virtual assets that fall within the definition of 'securities' under the SFO) may now apply to be licensed by the SFC. The position paper emphasises that the SFC will only grant licences to platform operators that are capable of meeting robust regulatory standards, being standards comparable to those that apply to licensed securities brokers and automated trading venues but which also incorporate additional requirements to address specific risks associated with virtual assets. For example, the SFC will impose licensing conditions requiring that platform operators offer their services exclusively to professional investors, only service clients who have sufficient knowledge of virtual assets and maintain stringent criteria for the inclusion of virtual assets on their platforms. In addition, licensed platforms will be placed in the SFC regulatory sandbox for a period of close and intensive supervision. The position paper makes clear that virtual assets traded on licensed platforms will not be subject to the same kind of regulation which applies to traditional offerings of securities or collective investment schemes. Moreover, the SFC has no power to grant a licence to or supervise platforms that only trade virtual assets or tokens which do not qualify as securities under Hong Kong law.

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x Proposed regulatory regime for depositaries of SFC-authorised collective investment schemes

On 27 September 2019, the SFC published a consultation paper on a proposed regulatory regime for depositaries (trustees and custodians) of SFC-authorised collective investment schemes. The consultation paper notes that trustees and custodians of public funds in Hong Kong are currently not subject to any specific licensing regime for, or direct on-going regulatory supervision of, their trustee or custodial function for public funds; and that the lack of a specific, direct regulatory handle gives rise to practical difficulties in ensuring appropriate regulation and supervision of these entities in their provision of trustee and custodial services to public funds. In view of this, as part of the SFC's asset management strategy to strengthen Hong Kong as an international, full service asset management centre and to enhance the regulation of public funds, the SFC proposes to introduce a new regulated activity under the SFO: Type 13 regulated activity (RA 13) – acting as a depositary (trustee or custodian) of an SFC-authorised collective investment scheme.

The proposed scope of RA 13 is intended to cover 'top-level' trustees and custodians (i.e., the entity at the top of the custodial chain). For a relevant collective investment scheme structured in the form of a unit trust, this entity will be the trustee. For a relevant collective investment scheme structured in any other form such as an OFC authorised under the SFO or a mutual fund corporation, it will be the global or top custodian. A depositary's nominees, agents and delegates, such as a sub-custodian or the global custodian appointed by a top-level trustee, will not fall within the proposed scope of RA 13. While top-level trustees and custodians may delegate their functions to third parties, the responsibilities of an RA 13 depositary with respect to these functions remain with the depositary.

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Appendix 1

ABOUT THE AUTHORS

JASON WEBBER

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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, which was 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. He has sat on a disciplinary committee of the Securities and Futures Commission and has published in the areas of asset management, mergers and acquisitions and the Hong Kong Listing Rules.

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Peter Lake is a partner at Slaughter and May. He is involved in a wide range of corporate work, advising companies, financial institutions and fund management groups. He is a member of the investment products and financial services committee of the Hong Kong Law Society.

His work includes advising Standard Chartered Bank on its strategic joint venture to build a new standalone digital retail bank in Hong Kong; Standard Chartered Bank on the establishment of a Hong Kong hub entity structure to enhance capital and liquidity utilisation across the SCB Group; various banks on banking portfolio acquisitions; Union Bancaire Privée, UBP SA on the setting up of its Hong Kong operations and its banking portfolio acquisition; Prudential plc on its demerging of European business and the taking on by the Hong Kong Insurance Authority of group-wide supervision of Prudential's Asian and US business; the Oxford Asset Management Group including in relation to OxAM Quant Fund; and Moore Capital on Hong Kong regulatory matters.

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Ben Heron is a partner at Slaughter and May. He specialises in mergers and acquisitions and a wide range of corporate and commercial transactions. His work includes advising Standard Chartered Bank on its strategic joint venture to build a new standalone digital retail bank in Hong Kong; Eastspring Investments on its acquisition of a controlling stake in Thanachart Fund Management; GE Capital on the sale of its stake in SBI Card to the Carlyle Group and the State Bank of India; Prudential on its bancassurance arrangement with United Overseas Bank; and FWD on the acquisition of SCB Life from, and bancassurance arrangement with, Siam Commercial Bank.

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Mike Ringer is a counsel at Slaughter and May. He has a wide-ranging practice covering the full spectrum of regulatory and financing work, with a particular focus on complex regulatory issues and fintech. His clients include regulators, market infrastructure operators, commercial and investment banks, insurers, brokers and hedge funds, as well as international fintech businesses and other emerging tech businesses at various stages of development.

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ISBN 978-1-83862-433-0

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