A New Era for Hong Kong's Asset Management Industry

The article discuses changes in the laws and regulations governing Hong Kong as a financial centre during 2017 and 2018 and the impact they have on open ended fund companies (OFCs), funds tax exemption, taxation of asset management groups, asset management regulation, distribution of funds and regulation of the insurance market.

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The period from 2017 to 2018 saw a rapid pace of change in the laws and regulations governing Hong Kong as a financial centre. These changes included the introduction of the new open-ended fund companies (OFCs) regime and measures to tighten regulation on how funds are managed and sold, as well as proposals to make tax exemptions for private equity and hedge funds more accessible. These changes also included the introduction of a new regulatory regime for insurance companies.

Open Ended Fund Companies

On 30 July 2018, Hong Kong introduced the new OFC regime. Under the OFC regime, asset managers can establish a Hong Kong incorporated vehicle as an open-ended fund vehicle. Prior to the introduction of the OFC regime, a Hong Kong domiciled open-ended fund vehicle could not take a corporate form as a result of company legislation which restricted redemptions of shares out of paid-up capital. With the introduction of the OFC regime, it is now possible to establish a Hong Kong domiciled fund which allows for full and easy redemptions of shares out of paid-up capital.

The OFC regime has particular potential for funds which employ a high degree of leverage. OFCs can be formed with multiple sub-funds. By law, the assets and liabilities of each sub-fund are segregated. This

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means that the liabilities of one sub-fund cannot be satisfied from the assets of another sub-fund.

For asset managers operating in Hong Kong with counterparties in Hong Kong, OFCs offer a higher degree of liability risk management than would be available using similar segregated liability vehicles incorporated elsewhere. It is clear that Hong Kong courts will recognise the segregation of liability available through OFCs but less clear that they will recognise similar segregation of liability under the laws of jurisdictions outside of Hong Kong.

OFCs offer Hong Kong asset managers and their investors a streamlined unitary fund regime. There is no longer a need for offshore service providers such as offshore lawyers, offshore auditors and offshore fund administrators in addition to Hong Kong service providers and there is no longer a need to comply, not only with the laws of Hong Kong, but also the laws of the offshore jurisdiction in terms of the registration and regulation of the fund and compliance with anti-money laundering obligations. Disputes can be settled through the Hong Kong courts rather than through the courts of an offshore jurisdiction, and a single regulator, the Securities and Futures Commission (**SFC**), will regulate both the fund and the fund manager.

Though the tax exemption package designed specifically for OFCs is uncommercial for smaller private funds, OFCs can continue to benefit from the offshore funds exemption which is now used by funds incorporated outside of Hong Kong.

Funds Tax Exemption

On this note, in April 2018, the Hong Kong government proposed modifying the offshore funds exemption to remove ring-fencing at both the fund and investment level. At the fund level, the exemption currently requires that the central management and control of the taxpayer be situated outside of Hong Kong. Under the proposal, the exemption will simply require that the taxpayer be a collective investment scheme. In other words, the central management and control of funds will no longer need to be situated outside of Hong Kong to qualify for exemption. As a result, if the proposal is adopted, asset managers will no longer need to make efforts to locate their board level activities outside of Hong Kong.

Taxation of Asset Management Groups

Hong Kong introduced the Organisation for Economic Cooperation and Development’s (the OECD’s) Base Erosion and Profit Shifting (**BEPS**) action plan in 2018. BEPS legislation will introduce a transfer pricing regime under which related parties will bear tax liability on the arm’s length value of goods and services provided by one related party to another.

Though the past few years have already seen the Inland Revenue Department (**IRD**) attacking fund management structures which seek to shelter performance fees and management fees offshore through the interposition of an offshore fund manager between the fund and the Hong Kong asset manager, BEPS legislation will give the IRD even greater reason to challenge such structures. The old paradigm structure is not yet dead with BEPS -- asset managers can still book fees to an offshore fund manager if they can justify those fees. However, asset managers who wish to minimise Hong Kong tax on their fees may need to look to a new model.

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Asset Management Regulation

As foreshadowed in last year's annual review, with effect from November 2018, major changes to the Fund Manager Code of Conduct (**FMCC**) will come into effect. Amongst other things, these changes introduce regulatory standards in respect of the funds managed by Hong Kong licensed asset managers. This change represents a paradigm shift as historically, private funds (*i.e.* funds which are not authorised by the SFC for sale to the public) have fallen completely outside the regulation of the SFC. The new FMCC establishes new requirements for the management and disclosure of conflicts of interest, securities lending and risk management which will apply to all funds. Equally, it will establish new requirements in respect of the use of leverage and in respect of fund valuation and custody for funds where the asset manager is 'responsible for the overall operation of the fund'.

It is not yet clear how the SFC will construe these new requirements. For example, the new FMCC mandates the disclosure of conflicts of interest but does not clarify whether the regulator's expectation is that generic disclosure in the offering document would suffice or whether specific disclosure on a case-by-case basis must be made.

Though the new requirements in the updated FMCC are not particularly onerous, the bigger concern is that the introduction of indirect regulation of private funds creates a slippery slope giving the SFC ample room over time to gradually step up the regulation of private funds.

Distribution of Funds

Following the consultation described in the 2017 edition of the *IFC Review*, the SFC brought into effect new requirements for the distribution of investment products. These requirements which were issued in August 2018 are intended to enhance transparency at the point of sale and are embodied in a revised Code of Conduct for Persons Licensed by or Registered with the SFC (Code of Conduct). Under these new requirements, distributors of funds must provide clear disclosure of whether or not they are independent. Distributors are prohibited from representing themselves as independent if they receive benefits which are likely to impair their independence to favour a particular investment product. At the same time, distributors must disclose not only the existence and nature of non-monetary benefits but also the maximum percentage of monetary benefits receivable each year.

On a related note, during 2018, the SFC completed a consultation on guidelines regarding the provision of investment products via online platforms. Intermediaries are currently responsible for ensuring suitability whenever they solicit or recommend a financial product to a client. The new guidelines, which will come into effect in April 2019, stipulate that, where investment products are provided via an online platform, the intermediary providing that platform will be responsible for ensuring suitability whenever a client transacts in 'complex products', notwithstanding that there has been no solicitation or recommendation. An investment product will be a 'complex product' if, objectively, it is not reasonably likely that retail investors will understand its terms, features and risks. The assessment is independent of the personal circumstances of a particular client and each platform operator must therefore determine generally whether a product is complex or non-complex. Controversially, the SFC has proposed rolling out a similar guideline in the offline sales universe so that the online and offline suitability approaches are aligned.

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It has not however, been all 'tough love' from the SFC. In July 2018, amendments were introduced to the professional investor rules in Hong Kong. These amendments relax the methods by which persons can meet the thresholds to qualify as a professional investor. For example, under these amendments, an individual can qualify as a professional investor through a portfolio held in joint account with a spouse or minor.

Regulation of the Insurance Market

As discussed in last year's annual *IFC Review*, 2017 saw the introduction of a new statutory regulator for the insurance market, the Insurance Authority (IA). Though the IA is scheduled to take over the regulation of insurance intermediaries, including both brokers and agents, the IA has yet to issue any market consultation on how it intends to exercise its powers under the new statutory licensing regime. The IA has been slow off the mark -- a new chief executive was only appointed in August 2018, a year after the IA assumed its role as the insurance regulator.

As the IA and market participants and their advisers continue to feel their way through the new statutory regime, the experience on the ground suggests that for now, there are no paradigm shifts in how the new regulator will approach its responsibilities as compared to the old regulator.

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