Strengthening Hong Kong's role as an asset management centre

Full implementation of the Financial Services Development Council's recent recommendations would lead to significant growth in Hong Kong's asset management sector.

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In brief

The Financial Services Development Council (FSDC)[1] issued three research reports on 7 December 2015 outlining its recommendations to the Hong Kong Special Administrative Region government, regulators and the industry to substantially strengthen Hong Kong's role as a leading international asset and fund management centre, as well as a fund domicile hub. While each of the three reports has a different focus, all three draw from the experience and expertise of industry players and specialists, with the overarching goal of setting out a clear road map for the development of Hong Kong's financial services industry, and in particular, its asset management industry. In this article, we summarise the key points and recommendations from each of the three reports.

In detail

The FSDC's three research reports (available from its website[2]) address different aspects of Hong Kong's financial industry and map out clear opportunities and recommendations for stakeholders to consider in order to strengthen Hong Kong's role as an asset management centre.

The key points from the reports and their recommendations are set out below.

1. The Retail Fund Paper

The Retail Fund Paper identifies and outlines specific objectives to make Hong Kong a leading regional fund distribution centre in the medium term, and a leading international fund distribution centre in the longer term.

The FSDC notes that Asia's fund market is changing, in part due to the growth of its middle class, an ageing population and the move away from traditional distribution channels. The industry is actively seeking different alternatives for fund distribution while minimising costs to the end investor. The introduction of fund passporting regimes and new distribution platforms are clear responses to such changes.

Against the current climate, the FSDC believes that certain challenges would need to be addressed before opportunities, especially those surrounding fund distribution, can be reaped.

Recommendations:
With that in mind, the FSDC makes four specific recommendations:

a. Support the diversification of fund distribution and innovation

b. Provide additional guidance on suitability requirements

c. Use FinTech and enhance the KYC process

d. Continue to engage with and develop cross-border initiatives.

2. The Tax Paper

The Tax Paper is a follow on from the FSDC's proposals published on 18 November 2013 on the legal and regulatory framework for open-ended investment companies in Hong Kong and, separately, on tax exemptions and anti-avoidance measures in private equity (PE) funds.

The FSDC sets out its recommendations on these two topics in turn.

Recommendations:
The open-ended fund companies (OFCs) tax framework in Hong Kong

The FSDC recommends that:

a. there should not be any restriction or stipulation on the residency of directors on the board of any private OFC, thus allowing a private OFC to be centrally managed and controlled in Hong Kong to be eligible for the profits tax exemption if the relevant exemption conditions are satisfied.

b. both public and private OFCs should be exempt from stamp duty.

1 The FSDC is a high-level, cross-sectorial advisory body established to engage the industry in formulating proposals to promote the future development of Hong Kong's financial services industry and to map out the strategic direction for development.

2 www.fsdc.org.hk/en/publications/2015

The profits tax exemption for offshore PE funds

The FSDC recommends that:

a. In determining whether or not a PE fund is "bona fide widely held", the criteria should be relaxed. A PE fund will be regarded as "bona fide widely held" if one of the two conditions below are satisfied:

- No person holds a participation interest of 20% or more in the non-resident fund; or
- There are no five or fewer persons with a combined participation interest of at least 50% in the non-resident fund.

b. The "bona fide widely held" concession should be extended to the following specified types of entities, which are genuinely widely held entities:

i. Sovereign wealth funds

ii. Pension funds that comply with the requirements /regulations of certain stipulated jurisdictions

iii. Central banks

iv. Government agencies; and

v. The special purpose vehicles for investments set up and controlled by (i) to (iv) above.

Other than the above two recommendations, the FSDC also suggests other issues the Inland Revenue Department (IRD) should address and/or clarify in its revised Departmental and Interpretation Practice note No. 43 (DIPN 43) and/or elsewhere.

3. The Limited Partnership Paper

In the Limited Partnership Paper, the FSDC sets out its recommendations to create an up-to-date legal structure for PE funds in the form of a new limited partnership law, with a view to further developing Hong Kong's status as a PE hub in Asia. The FSDC emphasises the importance of the unification of the location of fund domiciliation with its management centre to attract and retain the talent pool in Hong Kong.

In making its recommendations, the FSDC draws on the OFCs regime, which is being created for onshore mutual funds and hedge funds, and its first recommendation (below, on fund taxation) aligns the proposed PE limited partnership structure with the proposed OFC tax treatment being introduced for other offshore fund investors.

Recommendations:
The FSDC acknowledges that the standalone act of creating a "modern" legal framework for onshore private equity funds to flourish in Hong Kong would be insufficient. To ensure that Hong Kong will continue to be the preferred choice for PE operations, other changes would be required by the tax and regulatory authorities to the following:

a. Fund taxation – the fund should be profits tax neutral and transfers of partnership interests should not be subject to stamp duty.

b. Regulation of PE activities – once PE funds become domiciled in Hong Kong, an upgrade to the current licensing and/or registration requirements would be required to tailor it to the specifics of the PE sector.

c. Double tax agreements – Hong Kong will need to continue expanding its existing range of treaties (currently 33) to cover other major markets such as Australia and India.

Looking to the future

PwC welcomes the in-depth discussions contained within each of the three reports and agrees with the FSDC that there are ample opportunities to help asset managers and stakeholders overcome challenges and resolve issues identified in the reports.

Such changes are necessary for Hong Kong to remain competitive with comparable jurisdictions. Should the developments put forward by the FSDC be successfully implemented, the benefits to Hong Kong, asset managers and investors would be substantial. There would be greater fund flows and growth in assets under management, a boost to economic activity, a substantial increase in the fund management workforce and broader access for investors. PwC believes that these benefits, both immediate and longer-term, are there for the taking if Hong Kong seizes the opportunity.

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