2020

Asset Management Paper

Financial Services Business Council (FSBC) of the European Chamber of Commerce in Hong Kong

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Foreword

This Asset Management Paper is a sequel to the paper published in 2017 and follows the same keen diligence I have witnessed as Councillor to FSBC since 2014.

The paper offers professional insight into the most recent changes in the Asset Management industry in Hong Kong and Europe. It is intended to be a discussion paper and you are encouraged to offer comments, opinions, and praise if so inspired.

Personally, I am interested to understand the effects of COVID-19 and how to unlock the growth of the ETF market in Hong Kong. Discussions turn to the European markets and as well as development in the Greater Bay Area

Opinions are there to be challenged. However, FSBC's objective remains; to benefit Financial Services in Hong Kong with a European twist.

Happy reading!

Jens-Erik Olsen
Councillor to FSBC

Executive Summary

Commissioned to analyse developments in the asset management industry in Hong Kong and Europe, this paper seeks to identify how recent developments will impact the industry and assist asset managers in understanding new regulations and developments.

COVID-19 has had been unprecedented impact and it is likely that 2020 will be remembered around the world the disruption it has caused, including severe restrictions on movement and business activity, increased volatility in global financial markets and fluctuations in assets under management (AUM) in the asset management industry.

In Hong Kong, it has been reported[1] that the asset management industry is facing challenges from the ongoing global macroeconomic uncertainty, locally from the aging of the population, increased competition, talent shortages and the rise of compliance costs and fee pressure. Despite this, the outlook for the Hong Kong asset management industry remains positive, notably with recent announcements in relation to the development of the Greater Bay Area (GBA). In particular the launch of Wealth Management Connect[2], which is designed to enable cross-boundary distribution of investment products to residents in Hong Kong, Macao and 9 cities throughout the Guangdong province in Mainland China represents a significant development. As Hong Kong is the largest asset management centre in the GBA and has a large variety of investment products registered for sale in the territory, Wealth Management Connect presents a potential of unique opportunity for Hong Kong and international asset managers to broaden their client base and grow their AUM.

In addition, the pandemic is shifting investor focus to more sustainable initiatives[3] and further development of green finance and green investment products in Hong Kong is anticipated. This paper comments on the most recent advancements in Hong Kong as well as identifies best practice from Europe in this field.

Besides these two major developments, other important topics are covered and areas of cooperation between Hong Kong and Europe have been identified.

Section 1 considers recent trends with respect to the sale and distribution of European domiciled investment funds in Hong Kong. This section considers the manner in which the Securities and Futures Commission (SFC) monitor and regulate European domiciled funds sold to

[1] KPMG Vision 2025

[2] Hong Kong Government News 29/06/2020

[3] Financial Times, Climate Change: asset managers join forces with the eco-warriors.

the retail public in Hong Kong and notes the preference in recent years amongst the promotors of European domiciled funds to distribute in Hong Kong by way of private placement in preference to registration for sale.

Section 2 discusses recent changes to the regime governing cross border distribution of funds in Europe. Certain of these changes will be relevant to asset managers in Hong Kong as they will need to amend the manner in which their European products are distributed in Europe. The majority of these changes are to be welcomed as they simplify the distribution process and reduce associated costs.

In recent years Hong Kong has taken steps to bolster its attractiveness as a domicile for the establishment of investment fund vehicles. Section 3 provides a brief overview of the background to these new vehicles and some associated challenges and recommendations.

Globally the asset management industry has witnessed a sustained shift from active management of assets towards passive investing, most notably through the increased availability of Exchange Traded Funds (ETFs). The United States and Europe have been at the forefront of this development and it is expected that Asia will be next region to experience this trend. Section 4 explores the development of the ETF market in Hong Kong and discusses the distribution of European ETFs in Hong Kong and the potential for Hong Kong to become a regional hub for the distribution of ETFs.

Bi-lateral Mutual recognition of funds (MRF) schemes have been implemented between Hong Kong and various jurisdictions since 2015 with the aim of deepening cooperation between financial centres, providing access for Hong Kong asset managers to new markets, while also facilitating public distribution in Hong Kong for those agreed overseas products. Section 5 considers the success of the MRF schemes, which are a testament to the increasing cooperation between Hong Kong and overseas supervisory authorities.

Section 6 illustrates the potential of the GBA for the Asset Management industry while section 7 outlines the developments of green finance and ESG in greater detail.

Fintech and Cryptocurrency are increasingly relevant to the asset management industry in both Europe and Hong Kong. Section 8 outlines developments in Europe, Hong Kong and the Cayman Islands concerning cryptocurrency. We consider the HKMA’s new virtual banking licenses and support of talents from local universities.

We have provided an update on Brexit and on-going developments between the UK and the EU and the UK and Hong Kong in section 9.

In the final section of this paper, Deacons have kindly provided a contributing article in respect of the SFC's updates to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance in 2018 and 2019.

At the end of the day, let’s remember that the asset management industry in Hong Kong remains strong with continued opportunities for growth and development.

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1 Trends update in terms of registration and strategies in Hong Kong & European funds

Background

The first Undertakings for the Collective Investment in Transferable Securities (UCITS) Directive was adopted by the European Union in 1985 with the aim of creating a new investment product capable of being marketed across borders. Within three years, the SFC had authorised the first UCITS fund for sale in Hong Kong. Since then, UCITS funds have grown in popularity such that they now make up a large part of the retail funds space in Hong Kong.

Following the expiry of a 6-month pilot period, an enhanced process for new fund applications seeking the SFC's authorisation including UCITS was formally adopted on 9 May 2016. Under this regime, UCITS funds from certain European Union (EU) member states, including Ireland and Luxembourg, are known as "recognised jurisdiction schemes." This means that while the UCITS passport does not extend to Hong Kong, the SFC accept that UCITS already comply with certain provisions of the Code on Unit Trusts and Mutual Funds (the "Code") and accordingly benefit from a streamlined application process. Although recognised jurisdiction schemes may not fully comply with the Code, the SFC nonetheless deems that UCITS funds meet certain structural, operational, investment requirements and core investment restrictions. The SFC expects a scheme to comply in all material respects with the local requirements and reserves the right to require compliance as a condition of authorisation.

The streamlined process was initially designed to encourage and promote one-way fund sales into the Hong Kong market and as such was unilateral in nature. However, as the Hong Kong asset management market has grown, the SFC has begun to seek reciprocity from various European states. This is evident in recent memoranda of understanding entered into between the SFC and the relevant authorities in jurisdictions such as the UK, Switzerland, France and Luxembourg.

The SFC continues to expand the types of retail fund products which are available to Hong Kong investors, while at the same time seeking to improve access to the European markets for Hong Kong based investment managers. Furthermore, it is anticipated that the introduction of the open-ended fund company and limited partnership fund structures in Hong Kong will facilitate greater cross border distribution of Hong Kong domiciled funds in the future.

Challenges

The UCITS market in both Ireland and Luxembourg has enjoyed almost continuous year on year growth over the past decade both in terms of number of number of funds launched and the net asset value of those funds (see Table 1 below). Moreover, both Irish and Luxembourg domiciled UCITS continue to be widely sold in the retail funds space in Hong Kong with Irish and Luxembourg UCITS funds accounting for over 50% of the net asset value of schemes authorised by the SFC for sale to the retail public in Hong Kong (see Table 2 below).

The growth in the UCITS market has been achieved during a period of increased regulatory scrutiny. New regulations – principally the Markets in Financial Instruments Directive II, Packaged Retail and Insurance-based Investment Products Regulation and the General Data Protection Regulation have collectively consumed a significant amount of asset managers' resources and time, as well as adding to reporting and compliance requirements on an on-going basis. There has also been increased regulatory and industry focus on liquidity management in recent years. In September 2019, the European Securities and Markets Authority (ESMA) released guidelines on liquidity stress testing in UCITS which set out to increase the standard, consistency and, in some cases, frequency of liquidity stress tests and promote convergent supervision of these tests by National Competent Authorities (NCAs).

While the general trend has been one of improved access to the Hong Kong market for UCITS, there are certain provisions of the Code which management companies of UCITS should take note. For example, under Chapter 8 of the Code, index tracking ETFs will only be authorised where the index used: has a clearly defined objective; is broadly based and not overly concentrated; is investible; is objectively calculated and rules based; and is transparent. Moreover, the SFC imposes strict reporting requirements on fund managers to inform the SFC of any factors affecting the acceptability of the index after authorisation.

In addition, the SFC imposes an overall limit of 50% of the fund's Net Asset Value (NAV) on the use of derivatives for investment purposes (but not hedging purposes) by 'plain vanilla funds' sold to the retail public in Hong Kong (including UCITS). Fund managers must disclose in the product Key Facts Statement (KFS) the purpose of, and expected maximum leverage arising from, derivative investments. The templates for the KFS for the enhanced disclosure requirements for derivative instruments are posted on the SFC website. UCITS with derivative investments exceeding 50% of their net asset value, are regarded as derivative funds subject to the enhanced distribution requirements under 5.1A and 5.3 of the Code of Conduct for Persons Licensed by or Registered with the SFC.

In its recently published Annual Statistical Report, ESMA criticised UCITS' fund fees as a drain on performance, which often resulted in cheaper, passive products delivering better returns than their actively managed peers. ESMA's comments could be a precursor for further cost transparency requirements in the near future.

The Low Carbon Benchmarks Regulation (EU) 2019/2089 introduces a regulatory framework that lays down minimum requirements for EU climate transition benchmarks and EU Paris-aligned benchmarks at the EU level, to ensure that these benchmarks do not significantly harm other environmental, social and governance (ESG) objectives came into force 10 December 2019. The EU also has plans to introduce a taxonomy to enable customers to benchmark the green credentials of their asset managers. Furthermore, on 17 December 2019 the EU Parliament reached agreement with the EU Council on new criteria to determine whether an economic activity is environmentally sustainable. The EU taxonomy will provide investors with clarity on which activities are considered environmentally and socially sustainable. The agreement reached will now have to be approved first by the two committees involved and by a plenary vote. This regulatory and market-initiated drive towards sustainable funds will be a major trend in European domiciled funds during the course of the next decade and one which the industry must begin preparing itself for.

The COVID-19 pandemic is having an impact on the asset management industry in both Europe and Hong Kong. Increased volatility in the markets and lockdown measures in various countries mean that business activity is likely to decrease, leading to a lasting impact on the global economy. During periods of global uncertainty solvency concerns are exacerbated, leading to concerns around liquidity and large-scale redemptions. The full scope of the COVID-19 outbreak, its duration, intensity and consequences are uncertain and any resultant economic slowdown and/or negative business sentiment across markets may have a negative and long-lasting impact on the operations and financial performance of the asset management industry.

Market Trends

TABLE 1[4]

Number of Fund Launches in UCITS in Ireland and Luxembourg - 10 Year Trend				
	Number of Funds in UCITS launched	Value of Net Assets (€ million)	Number of Funds in UCITS launched	Value of Net Assets (€ million)
	Ireland		Luxembourg	
2009	2.721	597.331	3.463	1,840,993
2010	2.899	758.530	3.667	2,198,994
2011	3.085	820.050	3.845	2,096,512
2012	3.167	967.561	3.841	2,383,826
2013	3.345	1,043,666	3.902	2,615,363
2014	3.561	1,275,470	3.905	3,094,987
2015	3.864	1,446,871	3.878	3,506,201
2016	4.051	1,578,920	4.144	3,741,330
2017	4.266	1,830,519	4.044	4,159,614
2018	4.510	1,810,825	3.908	4,064,644
2019	4,641*	2,191,083*	3 807*	4,569,999*
***as at Q3 2019**				

[4] Monterey Insight, 2019

TABLE 2[5]

SFC Authorised Unit Trusts and Mutual Funds by Origin							
	As of 31 March 2020					As of 31 March 2019	
	Umbrella Funds	Sub Funds	Single Funds	Total	Total NAV (US$ mil-lion)	Total	Total NAV (US$ mil-lion)
Hong Kong	142	543	77	762 (35.7%)	138,163 (10,1%)	789 (35.6%)	154,831 (9.9%)
Luxembourg	46	985	1	1,032 (48.3%)	884,587 (64.8%)	1,064 (48%)	1,059,476 (67.8%)
Ireland	23	197	2	222 (10.4%)	204,602 (15%)	218 (9.8%)	207,154 (13.3%)

[5] SFC annual report 2019-20, page 160.

TABLE 3[6]

Irish-domiciled UCITS with Hong Kong Promoters

2018			
Name of Promoter	**Assets (US$)**	**No. of Funds**	No. of Funds Authorised for Sale in Hong Kong [1]
GaveKal Capital	813,414,164	5	0
Pacific Capital Management	349,559,008	5	0
Value Partners Group	249,851,380	5	0
China Post Global	221,658,593	1	0
Atlantis Investment Management	193,201,131	4	0
Frontier Asia Capital Hong Kong	81,787,366	1	0
CSOP Asset Management	38,620,561	2	0
Hamon Investment Group	19,989,029	2	1
Total:	1,968,081,232	25	1
***these UCITS are in most cases distributed in multiple jurisdictions and therefore the assets figure does not represent the capital**			

[6] Monterey insight, 2019

TABLE 4[7]

Luxembourg domiciled UCITS with Hong Kong Promoters (2018)

Name of Promoter	Assets (US$)	No. of Funds
OP Investment Management	759,945,636	2
PAG	222,547,133	3
China Post Global	222,547,133	8
Bank of China Group	136,912,925	2
CSOP Asset Management	104,956,370	2
JK Capital Management	85,825,750	2
Wistech Capital	10,274,043	1
SINO-CEEF Capital Management Company	Not disclosed	1
SIF Private Label	871,416,563	7
Total:	1,768,275,124	28
*these UCITS are in most cases distributed in multiple jurisdictions and therefore the assets figure does not represent the capital raised in Hong Kong. [1]		

The general market trend in recent years towards private placement is evident in the UCITS market, with the vast majority of Hong Kong promoters of UCITS opting to sell into the Hong Kong market by means of private placement.

[7] Monterey insight, 2019

Conclusions

- While enhanced protection and transparency for investors is to be welcomed, investors are also investing to make a profit. The European Commission is therefore encouraged to ensure that new regulatory developments and requirements should are proportionate to the risk they are seeking to mitigate.

- The Hong Kong government and European Commission are encouraged to explore the possibility of European domiciled funds being distributed in Mainland China, potentially through the Hong Kong – Mainland China Mutual Recognition of Funds Scheme.

- ESMA's review of UCITS performance fees is a welcome development in ensuring the continued competitiveness of Irish and Luxembourg UCITS for investors located in Europe and Hong Kong.

- ESMA's and European regulators increased focus on liquidity is welcomed, particularly in light of on-going macro-economic trends. Standardised liquidity stress testing at a European level will enhance investor protection and ensure consistency across market participants.

2 Regulatory Changes to the Cross-Border Distribution of Funds in Europe

Background

On 20 June 2019, the European Parliament and the Council introduced a more harmonised framework on cross-border distribution of funds. The aim of the new Directive 2019/1160 (the “**New Directive**”) and the Regulation 2019/1156 (the "**New Regulation**") is to reduce regulatory roadblocks or barriers that hinder cross-border distribution of funds within the EU and to enhance fund managers’ ability to fully benefit from the internal market. The new rules provide notably for a harmonised definition of pre-marketing, create a central database on cross-border marketing, modify the rules applicable to marketing communication requirements and specify new requirements regarding facilities available to investors.

The most substantive provisions of the new regulation and directive will apply from 2 August 2021, the date by which such provisions must be transposed into national law.

Changes to note for Hong Kong Asset Managers

Local Agents (UCITS)

- The UCITS Directive gave EU member states discretion over whether to require the appointment of a local agent by a UCITS to provide facilities to local investors, e.g. facilities for payment of subscriptions and redemptions, availability of fund documents, etc. In many cases, EU Member States exercised this discretion and require a local agent to be appointed; thereby increasing the costs associated with passporting a UCITS fund into those jurisdictions.

- A UCITS will be required to provide certain facilities in all Member States where its shares are registered for marketing, e.g. facilities for processing of subscriptions and redemptions; handling of investor complaints; making available fund documents; and acting as a point of contact for competent authorities.

  Crucially, Member States will not be permitted to require a UCITS to have a physical presence in the provision of such facilities, meaning it should be possible to provide the facilities remotely from another Member State.

- A UCITS must ensure that the facilities are provided in the official language (or one of the official languages) of a Member State where its shares are marketed, or in another language which is approved by that Member State's NCA. The UCITS may appoint a third party to perform some or all of the tasks concerned; however, such appointment must be in writing.

The harmonisation of requirements will reduce the burden of appointing local agents for Hong Kong fund managers who market UCITS in multiple EU jurisdictions. Unless there is a commercial reason to do so, it should not be necessary to appoint a separate local agent in each jurisdiction once this is no longer legally required.

Update Notifications (UCITS)

The current requirement is for such changes to be notified promptly to each individual host Member State NCAs after they have taken effect.

The New Directive states that these changes must be notified to both the UCITS home and host Member State NCAs at least one month before implementing the change. This will also apply to the registration of new share classes, meaning that both the home and host Member State NCAs must be notified at least one month in advance of the new share classes being marketed.

De-registration for marketing (UCITS)

The current process for de-registering a UCITS varies between EU Member States due to a regulatory gap at EU level. The new provisions are designed to fill this gap and to align the procedure for de-registering a UCITS with the de-registration process for Accredited Investment Fiduciary (AIF).

The New Directive requires that certain conditions are fulfilled in order to de-register a UCITS, including:

1. There must be a blanket offer to repurchase or redeem, free of any charges, all shares held by investors in the host Member State. The offer must be publicly available for at least 30 working days and addressed individually to all investors whose identity is known.

2. The intention to de-register must be made public at least by electronic means and in a medium, which is suitable for a typical UCITS investor;

Note: The information in 1) and 2) above must be provided in the official language (or one of the official languages) of the host Member State, or in a language approved by that state's NCA.

3. Contractual arrangements with financial intermediaries or delegates must be modified or terminated with effect from the date of de-registration in order to prevent any further offering of shares.

While notifications to de-register are currently notified directly to the host Member State NCA, the New Directive requires notifications to be filed with the UCITS home Member State NCA for onward transmission to the host member state NCA and the ESMA.

Pre-Marketing (AIFs)

The New Directive will introduce a definition of "pre-marketing" to enable EU AIFMs to test market interest before establishing an AIF or registering it under Article 31 or Article 32 of Alternative Investment Fund Managers Directive (AIFMD).

The current position on pre-marketing, whether it is permitted and, if so, the conditions under which it is permitted, varies considerably between Member States and are often unclear.

EU AIFMs will be permitted to engage in pre-marketing of an AIF (or a sub-fund of an AIF) which is not yet established, or if established, which has not yet been notified for marketing under Article 31 or Article 32 of AIFMD in the Member State where the potential investors are domiciled. There are certain conditions that will apply to pre-marketing including that: the information must not be sufficient to allow investors to commit to acquiring shares in an AIF and must not constitute an offer or invitation to subscribe for shares in an AIF; the information must not amount to subscription forms or similar documents in draft or final form; an EU AIFM shall be required to notify its home Member State NCA within two weeks of having commenced pre-marketing outlining certain details e.g. regarding the Member States where pre-marketing is being conducted, investment strategies presented and a list of the AIFs which form part of the pre-marketing activities (if relevant); and an EU AIFM must ensure that pre-marketing is adequately documented.

Finally, it is important to note that pre-marketing under the New Directive will be available to EU AIFMs only. The provisions on pre-marketing do not apply to non-EU AIFMs.

Conclusions

The New Directive and New Regulation contain welcome enhancements in the area of cross-border distribution of investments funds, particularly in the context of pre-marketing of AIFs and the requirements for de-registration. The introduction of a pan-European definition of pre-marketing for EU AIFMs should significantly reduce the costs associated with gauging interest in a proposed strategy.

The increased harmonization with regard to local representatives should result in greater certainty for UCITS managers with a distribution footprint across the EU, as well as removing barriers for those managers planning to distribute in new EU markets. Importantly the removal of the requirement to appoint local agents in certain Member States should result in reduced costs for UCITS managers and a quicker process to commence marketing in new jurisdictions.

3 Updates from Hong Kong – Opened Ended Fund Companies and Limited Partnership Funds

Background

Hong Kong continues to bolster its position as a preferred fund domicile by expanding the range of legal structures for investment fund vehicles. In 2018, the SFC launched the open-ended fund company (OFC) and it is anticipated that the Limited Partnership Fund Bill will be enacted into law in Hong Kong and come into force on 31 August 2020. The new limited partnership regime is intended to bolster Hong Kong as domicile for private equity funds.

Current Situation and Challenges

Open Ended Fund Companies

The SFC launched the open-ended fund company on 30 July 2018. Prior to that, investment funds in Hong Kong were commonly established in the form of unit trusts but not in corporate form – which is widely used in other international fund domiciles.

The OFC is an investment fund established in corporate form with limited liability and variable share capital in Hong Kong. As the primary regulator, the SFC oversees the regulation and supervision of OFCs. OFCs can be launched in either public or private form and can be listed or unlisted. With regard to tax, OFCs are exempt from profits tax under the Inland Revenue Ordinance if certain conditions are met. OFCs offer three main advantages. Firstly, they allow for the redemption of shares from paid-up capital, thus providing for the first time a Hong Kong domiciled corporate vehicle suitable for open-ended investment funds. Secondly, as corporate vehicles, OFCs offer not only limited liability but statutory segregation of assets and liabilities between sub-funds so that the liabilities of one sub-fund cannot be satisfied from the assets of another sub-fund.

To date, four OFCs have been launched in Hong Kong. Two these are umbrella OFCs and are publicly available, namely Global X Exchange Traded Funds Series OFC and BU Fund Series OFC. Mirae Asset Global Investments (Hong Kong) Limited is the promotor of Global X Exchange Traded Funds Series OFC, which is comprised of three ETF sub-funds listed on HKEx. OFC ETFs provide certain tax benefits for Korean and Japanese institutional investors.

Challenges associated with the Open-Ended Fund Companies Regime

The level of prescription and oversight exercised by the SFC may deter Hong Kong hedge fund managers who are familiar with offshore vehicles from establishing private OFCs. For example, the OFC code limits the investment scope of a private OFC to at least 90% of its gross asset value in securities and futures contracts and/ or cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts, with a maximum of 10% of gross asset value in other assets classes. The SFC is currently consulting on expanding the investment scope of private OFCs to include two common asset classes (loans and shares of private companies) which may enhance the attractiveness of private OFCs to Hong Kong hedge fund managers.

The requirement to appoint a custodian which is approved by the SFC and meets the eligibility requirements set out in the Unit Trust Code, may prevent managers for opting to establish a private OFC as the standard practice for such vehicles domiciled offshore is to appoint one or more prime brokers, although it is of course worth noting that many of the prime brokers operating in Hong Kong are part of large global banking groups, who will have custodian entities in Hong Kong eligible to act as custodian of an OFC under the Unit Trust Code.

The prescriptiveness of the SFC's requirements may lead to more public OFCs being established than private OFCs representing a missed opportunity for Hong Kong to attract increased domiciliation in the Hedge Fund industry.

Investor familiarity and distribution channels may present challenges for the OFC. Private OFCs will be privately placed throughout the region, however, it remains to be seen how investors in the region will view the new structure. At present public OFCs may be distributed to the retail public in Hong Kong or through the various Mutual Recognition of Funds regimes in place.

Limited Partnership Funds

In the Financial Secretary's 2019-20 Budget Speech, the Hong Kong Government announced it has been "studying the establishment of a limited partnership regime for private equity funds, with a view to providing the industry with more fund choices."

Following extensive industry engagement, Hong Kong’s limited partnership fund (LPF) bill was gazetted on 20 March 2020, passed its third reading at the Legislative Council on 9 July 2020 and will become law on 31 August 2020.The LPF regime will be a registration regime with the Registrar of Companies in Hong Kong and will not directly involve the SFC. The SFC will continue to license the entity that manages the assets of the LPF in Hong Kong, whether that is the general partner of the LPF or a delegate investment manager.

An LPF will be constituted by a limited partnership agreement between the general partner and the limited partners and there will be no minimum capital requirement or restriction on the investment scope for an LPF.

Complementing the OFC regime as an onshore vehicle for hedge funds, the LPF as an equivalent regime for private equity, venture capital, real estate and infrastructure funds will encourage more investment funds and fund managers to domicile in Hong Kong thereby providing market players with more flexibility in structuring and domiciliation with substance.

Challenges associated with Limited Partnership Funds

Investor inertia is likely to be the greatest challenge to the LPF regime in Hong Kong, large institutional private equity investors may be more familiar with the regimes in the Cayman Islands or Delaware and may be less inclined to invest in a Hong Kong LPF until the structure has been proven to work.

Conclusion

The introduction of two new fund structures in Hong Kong is to be greatly welcomed. In light of the increased trend towards domiciliation in the jurisdiction where the assets are being managed and given the large number of hedge fund and private equity managers in the region, Hong Kong is now well placed to capitalize on this trend.

The FSBC supports the proposals contained in the SFC's consultation paper on the OFC regime in Hong Kong which set out the following four proposed enhancements:

- Allow licensed or registered securities brokers to act as custodians for private OFCs;
- Expand the investment scope for private OFCs to include loans and shares and debentures of Hong Kong private companies;
- Introduce a statutory mechanism for re-domiciliation of overseas corporate funds to Hong Kong; and
- Require OFCs to keep a register of beneficial shareholders to enhance anti-money laundering and counter-terrorist financing measures.

The FSBC would advocate for the removal of all investment restrictions applicable to private OFCs to ensure that they can compete with vehicles available in other jurisdictions.

The FSBC recommends that the new LPF regime be introduced as soon as possible and that the Hong Kong government opt to follow established industry practice with regard to private equity funds generally to ensure that the new regime is competitive on the global stage.

4 The Expansion of UCITS ETFs in Hong Kong

Background

The Evolution of the ETF industry

The development of ETFs since the financial crisis is one of the more important developments in global capital markets over the past decade. More than US$3.5 trillion in new cash has been invested in ETFs globally over the past 10 years; global assets held by ETFs climbed to a record US$6 trillion in December 2019.

US investors have led ETF adoption globally, with European investors now increasingly allocating to ETFs. The European UCITS[8] ETF industry size has doubled in the last 4 years with assets exceeding the US$1 trillion mark. ETF adoption rates in Asia remain below those in the US and Europe, however it is expected that increased familiarity will lead to significant growth in the near future.

There are multiple drivers behind the growth of the ETF industry in Europe:

- A combination of a fee war, underperformance by active managers[9] and robust returns in the equities market in recent years have accelerated the shift towards ETFs. Certain investors have abandoned their plans to continue to invest in actively managed products while others have increasingly allocated a portion of their portfolio toward ETFs.

- The growth in passive investing has also been supported by regulatory changes in Europe; for instance, the introduction of bans on payment of commissions in the U.K., Netherlands and Switzerland has created a more level playing field between ETFs and actively managed funds in these jurisdictions.

- Furthermore, the decision in September 2019 by the European Central Bank (ECB) to restart its asset purchase program, known as quantitative easing, has encouraged

[8] Undertakings for the Collective Investments in Transferrable Securities (“UCITS”)

[9] 9 of 10 actively managed pan-European equity funds underperformed a passive benchmark over the 12 months. Active pan-European fund managers could only demonstrate a modest improvement in performance over longer periods up to 10

interest in Bond ETFs. They have drawn a record $61bn in new money last year, outpacing net inflows for equity UCITS ETFs for the first time in 3 years.

- The new iETF post-trade model (Euroclear ICSD model[10]), an industry-wide initiative, has also been instrumental to support the growth. It has enabled in Europe to (1) seriously improve the settlement efficiency (which was formerly low) and (2) remove important frictional costs allowing for a more competitive spread in the market.

It is anticipated that Asia will represent the next frontier in the growth of the ETF industry as Asian investors will be influenced by some of the growth drivers outlined above. The Asia Pacific (ex-Japan) region has already attracted investment in $250bn of local products according to ETFGI LLP data, from December 2019. A peculiarity of the Japanese ETF industry is the substantial investment by the Bank of Japan in Japanese ETFs, holding in excess of US$250 billion of assets in ETFs.

An estimated US$150 billions of institutional investment from APAC has been invested in products issued outside of the region (predominantly US ETFs and EU UCITS ETFs)[11] with an estimated 30-40% of that amount invested in EU UCITS ETFs.

Window of Opportunity in Hong Kong

In recent years, the size of the ETF market in Hong Kong has been relatively stable (around US$37bn), compared to the substantial growth witnessed in other markets in the Asia Pacific region such as Australia, Taiwan and South Korea.

Scale is a critical component of the ETF industry, and to date the range of ETFs listed in Hong Kong has been limited, with those established mainly investing in securities or bonds of Chinese and Hong Kong issuers, however recently the Hong Kong market is seeing increased development and investor interest in leverage/inverse products. This suggests a lack of diversification, and limited investor choice, this in turn may explain why the above inflows into European and US ETFs from the APAC region have been so strong.

In Hong Kong, there is a growing appetite for UCITS ETFs[12]; to date a limited number of European ETFs issuers have cross-listed their ETFs on the Stock Exchange of Hong Kong (HKEx). Cross-listing allows these UCITS ETFs to be traded on the secondary market during the Asian time zone and may assist in addressing investors best execution requirements.

[10] Pioneered by BlackRock and Euroclear. For more information please refer to Euroclear- Harnessing the European ETF opportunity.

[11] Pensions & Investments- ETF managers focusing on Asia-Pacific opportunities

[12] HK investors have a better tax advantage when they invest in UCITS ETFs versus US ETFs.

The HKEx is now redoubling its efforts to encourage exchange trading by recently introduced two new measures (new spread tables and new market making program) designed to tighten spreads, improve visibility of liquidity and reinforce the competitiveness of the market making function.

Furthermore, thanks to recent collaboration between HKEx and Euroclear Bank, it is now possible to move UCITS ETF shares from Europe to Asia on a same-day basis, which was not previously possible. A successful pilot was conducted in December 2019, whereby a market maker and an ETF issuer demonstrated the benefits of this structure. Indeed, this link has removed a critical obstacle which was generating huge friction costs which translated into high spread in the market (in the range of 200-300bp). This development gives global market makers the opportunity to quote more competitive spreads in the range of 30bps, and even lower for certain UCITS ETFs. Quotations which are competitive with those from London, Frankfurt and Paris are now possible during the trading day in Hong Kong; in particular for strategies with Asian exposures and products with ability to hedge with futures during Asian time zones. This brings a window of opportunity for local institutional and retail investors to invest in a wider range of UCITS ETFs in the near future.

There is one more supportive move, in the form of a stamp duty exemption for market-makers when dealing in the primary market. It is aimed at reducing transaction costs for ETF market-makers and so enhancing the competitiveness of Hong Kong as a listing venue.

It is worth noting however, that UCITS ETF issuers face other obstacles when seeking to distribute their products in Hong Kong. A significant challenge is the amount of time it takes to authorise UCITS ETFs for sale in Hong Kong with the SFC. In some markets non-European markets, for example Mexico, it may only take one month to list an ETF. Whilst the SFC registration process has shortened in recent years, for certain UCITS ETF issuers it may still be viewed as cumbersome and discourage cross listing.

The so-called 'on-going obligation' by the SFC also presents challenges as the SFC's may require prior approval of certain material changes in UCITS ETF documentation.

We welcome on-going dialogue between global ETF issuers, the HKEx, market participants and the SFC to discuss the SFC's requirements with an objective to create a more flexible and efficient registration process in the near future.

Increased listing of UCITS ETFs in Hong Kong would present Hong Kong with the opportunity to become a regional hub for the sale of ETFs. Furthermore, with the settlement occurring locally, this would allow Hong Kong capital flows to remain in the local central securities depositary, CCASS.

In addition, the SFC issued a circular in December 2019 stating they will allow increased flexibility in a master-feeder ETF structures so that an SFC-authorized feeder ETF may invest its assets in an overseas-listed master ETF which is not authorized by the SFC or listed on the HKEx subject to certain key regulatory requirements being met.

Cross-listing of UCITS ETFs and master-feeder structures in Hong Kong, are complementary approaches and can help support growth of the ETF industry as a whole in the region[13]. On 22 July 2020, iShares has listed the first feeder ETF[14] on HKEx.

Conclusion

The FSBC would like to propose that the constructive dialogue which is on-going between ETF market participants (i.e. global ETF issuers, infrastructure providers and market makers) with regulators like the SFC should continue. As scale is such an important feature of the ETF market, any efforts to facilitate the distribution of large-scale ETFs (such as European UCITS ETFs) in Hong Kong is to be welcomed as it provides more choice for investors in the region.

[13] Euroclear White Paper June 2020

[14] MSCI Emerging market ETF as a feeder ETF that invests into its Irish domiciled ETF that tracks the MSCI Emerging Markets Index.

5 Mutual Recognition of Funds and Distributing Hong Kong and China funds into Europe

Established schemes

The Mainland-Hong Kong Mutual Recognition of Funds

The Hong Kong-Mainland Mutual Recognition of Funds (Mainland-HK MRF) is a joint scheme launched in 2015 by the SFC and the China Securities Regulatory Commission (CSRC) under which eligible Mainland and Hong Kong funds can be distributed in each other's retail markets through a streamlined vetting process. To be considered eligible, funds in both jurisdictions must comply with a number of rules and transparency requirements set out under the Memorandum of Regulatory Cooperation on Mainland-Hong Kong Mutual Recognition of Funds signed between the SFC and the CSRC. In particular, the following types of funds are eligible under the programme:

- general equity funds;
- bond funds;
- mixed funds;
- unlisted index funds; and
- physical index-tracking ETFs

As of 30 June 2020, 51 Mainland Funds have been approved by the SFC for sale to the retail public in Hong Kong under the Mainland-HK MRF. As of 30 February 2020, 29 Hong Kong funds have been approved by the CSRC for sale to the retail public in Mainland China under the Mainland-HK MRF.

The initiative opened the Mainland retail fund market to foreign funds for the first time and made a wider selection of fund products available to investors in both jurisdictions. The Mainland-HK MRF enhanced the international competitiveness of both the Mainland and Hong Kong fund markets and is expected in particular to further consolidate Hong Kong's position as Asia's leading asset management centre. At present only Hong Kong domiciled funds domiciled managed by an SFC-licensed fund manager are eligible to apply for authorisation for

Mainland retail distribution under the Mainland-HK MRF, which means that European funds such as UCITS are for the time being excluded from the scheme.

Swiss-Hong Kong Mutual Recognition of Funds

The SFC announced on 2 December 2016, the entry into force of a mutual recognition of funds programme between Switzerland and Hong Kong (Swiss-HK MRF). The arrangement creates new opportunities for fund managers in both Switzerland and Hong Kong, as it streamlines the vetting process of retail funds in both jurisdictions.

Switzerland is an important private banking centre globally (although not a member of the European Union). The new program provides an incentive to Hong Kong based fund managers to distribute their fund products to Switzerland by giving them access to a large market of high net-worth investors.

The scope of the Swiss-HK MRF is broader than the scope of the Mainland-HK MRF. Equity funds, bond funds, mixed funds, index tracking funds, ETFs, feeder funds, money market funds, structured funds and funds that use financial derivatives are eligible to participate in the scheme.

In order to be eligible for the Swiss-HK MRF, funds seeking approval must, be domiciled, managed, and have been approved for retail distribution in Switzerland or in Hong Kong, respectively. The manager must be appropriately licensed by the home regulator to conduct asset management activities, with no regulatory breach reported in the last three years. As with the Mainland-HK MRF scheme, a local representative or agent must be appointed in the host jurisdiction. Other requirements such as proper investor protection as well as fair and equal treatment must also be complied with.

As of July 2019, three asset managers of Hong Kong domiciled funds have been approved by Swiss Financial Market Supervisory Authority to distribute their funds in Swiss under the MRF scheme.

France-Hong Kong Mutual Recognition of Funds

On 10 July 2017, the SFC and France’s Autorité des Marchés Financiers (AMF) signed a MoU on a France-Hong Kong mutual recognition of funds scheme (France-HK MRF). The France-HK MRF is the first agreement of this kind entered into between Hong Kong and a member of the European Union.

The MoU sets out in particular the various requirements that funds must comply with to fall within the scope of the program. Eligible funds can then be offered, marketed and distributed to retail investors as well as to professional investors on a cross-border basis between the two jurisdictions.

Equity, bond and mixed funds are eligible under the France-HK MRF. The MoU thus encompasses UCITS, excluding however money-market funds, ETFs (all categories of ETFs), index funds and structured funds (unlike the Swiss-HK MRF).

Key requirements applying to cross-border distribution under the France-HK MRF include the need to translate the offering documentation in the target investor's language and the obligation for eligible French funds to be managed by a management company established in France.

The entry into of the MoU established a revised framework for cooperation and joint supervision between the AMF and the SFC. The newly established bridge between France and Hong Kong is seen by the industry as an important breakthrough for French asset managers, as the Paris seeks to develop itself as a financial service centre internationally in response to Brexit. As of December 2019, no Hong Kong domiciled funds have been reported for distribution in France and similarly no French funds were authorised for distribution in Hong Kong.

United Kingdom - Hong Kong Mutual Recognition of Funds

On 8 October 2018, the SFC and the UK's FCA signed a MoU establishing a framework for eligible funds to be distributed to retail investors in each other's markets through a streamlined authorisation process.

Regarding applications, the MoU establishes a framework that includes a streamlined process where both the FCA and SFC grant authorisation to a fund covered by this MoU, for public distribution into their respective territories. Any change to a covered fund affecting investors of the host market, including fund termination, must be made in accordance with the terms of the FCA-SFC MoU and must be filed with the host competent authority.

Luxembourg-Hong Kong Mutual Recognition of Funds

On 15 January 2019, the SFC and the Commission de Surveillance du Secteur Financier (CSSF) entered into a Memorandum of Understanding (MoU) on Mutual Recognition of Funds (Luxembourg-HK MRF), which will allow eligible Hong Kong public funds and Luxembourg UCITS funds to be distributed in each other's market through a streamlined process. The MoU also establishes a framework for exchange of information, regular dialogue as well as regulatory cooperation in relation to the cross-border offering of eligible Hong Kong public funds and Luxembourg UCITS funds. New Luxembourg UCITS seeking to access Hong Kong market can take advantage of the streamlined authorisation process and its key operators (i.e., management companies and custodians) are deemed to be compliant with relevant Hong Kong requirements once they are compliant with Luxembourg laws and regulations. The Luxembourg-HK MRF will facilitate the offering of Hong Kong domiciled funds to the retail public in Luxembourg and will facilitate an easier path for managers to distribute Luxembourg UCITS in Hong Kong.

Hauck & Aufhäuser Fund Services S.A. (HAFS) is the first capital management company to have authorized a Luxembourg mutual fund for public distribution under the MRF between Hong Kong and Luxembourg.

	France	Switzerland	United-Kingdom	Luxembourg
Date of MoU	July 2017	December 2016	October 2018	January 2019
Eligible Fund Managers	Authorised by AMF to manage publicly offered funds, and remain eligible	Authorised by FINMA to manage publicly offered funds and remain eligible	Authorised by FCA to manage publicly offered funds and remain eligible	Authorised by CSSF to manage publicly offered funds and remain eligible
Eligible funds from Host to HK	French Funds recognised and approved by AMF French "covered funds" and remaining authorised	Swiss Covered Funds recognised and approved by FINMA and remaining authorised	UK Covered Funds authorised by FCA and remaining authorised	Luxembourg Covered Funds, managed and domiciled in Lux Authorised by CSSF as UCITS and remaining authorised
Eligible funds from Hong Kong	All HK authorised and domiciled	All HK authorised and domiciled	All HK authorised and domiciled	All HK authorised and domiciled
Investment types	General Equity Bond and Mixed Funds	General Equity Bond and Mixed Funds Feeder Funds Money Market Funds Index FundsETFs Structured Funds Funds that invest in FDIs	General Equity, Bond and Mixed Funds Feeder or Fund of Funds Index Funds ETFs	General Equity Bond and Mixed Funds Feeder Funds
Fund types not allowed	Commodity Money Market ETF Index Fund Structured	Commodity	Commodity Money Market	Commodity ETF Index Structured Money Market
Other requirements	Min. 20% French domiciled investors Appoint a HK Rep.	Appoint a HK representative	Appoint a HK representative	Appoint a HK representative

Offering documents in HK	AMF approved Prospectus plus HK KFS and Covering Document in E and C	FINMA approved Prospectus plus HK KFS and Covering Document in E and C	FCA approved Prospectus plus HK KFS and Covering Document in E and C	CSSF approved Prospectus plus HK KFS and Covering Document in E and C[15]

Looking into the future: Asia Region Funds Passport has been officially launched

The Asia Region Funds Passport was officially launched on 1 February 2019 but the initiative commenced three years before that when in June 2016, Australia, Japan, the Republic of Korea, New Zealand and Thailand entered into a memorandum of co-operation (MoC) and a Joint Committee was established to oversee the effective implementation and operation of the Passport.

Hong Kong is not a member of the scheme, but it is noted that representatives of the SFC have attended some recent meetings in an observer capacity.

The Passport aims to provide significant benefits to investors through enabling greater fund choice, while maintaining effective legal and regulatory arrangements for investor protection. It is also intended to strengthen the capacity, expertise and international competitiveness of the funds industry and financial markets in the region.

By late 2019, Australia, New Zealand, Thailand and Japan had implemented the necessary measures for the scheme to commence and the South Korean implementing measures were expected to launch at the end of May 2020.

Challenges - A Pan-European Distribution Framework for Hong Kong Registered Funds

Foreign funds, including UCITS products, have the ability to be registered with the SFC and sold to the retail public in Hong Kong. UCITS are first required to submit an application to the SFC in order to be approved to be marketed and there are a number of conditions that the product, the fund documentation and the investment manager must meet under the SFC's Handbook for Unit Trusts and Mutual Funds, Investment-Linked Assurance Schemes and Unlisted Structured Investment Products in order to be approved.

The FSBC recommends to the European Commission and the SFC that a pan-European reciprocal arrangement be implemented for the distribution of Hong Kong registered funds in Europe. This arrangement would permit Hong Kong registered funds to apply to be permitted

[15] The MRF Schemes compared (Source: Citi & SFC)

to distribute to the retail public in EU member states on the basis of a common set of rules and regulations. The registration process should be similar to the process that UCITS funds are subject to in Hong Kong. Once the Hong Kong fund has been approved by a member state it should then benefit from a European passport so that it can be distributed throughout the EU.

In the SFC's 2018-2019 annual report it was noted that there are 789 Hong Kong domiciled funds and there are 1,338 European UCITS funds registered for sale in Hong Kong. Separately, it is worth noting that offshore products (in particular Cayman products) are more popular in the Hong Kong market and the Hong Kong Investment Funds Association represents 67 managers with 1,944 funds, representing assets of €901 billion, with 94% of funds being offshore." Therefore, the implementation of a pan-European distribution framework which grants UCITS funds access to MRF with China would be more beneficial for UCITS and would likely lead to an increase in the number of UCITS registered in Hong Kong which would also be beneficial for the SFC.

Conclusions

The FSBC would like to make the following recommendations:

- The European Commission and the SFC are encouraged to commence a dialogue on the implementation of a Pan-European distribution framework for Hong Kong retail funds, or promote further implementation of new bilateral distribution arrangements between other member states and Hong Kong.

- The European Commission is encouraged to continually consider how best to position UCITS so that they can gain access to the MRF scheme between Hong Kong and China and be sold to the retail public in China or through the GBA initiative.

6 Greater Bay Area Development

Background

The GBA aims to promote strategic cooperation between Hong Kong, Macao and nine cities in Guangdong Province to create a globally competitive and world-class city cluster. With a population of around 70 million and GDP of $1.6 trillion, the GBA is larger than some G20 countries in terms of economic output[16].

Fund managers who offer investment choices to the public and pension schemes form a fundamental part of the overall asset management industry in Hong Kong. However, their growth potential is currently limited by a small domestic retail customer base and bank-dominated distribution networks. To understand these barriers and illuminate a path to growth, the HKIFA surveyed its members to assess the current retail and pension asset management environment in Hong Kong and identify the GBA as the biggest growth opportunity.

On 18 February 2019, China's central government authorities issued the Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area (the "Outline Plan"), commencing a new phase of economic and social integration for the Pearl River Delta region [17]. As identified in the Outline Plan, Guangzhou, Shenzhen, Hong Kong and Macao are named as the four 'core cities' of the Greater Bay Area, with specific development areas identified for each. The Outline Plan aims to leverage Hong Kong's leading position in the financial services sector to forge China's foreign-oriented investment and financing platform. The Plan gives support to Guangzhou to cultivate a regional Private Equity trading market and regional property rights and commodities trading centers. Further, the Plan stipulates that Macao can leverage its position as the headquarters of the Sino-Portuguese Fund to spearhead cooperation between Chinese and Portuguese-speaking countries.

Moreover, China's central government authorities and financial regulators revealed on 14 May 2020, a plan to facilitate cross-border financial services, transactions and investments as well as insurance products between Hong Kong, Macao and nine Guangdong provincial cities. As a part of the Wealth Management Connect scheme, the initiative is the fourth cross-border investment initiative between Hong Kong and mainland China since 2014. The scheme

[16] Hong Kong Monetary Authority- Keynote Speech at HKIFA 13th Annual Conference

[17] KPMG - Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area

has the potential to advance the GBA into one of the world's largest economic regions, connecting the two financial markets.

Firstly, the plan allows cross-border transactions of wealth management products (including investment funds) between lenders in both regions. Residents of Hong Kong and Macao may purchase wealth management products sold by banks in Mainland China through local banks in Hong Kong and Macao. The initiative signifies an important step in the procession of Hong Kong as a financial gateway into China. Consequently, the scheme will have a great impact on the banking industry, as it allows cross-border loan business and asset transfer, which will further facilitate the development between mainland non-bank financial institutions and Hong Kong and Macao. The expansion of the bank sector also allows allow banks to expand their business and open up facilities in the region.

Secondly, the scheme will facilitate cross-border trade and financing as the banks in the region may provide cross-border capital exchange services such as claim settlement for Mainland Chinese residents who have obtained insurance commodities in Hong Kong and Macao[18]. Moreover, the scheme will increase the level of innovation in financial services, as the scheme facilitates the flow of venture capital funds and exchange of income in technology innovation. In total, 2,135 funds will be made accessible in the region through the SFC. This includes assets such as investments stocks, bonds and other financial products of a value of US$1.78 trillion.

Despite these announcements, one should note that the details of the wealth management connect, including the product scope, have not been announced yet.

Thirdly, the insurance industry will expand as the scheme supports the establishment of foreign-funded insurance groups and other institutions. Insurance companies will be able to establish service centers in the GBA and engage in cross-border transactions of funds. As for reference, in 2016, Chinese mainland customers purchased HK$72.68 billion (US$9.4 billion) in insurance policies in Hong Kong. In 2017, this number dropped to HK$43.4 billion, as the currency outflow was hampered by Chinese regulators due to the anti-government protests in Hong Kong which discouraged Chinese visitors[19]. Finally, the scheme allows increased cross-border cooperation, business development and support the multiple Connect programmes.

[18] Heavy and positive! The Central Bank's Securities Regulatory Commission and other enlarged moves, 30 financial policies, support the construction of the Guangdong-Hong Kong-Macao Greater Bay Area! translated

[19] SCMP - China unveils financial plan for Hong Kong, Macau to spur tighter embrace of Greater Bay Area master plan

Challenges – Leveraging Hong Kong's Financial Services Expertise

Part of the Outline Plan is to strengthen Hong Kong's status as a global offshore RMB business hub and expand the scale and scope of cross-boundary use of renminbi in the GBA. To achieve this, cross-distribution of a number of banking products should be allowed in the GBA.

Currently, fund managers and banks are required to get a separate set of approvals from regulators in Mainland China, Hong Kong and Macao respectively for cross-border fund flows and the opening of capital accounts. In fact, companies registered in the mainland that want to sell products in Hong Kong need to set up a new office and acquire licenses in the latter. Banking institutions in the Greater Bay Area may launch, in accordance with relevant regulations, cross-boundary RMB interbank lending, RMB foreign exchange spot and forward businesses, related RMB derivative products and cross-distribution of wealth management products.

Moreover, In Hong Kong, certain complex products are only available to individuals with a portfolio of at least HKD 8 million, known as professional investors. In China, meanwhile, an investor needs to have RMB 10 million (US$1.4 million) in net assets to buy products such as private funds[20]. In addition, the cross-border selling of several investment vehicles is not allowed between the three jurisdictions. While some insurance and equity-based products can be traded due to schemes such as the Stock Connects, there's room for more products to be allowed.

Conclusions

The FSBC would like to make the following recommendations:

- Subject to compliance with laws and regulations, to progressively promote cross-boundary transactions of financial products such as funds and insurance within the GBA.
- Continue expanding specific types of investment products and investment channels and establish a mechanism for mutual access to capital and products
- To allow European UCITS funds registered with SFC to be distributed in GBA as part of Wealth Management Connect.

[20] CityWire Asia- Can China's Greater Bay Area be the next wealth management hub?

7 Green Finance and ESG Investing

Background

Globally sustainable funds continue to attract investors. Despite the pandemic, $45.6 billion has been poured into ESG funds in the first quarter of 2020 while a global outflow of $384.7 billion across the overall fund universe was happening at the same time[21].

ESG products and services are expected to create opportunities for asset and wealth managers in Hong Kong as well, as investors in the region increase their allocation to socially responsible investments. Technologies and products which are designed to mitigate climate change and are responsible towards the environment are being developed at a rapid pace, these developments require financing and may not be suitable for traditional lending institutions. This had led to the development of green finance initiatives and institutions which play a crucial part in meeting global commitments to build a green and sustainable world economy.

The financial sector has a key role to play, as it can shift investments towards more sustainable technologies and business. It can also ensure the financing of growth in a sustainable manner over the long-term, including the creation of a low-carbon, climate resilient and circular economy.

In order for green finance initiatives and organisations to build sufficient scale, collaboration on a global basis will be important. For example, the UK-China Climate and Environmental Information Disclosure Pilot, has developed into a successful platform for green finance. In this region, Mainland China has taken a leadership position with regard to green finance.

Financial centres, including London, Paris and Luxembourg in Europe, are trying to position themselves as leaders in green finance. Given Hong Kong's unique position as a leading international financial hub in the APAC region and an access route to global capital markets for Mainland Chinese companies it had the potential to become a global green finance hub. Initiatives like Stock Connect and Bond Connect may play a key role in green finance initiatives between European and Chinese markets.

[21] Morningstar: Investors Back ESG in the Crisis

Green Finance Developments in Hong Kong

In September 2018, the SFC introduced a "Strategic Framework for Green Finance[22]" which sets out a five-pronged strategy to, among others, enhance listed companies reporting on environmental information emphasising climate-related disclosure; formulate appropriate policies, codes and guidance for asset managers when considering climate-related factors in the investment and risk analysis process; facilitate the development of wide range of green-related investments; and promote Hong Kong as an international green finance centre. In May 2019, the HKMA released key measures on sustainable banking and Green Finance to increase awareness in the banking industry[23].

In August 2019, the Hong Kong Investment Funds Association (HKIFA) published a Green/Sustainable Finance Roadmap for the Asset Management Industry, which outlines three key proposals to foster the long-term development of green and sustainable finance in Hong Kong. The three key recommendations contained within the roadmap are to allow electronic/digital means as the default mode to deliver fund documentation, to modernise the record keeping requirements and to promote ESG integration into the investment process.

In December 2019, the Stock Exchange of Hong Kong Limited announced new ESG disclosure requirements for listed companies. Key changes to the ESG Guide and related Listing Rules include the introduction of mandatory disclosure requirements. These include a statement from the Board of any listed company setting out how the Board have considered the company's ESG impact. The changes will be effective for financial years commencing on or after 1 July 2020.

In May 2020, the HKMA and the SFC initiated the establishment of the Green and Sustainable Finance Cross-Agency Steering Group in Hong Kong. Other members of the group are the Environment Bureau, the Financial Services and the Treasury Bureau (FSTB), HKEx, the Insurance Authority (IA) and the Mandatory Provident Fund Schemes Authority (MPFA). The Steering Group aims to co-ordinate the management of climate and environmental risks to the financial sector, accelerate the growth of green and sustainable finance in Hong Kong and support the Hong Kong Government's climate strategies.

In June 2020, the HKEx announced the launch of STAGE, a Sustainable and Green Exchange platform, a first in its kind in Asia. STAGE will act as central hub for data and information on sustainable and green finance investments in the region[24].

[22] SFC Strategic Framework for Green Finance

[23] Hong Kong Monetary Authority- Green and Sustainable Banking

[24] HKEx Stage

Challenges to the development of ESG and Green Finance

Labelling definitions, Standardisation, Taxonomy

Although interest and activity in Green Finance has grown rapidly in recent years, there is still a lack of consistency in market terms, standards and evaluation mechanisms. In fact, the definition of what is 'green' or 'sustainable' is still disputed. The definitions are not only unclear at an international level, but also at an inter-agency level with various labelling agencies applying differing guidelines.

In the absence of any common minimum legal standards, asset managers have until now largely been free to self-certify and market funds as being environmentally friendly, which may lead to investor confusion or mis-selling. The lack of standardisation can be found around the world. In November 2019, London-based wealth manager SCM Direct published a report on Greenwashing – Misclassification and Mis-selling of Ethical Investments. In this report, it was found that definitions of 'ethical', 'socially responsible' or 'sustainable' investing are loose.

As of July 2020, there are 31 SFC-authorised funds with green or ESG focus available for distribution to retail investors in Hong Kong. The SFC recently conducted a "Survey on Integrating Environmental, Social and Governance Factors and Climate Risks, in Asset Management" to understand how licensed asset managers regard ESG factors and climate risks in their investment decisions[25]. 660 respondents to the survey and who are licenced asset management firms are currently active in asset management and considered at least one ESG factor when evaluating a company's investment potential. Within the 660 firms, 35% consistently integrated ESG factors in their investment and risk management processes and 23% have processes in place to manage the financial impact of risks arising from climate change. A taxonomy would make it possible to determine which investments including loans, stocks or bonds are environmentally sustainable. Thus, it would be easier for market participants to finance these activities and limiting the risk of greenwashing. The risk of an increase in the practice whereby companies and financial service providers make themselves look sustainable without tangible change in their actual way of operation and strategy is especially high in a sector where growth potential is very high, and taxonomy and standards are not yet defined.

[25]Mayer Brown- Hong Kong: Results of Hong Kong SFC's survey on ESG and Climate Change in Asset Management: Key Takeaways for Asset Managers

Lack of Reliable Data

A serious challenge is the lack of reliable data, investors around the world have expressed the need for quality ESG data. BDO, the global accountancy network has recently published a survey entitled "The Performance of ESG Reporting of Hong Kong Listed Companies" which has found that ESG reporting amongst Hong Kong listed companies, while improving is "still far from satisfactory in terms of compliance and quality"[26].

Talent

Hong Kong Quality Assurance Agency (HKQAA) and Hong Kong Securities and Investment (HKSI) Institute offer joint programmes for Green Finance for Wealth and Asset Management (WAM) Professionals. These trainings aim to equip the WAM professionals with the knowhow in Green Finance, including its key features, latest development and management framework, so that they can be better prepared for the opportunities and challenges introduced by Green Finance.

Impact Investing

Impact investing aims to invest in projects and mission-driven companies in which positive social and environmental value creation is fundamental to their business models. Within this approach to asset management, investors may view impact investing both as an asset class to which specific investment allocations are made and as a strategic lens through which all asset classes are assessed for impact opportunities.

In order to attract large scale private capital and demonstrate that social investment is not just an investment approach but a viable new asset class, the key challenge includes raising awareness of impact investing as a concept. This means that both commercial investors and philanthropists need to understand how they can align their social values with their investment strategy. The misconception that social means less profit, and that profit excludes social, needs to be addressed.

[26] BDO Hong Kong – BDO Survey: Third Year ESG reports showed little improvement in overall disclosure and ESG practices in tackling the climate-related issues

Best Practices

European Green Deal

In December 2019, the European Commission unveiled a new economic strategy, known as the European Green Deal[27]. It is a most ambitious package of measures that should enable European citizens and businesses to benefit from sustainable green transition. Measures accompanied with an initial roadmap of key policies range from ambitiously cutting emissions, to investing in cutting-edge research and innovation, to preserving Europe's natural environment.

This strategy will support a transition to carbon neutral economy in Europe, an additional investment of €260 billion (US$288 billion) annually from private and public sector is needed. The European Green Deal focuses on investments and loans needed to enable moving to a recycling-based economy, stopping climate change and reversing biodiversity loss. Among key upcoming initiatives, the commission said it will present a green financing strategy in the third quarter of 2020, outlining how private sector companies could contribute to the financing of the energy transition.

European ESG Taxonomy

In Europe, sustainable finance has led to the creation of about ten specialized ESG labels. Granted to less than 500 financial products out of over 60,000 funds on the European market, they are used as points of reference by responsible investment practitioners. The variety of terminologies distribution processes further complicates the reliability of the approach, which seems to partly explain the low number of labelled funds, which account for less than 1% of assets in European asset management.

In December 2019, European Commission has as well welcomed a political agreement between the European Parliament and the Council on the creation of the world's first-ever "green list" – a classification system for sustainable economic activities, or taxonomy[28].

This green list will create a common language that investors can use everywhere when investing in projects and economic activities that have a substantial positive impact on the climate and the environment. It will help scale up private and public investments to finance the transition to a climate-neutral and green economy, redirecting capital to economic activities and projects that are truly sustainable.

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[27] European Commission - A European Green Deal: striving to be the first climate-neutral continent

[28] European Commission - Sustainable Finance: Commission welcomes deal on an EU-wide classification system for sustainable investments (Taxonomy)

Technical Expert Group on Sustainable Finance (TEG)

The European Commission set up a technical expert group on sustainable finance (TEG) to assist in the development of a unified classification system for sustainable economic activities, an EU green bond standard, methodologies for low-carbon indices, and metrics for climate-related disclosure. The TEG began work in July 2018 and consists of members from civil society, academia, business and the finance sector, as well as additional members and observers from EU and international public bodies work both through formal plenaries and subgroup meetings for each work stream.

Luxembourg And London – Leadership Positions

Luxembourg's stock exchange is well positioned to become a standard bearer for the green and sustainable finance industry of the future. The world's first dedicated green stock exchange, the Luxembourg Green Exchange (LGX) lists 50% of the world's green bonds. Investors can freely access the documentation of the underlying green or sustainable products, and thus make informed decisions. LGX references 8 labels and one standard for European sustainable financial products. A distinction is made between ESG and green labels. The former must guarantee that financial products rely on an integrated ESG strategy. The latter are awarded to so-called "green" thematic environmental funds.

London was also one of the first exchanges to set up dedicated Green Bond Segments and currently houses more than 200 green bonds. London Stock Exchange's dedicated Sustainable Bond Market (SBM) champions innovative issuers in sustainable finance and improves access, flexibility and transparency for investors. In October 2019, the London Stock Exchange announced a new green classification in order to toughen standards for eco-friendly "green" bonds listed on its market as competition among exchanges in the fast-growing sustainable finance industry rises. Bonds issued by companies with revenues dominated by green activities will be required to submit annual, verified reports about how the proceeds are being used, the exchange said on Friday, while the "Green Economy Mark" will identify equity issuers with at least half of their revenues coming from environmental activities.

Global Alignment

Furthermore, the EU is also in discussions with China to consider ways of aligning their frameworks. In October 2019, the European Union, China, India and several other countries released a strategy to coordinate rules and standards of private and public "green" investment needed over coming decades to prevent irreversible climate change. The initiative, called the International Platform on Sustainable Finance (IPSF), also involves Argentina, Chile, Canada, Kenya and Morocco - a group responsible for 44% of the world's GDP and the same

amount of carbon dioxide emissions[29]. Its aim is not to raise money, but to harmonize rules on what is sustainable, or “green” investment, across the world so that private capital can flow into it more freely.

Another compelling example is European Investment Bank (EIB)’s commitment to enhanced transparency and comparability in the green bond market by setting up a partnership with its China’s Green Finance Committee (GFC) and the PBoC in 2015. The initiative intends to provide a clear framework for analysis and decision-making in green finance. Development of a common language will enhance the confidence of Chinese and international investors to support green finance through more consistent definitions and methodologies.

Conclusion

The FSBC would like to make the following recommendations:

- Hong Kong should work towards a common taxonomy which defines rules to promote sustainable investment. Going green promotes transparency. In particular, the imposition of more determined transparency standards for green funds and bonds will raise the disclosure level.
- Hong Kong should participate in international discussion with the European Commission and Mainland China, especially including the GBA, to align various ESG / Green taxonomies.
- Hong Kong should invite European experts to participate in its newly launched Joint Green and Sustainable Finance Steering Committee.
- Hong Kong should raise awareness for new products, such as impact investing, to enhance investments in large scale private capital and demonstrate that social investment is a viable new asset class.
- Hong Kong should make government funding available for re-training individuals from other industries to address the lack of relationship managers as a critical and key talent gap.

[29] Reuters- EU, China, others, team up to coordinate “green” investment financing

8 Trends in Cryptocurrency and FinTech distribution

Background

The financial services landscape is changing as FinTech start-ups and eCommerce giants with sophisticated online capabilities launch their own financial products. Investment firms and financial institutions recognise that they must adapt to these industry changes to succeed long-term. Incumbents need to innovate and transform their businesses to adapt. Regulators should create a succinct set of rules to support these developments and enhance in particular the online distribution of investment funds

The Rise of Cryptocurrency

European Developments

With the rise of cryptocurrency assets, concerns about their ability to act as a vehicle for money laundering have been raised across European Union member states. This concern stems from crypto asset's potential anonymity and global transfer risks. In May 2018, the European Parliament and Council of the European Union published Directive (EU) 2018/843, otherwise known as the Fifth Money Laundering Directive ("5MLD")[30]. 5MLD introduce requirements on crypto exchanges and custodian wallet providers for the first time.

Following the introduction of 5MLD crypto exchanges and custodian wallet providers conducting activities with all three broad types of crypto assets, namely exchange tokens, security tokens and utility tokens, will be required conduct customer due diligence, risk assessments and to report suspicious activity.

On 10 January 2020, the Money Laundering and Terrorist Financing (Amendment) Regulations 2019 (MLR 2019) came into force transposing the European Union's (EU) 5th Money Laundering

[30] Directive (EU) 2018/843 of the European Parliament and of the Council of 30 May 2018 amending Directive (EU) 2015/849 on the prevention of the use of the financial system for the purposes of money laundering or terrorist financing, and amending Directives 2009/138/EC and 2013/36/EU (Text with EEA relevance)

Directive into UK law[31]. Businesses carrying out crypto asset activities have to fulfil Customer due diligence (CDD) obligations, assess money laundering and terrorist financing risks, and report suspicious activities. These CDD measures must be completed before the establishment of a business relationship and these businesses will be required to register with the FCA during 2020.

The European response to cryptocurrency funds has been inconsistent and hesitant. This has been motivated largely by a desire to protect retail investors who typically invest in UCITS funds. Jurisdictions such as Ireland have, to date, not introduced any specific rules to govern the use of the UCITS structure to invest in cryptocurrency. The Central Bank of Ireland (CBI) has issued warnings in relation to Initial Coin Offerings (ICOs) and cryptocurrencies and has also contributed to the European Securities and Markets Authority (ESMA)'s warnings in relation to both consumers and professional investors engaged in ICOs. In Luxembourg, the CSSF have gone further and have stated that UCITS and other regulated funds targeting retail clients and pension funds will not be permitted to invest directly or indirectly in crypto assets.

In order for a crypto UCITS fund to be launched significant hurdles would first have to be cleared. First, the crypto exchange through which the fund was to invest would have to become authorised as a regulated market. Secondly, any crypto UCITS fund would have to avoid investing directly in utility tokens or cryptocurrencies as neither fit within the categories of permissible holdings for UCITS as set out in Article 50 of UCITS V. Notwithstanding the above, it is conceivable that a crypto UCITS fund could be launched using derivatives with utility tokens or cryptocurrencies as underlyings provided regulators clarified that such underlyings could be regarded as "currencies" for the purposes of UCITS V. However, such a fund would still be subject to the liquidity requirements imposed on all UCITS funds, requirements, which crypto UCITS may fail to meet.

Alternatively, UCITS funds could also invest in other, non-UCITS collective investment undertakings, which themselves have invested in crypto assets. However, this approach would only allow limited exposure to crypto assets as UCITS funds are restricted to investing 10% of their total assets in AIFs.

[31] HM Revenue & Customs- Policy Paper: Money laundering and terrorist financing (amendment) regulations 2019

Developments in Hong Kong

In November 2018, the SFC announced a regulatory framework for cryptocurrency trading platforms and cryptocurrency fund managers at Hong Kong FinTech week. This updated set of regulations covers main areas of concern such as investor protection, safe custody of assets, and AML/CFT requirements. One notable revision is that the SFC is now licensing exchanges under strict criteria to ensure security and to prevent fraud. In light of the significant risks virtual assets pose to investors, the SFC has adopted new measures within its regulatory remit to protect those who invest in virtual asset portfolios or funds. The SFC will impose licensing conditions on licensed firms which manage or intend to manage portfolios investing in more than 10% virtual assets, irrespective of whether the virtual assets meet the definition of securities or future contracts.

In November 2019, the SFC issued a position paper: Regulation of Virtual Asset Trading Platforms (SFC Position Paper, 6 November 2019), setting out new regulations for licensing cryptocurrency exchanges with a strong emphasis on investor protection issues including custody of virtual assets, anti-money laundering obligations and obligations on licensed platforms to ensure that professional investors to whom they offer services have sufficient knowledge of virtual asset investments.

Under the further regulatory guidance introduced in 2019, fund managers that hold crypto assets on behalf of clients must have at least 3 million HKD of capital. The SFC also requires that the clients' fiat currency must be kept in a licensed Hong Kong financial institution or in a jurisdiction approved by the SFC.

Motivated by concerns regarding the use of cryptocurrency as an instrument for fraud, the SFC required cryptocurrency funds managers to comply with anti-money laundering requirements. Detailed compliance procedures must also be drafted for such funds and extensive due diligence must be carried out by fund managers before using any virtual asset trading platform.

Developments in the Cayman Islands

Of all offshore locations, the Cayman Islands have perhaps been the most proactive in encouraging FinTech companies to establish a presence in their jurisdiction. Cayman Islands domiciled FinTech companies can avail of a "tech city" special economic zone in which they have access to a streamlined business licensing process, inclusive of trade certificates, employee work visas, and physical office space. Businesses can be set up and be operating in their Cayman Islands office in the tech city within 4-6 weeks. The Cayman Islands also provides an express service for the setting up of fund entities, under which a fund can be established within one business day. This proactive approach on the part of the Cayman Islands

has found favour with the FinTech industry with over fifty blockchain focused companies having been established there to date with this number expected to continue to grow.

As the Cayman Islands is a fund domicile for funds which target professional investors, the Cayman Islands government has not introduced any legislation which regulates funds investing in cryptocurrency or cryptocurrency exchanges. Instead, such funds and exchanges are regulated pursuant to existing legislation and regulation. As such, any pooling vehicle that is investing in cryptocurrency or accepting cryptocurrency by way of subscription and then investing into more traditional asset classes, would be registered with the Cayman Islands Monetary Authority pursuant to the Mutual Funds Law (2020 Revision) in the same way as more traditional funds.

The Securities Investment Business Law (2020 Revision) of the Cayman Islands which regulates fund managers carrying on business in or from the Cayman Islands does not impose any specific requirements on managers that manage crypto assets.

The flexible legal framework in the Cayman Islands means that crypto fund vehicles can be tailored to reflect onshore requirements, investor preferences and investment strategy, making the Cayman Islands an attractive domicile for cryptocurrency funds targeting investment from professional investors.

FinTech and Online Distribution

Hong Kong is among the world's top ten FinTech hubs. In 2018, Hong Kong ranked 5th in digitalization of the traditional financial sector, and the percentage of its FinTech users in Hong Kong reached 35.1%. In 2019, the consumer FinTech adoption rate reached 67% in Hong Kong[32].

The accumulation of market intelligence, regulatory insights, and technical knowhow from both East and West makes the city a hub for global FinTech innovation and adoption. Hong Kong is now home to 550 FinTech companies of which 52% have founders from overseas, with the remainder being entrepreneurs from Hong Kong and mainland China. According to Accenture, Hong Kong FinTech companies have raised over US$1.1 billion between 2014 and 2018.

Some of these FinTech companies have successfully moved into the investment fund distribution space, which in Hong Kong alone is estimated to be worth around $1.3 trillion. For example, TORA, a FinTech start-up backed by Goldman Sachs, has successfully moved into this market, and now processes around 4% of all trading volume on the Tokyo Stock Exchange.

[32]HKSAR InvestHK- Fact Sheet: Hong Kong Fintech Landscape

Digital Asset is another major player in the Hong Kong market having recently collaborated with the HKEx to build a blockchain platform for post-trade allocation and processing of northbound transactions.

Digital Asset's platform has been used as a prototype for a new Stock Connect system which will accelerate the post-trade process and reduce settlement. However, while Hong Kong companies have had success in this area, e-commerce giants in Mainland China have had the most success in distributing investment products on their platforms. Ant Financial Services Group, an affiliate of Alibaba launched on of the world's largest money-market fund, Yu'e Bao. Ant Financial Services Group is also the owner of China's biggest mobile payment network, Alipay. Its nearest rival is Tencent Holdings Ltd. Among other major Chinese companies, it owns include China's other giant mobile payments network, WeChat Pay.

Chinese e-commerce giants are evidently well placed to take advantage of the growing trend towards the use of FinTech as they already have access to major customer databases to which they can market their investment products. There are also significant synergies between the various business lines of such companies giving them a further competitive advantage over smaller start-ups which focus almost exclusively on providing FinTech solutions to the finance industry.

HKMA: Virtual Banks and Fund Distribution

The HKMA has recently announced the award of eight virtual banking licenses to Livi VB Limited, SC Digital Solutions Limited, ZhongAn Virtual Finance Limited, Welab Digital Limited, Ant SME Services (Hong Kong) Limited, Infinium Limited, Insight Fintech HK Limited and Ping An OneConnect Company Limited. The virtual banks will offer online banking services, predominantly to retail customers. Virtual banks will not only help drive FinTech and innovation, but also bring about brand-new customer experiences and further promote financial inclusion in Hong Kong.

FinTech has the potential to significantly disrupt the current model of fund distribution in Hong Kong which is dominated by the traditional bricks and mortar banks. Blockchain technology and the development of 'smart contracts' could radically transform the investment fund distribution landscape. A smart contract is one where two parties agree the terms of a contract at the outset, the contract is then automatically executed upon certain conditions being met, for example AML / KYC checks in a contract to subscribe for units of a fund.

Talent

Six local universities have rolled out bachelor’s or master’s degree programs related to FinTech. The Study Subsidy Scheme for Designated Professionals/Sectors also covers self-financing FinTech-related undergraduate programs starting from the 2018/19 academic year.

Challenges

Lack of Regulation / Guidance

So far, under Hong Kong law there is no legal definition of cryptocurrency. The HKMA has classified cryptocurrency as a virtual commodity which is not regulated by the HKMA.

Apart from the issue of compliance with FATF requirements, crypto regulation is also highly relevant in terms of providing a means for start-up enterprises to raise funds, for example, by way of ICOs or STOs. The SFC published a statement on Initial Coin Offerings in September 2017[33] clarifying that some ICOs may or may not fall within securities law in Hong Kong. The SFC also published a statement on Security Token Offerings in March 2019[34] explaining the regulations relevant to STOs. A balance needs to be struck between investor protection and excessive regulation which stifles innovation. There is possibly a second mover advantage for regulators, yet the SFC could be monitoring developments in other jurisdictions and consider publishing more helpful guidance on how different types of virtual assets will be regarded as securities subject to Hong Kong's securities laws and regulations. Reference could be made, for example to the UK FCA's recent guidance on crypto assets published in July 2019[35].

Implementation of FATF's requirements

Hong Kong has yet to implement measures to comply with the Financial Action Task Force (FATF)'s requirement that all "virtual asset service providers" (which include operators of crypto exchanges / trading platforms) be licensed or registered by a designated competent authority. Other obligations include ensuring that these entities implement and comply with FATF anti-money laundering requirements.

The FATF introduced this and other requirements on 21 June 2019: the FATF updated its Guidance on virtual assets and related providers and issued a Public Statement on Virtual Assets and Related Providers. FATF expects member countries to apply the FATF Recommendations to virtual asset service providers promptly and will conduct a review of implementation by June 2020. Notably failure to comply with FATF Recommendations can result in jurisdictions being "blacklisted" or "greylisted".

[33] SFC Statement on Initial Coin Offerings

[34] SFC Statement on Security Token Offerings

[35] Financial Conduct Authority- Guidance on Cryptoassets: Feedback and Final Guidance to CP 19/3

Voluntary License Scheme

The SFC's regulatory authority extends only to "securities" and "futures contracts". In HK, as in all jurisdictions, there is a lack of certainty as to the circumstances in which a virtual asset is a "security" as statutorily defined. To date, the Hong Kong SFC has invited crypto exchanges wanting to be licensed to enter the SFC's Regulatory Sandbox. The programme requires participating exchanges to deal in at least one crypto asset that is a "security". Moreover, the conditions the SFC is suggesting for licensing crypto exchanges are restrictive (e.g. restricted to professional investors only whereas most crypto investors are retail) and onerous. Crypto exchanges are unlikely to want to be licensed under this voluntary programme.

Opening Bank accounts

A major problem facing crypto exchanges is the difficulty of opening bank accounts. The largest banks such as HSBC and JPMorgan Chase routinely refuse banking services to crypto businesses, even those attracting investments from multibillion-dollar institutions such as Singapore's sovereign wealth fund. In March 2019, Hong Kong-based crypto exchange, Gatecoin went into liquidation after unsuccessfully seeking to recover funds lost in a dispute with a payment series provider. Gatecoin was one of the first crypto exchanges to set up in Hong Kong and it operated for six years before being wound up. During that time, nine Hong Kong banks froze the company's bank accounts. Leading it to switch to a French payment service provider that ultimately failed to return Gatecoin funds linked to a large volume of transfers, Licensing of exchanges may potentially make it easier for them to open bank accounts.

Start-up Barriers

Hong Kong lacks a centralised and coordinated mechanism for directing its many start-ups towards a common goal. Hong Kong's sophisticated and diversified economy has proven the financial sector to be a challenging market for FinTech start-ups to penetrate primarily due to its sector-specific regulatory and fragmented regimes.

Global Competition

The Hong Kong government needs to continue to promote the adoption of FinTech by Hong Kong people. According to the Global Financial Centres Index (GFCI) 25 report, Hong Kong's position as the leading financial centre in the region may slowly by slipping, with Shanghai and Singapore garnering more attention for their future technology focused plans. Experts warn that Hong Kong risks being overtaken by rivals such as Singapore if the city, already seen as lagging in innovation, does not further develop its strengths in financial technology.

Conclusion

The FSBC would like to make the following recommendations:

- The Hong Kong Government should play a more active role in nurturing financial technology development to maintain Hong Kong's position as the region's leading financial centre.
- The Hong Kong Government should look to introduce further guidance on crypto assets so that there is certainty around these instruments as an asset class.
- The SFC should continue to support new avenues of fund distribution and in particular through online platforms and virtual banks.

9 Update on Brexit

Background

The United Kingdom's (UK) departure from the European Union (EU), referred to as Brexit, will have complicated, significant and long-term impacts on the financial services sector in the UK and the rest of the world.

Following the UK's formal departure from EU on 31 January 2020, further negotiation and legislation will be required to implement an orderly exit. This will need to be addressed during the transition period – or the implementation period - which began on 1 February 2020 and is due to end on 31 December 2020. During this 11-month period, the UK will continue to apply all of the EU's rules and its trading relationship will remain unchanged. Furthermore, the transition period is meant to give space to negotiate a new free trade agreement, as the UK is scheduled to leave the single market and customs union at the end of the period.

In anticipation of Brexit, several financial businesses with offices in the UK have responded by relocating part of their business, moving staff or setting up new entities in the EU.

Challenges - Financial Services Mobility and Relocation

The proportion of financial services firms considering or confirmed to have relocated operations and/or staff from the UK to EU member states has stabilized at 41%, according to a study conducted by EY.[36] Furthermore, 22% of financial services firms have publicly voiced concerns that Brexit is having a negative impact on their operations, through a mixture of reduced profitability, asset outflows, deferred Mergers&Acquisitions (M&A) and slowdown in lending.

Financial services businesses are now focusing on fulfilling their commitments to regulators in the EU and the UK. In general, the main challenges faced by such businesses are the increased regulatory burden of being subject to regulation in more jurisdictions and aligning operational processes across multiple locations. The technical preparation, the legal prepa-

[36] EY Press Release- EY Financial Services Brexit Tracker: Firms go quiet on relocation announcements as focus moves to securing a strong future trading relationship

rations have significant degrees (about 80%) of implementation. However, the actual execution on the client-side, based on such preparations, is much lower with an average of less than 30%[37]. For now, there is no one solid alternative emerging to compete with London as the preeminent financial centre in Europe.

EU Regulations after Brexit And Delegation

As the UK and EU prepare to embark on negotiations to decide their future relationship, the big question for many UK asset managers that operate in Europe is how far the EU27 will reshape existing regulations and ensuring continued access to the EU market. The ability to domicile a fund in one EU member state but make investment decisions from outside the EU, referred to as the delegation model, is at the heart of many asset manager's business models. The practice essentially allows portfolio managers operating from financial centres such as Hong Kong, New York or London to manage money for investors on the other side of the globe.

However, the liberal approach to delegation under the EU's main regulations governing fund management, UCITS and AIFMD, has become a lightning rod for critics who believe this could allow UK managers to access the EU via the back door. Three years ago, France led an attempt to overhaul the rules on these grounds. This failed after resistance from other EU countries. However, regulatory experts believe delegation may come under attack again when the EU reviews the UCITS and AIFM directives in the coming years.

Hong Kong and Brexit

With regard to the impact of Brexit on the Asian asset management industry, it is important to highlight that for many Asian investors and economies Brexit is presenting new opportunities. Brexit is compelling UK asset managers to look beyond European borders for opportunity and the UK and Hong Kong are already interconnected, as more than 300 UK-based companies have regional headquarters or offices in Hong Kong.

In October 2018, the SFC and the FCA have entered into a MoU on Mutual Recognition of Funds, which allows eligible Hong Kong public funds and United Kingdom retail funds to be distributed in each other's market through a streamlined process. The MoU also establishes a framework for exchange of information, regular dialogue as well as regulatory cooperation in relation to the cross-border offering of eligible Hong Kong public funds and United Kingdom retail funds.

[37] Bloomberg- Deals: Banks have a key weakness in preparing for Brexit: their clients

On 6 February 2020, SFC issued an updated "List of recognised jurisdiction schemes", "List of inspection regimes", and "Application of the Code on Unit Trusts and Mutual Funds on UCITS funds". These changes reflect the fact that UCITS domiciled in the UK will no longer be classified as UCITS, but as "UK UCITS" post Brexit and during the transition period.

Furthermore, the application procedure in Hong Kong for UK collective investment schemes classified as UK UCITS remains unchanged. It continues to follow either the MRF between the United Kingdom and Hong Kong' dated 8 October 2018 - or the streamlined process for UCITS funds, which also applies to UCITS domiciled in other EU jurisdictions.

Conclusion

The FSBC would like to make the following recommendations:

- To further establish frameworks for exchange of information, regular dialogue and regulatory cooperation in relation to the cross-border offering of eligible Hong Kong funds and UK funds to the retail public in both Hong Kong and the UK.

10 Update on Hong Kong's anti-money laundering regime for asset managers

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In March 2018, Hong Kong updated its Anti-Money Laundering and Counter-Terrorist Financing Ordinance **(AMLO)** to better align it with international standards and facilitate the use of technology. In addition, during the course of 2018 and 2019, the Securities and Futures Commission (**SFC**), the securities market regulator, made significant developments in relation to the requirements for anti-money laundering **(AML)** and counter-financing of terrorist **(CFT)** practices including remote client onboarding and account opening. These updates were partly made in preparation for the Financial Action Task Force's **(FATF)** on-site mutual evaluation of the effectiveness of the AML/CFT regime in Hong Kong, which in September 2019, FATF assessed to be compliant and effective overall.

In this article, we highlight some key updates for asset managers.

The SFC's AML Guideline

The SFC's Guideline on Anti-Money Laundering and Counter-Financing of Terrorism **(AML Guideline)** sets out relevant AML/CFT statutory and regulatory requirements that SFC licensed corporations **(LCs)** must comply with.

1 March 2018

On 1 March 2018, the SFC amended the AML Guideline to reflect changes to the AML/CFT legal regime in the updated AMLO. In particular, the amendments related to customer due diligence **(CDD)** for ultimate beneficial owners, reliance on CDD performed by intermediaries, as well as changes to the retention period for CDD records.

1 November 2018

Following a public consultation, the SFC further updated the AML Guideline on 1 November 2018 (**Updated AML Guideline**). In general, the Updated AML Guideline reflects strengthened FATF minimum standards in several high risk areas. However, it also gives LCs more flexibility under the risk-based approach to determine how to conduct ongoing CDD and monitoring in general so long as minimum standards are met.

Key changes in relation to CDD include:

- Providing the framework for flexibility to use technology in non-face-to-face customer identification and verification which requires firms to assess, mitigate and manage risks in relation to new or developing technologies such as facial recognition and biometrics.

- Expanding the list of politically exposed persons (**PEPs**) to include international organisation PEPs.

- Providing new guidance to determine whether to apply or continue to apply the additional measures to a high-risk relationship with a domestic or international organisation PEP who ceases to hold a prominent (public) function. Such additional measures include for example, taking measures to obtain substantive information to establish source of wealth and source of funds of the customer and beneficial owner.

- Providing detailed guidance for LCs incorporated in Hong Kong with overseas branches or subsidiaries that carry on the business of a 'financial institution' as defined by the AMLO **(Hong Kong Group**), in relation to maintaining effective group-wide AML/CFT systems.

- For a Hong Kong Group, if the AML/CFT requirements of the jurisdiction where the overseas branch or subsidiary is located differ from those in the Updated AML Guideline, the branch or subsidiary should apply the more onerous of the two sets of requirements.

- Removing the mandatory requirement to conduct a company search for corporations.

- Dropping address proof requirements.

The SFC's AML/CFT FAQs

On 22 February 2019, the SFC issued new AML/CFT Frequently Asked Questions **(FAQs)**. The FAQs were updated to reflect the amendments made to the AMLO on 1 March 2018 and the Updated AML Guideline.

Some existing FAQs were revised (for example those relating to overseas subsidiaries, expired documents and unsuccessful applicants) but most of the new FAQS are largely intuitive, and industry players who prefer prescriptive rules may find them useful.

The key points in the new FAQs are as follows:

- Ongoing monitoring: LCs can employ an external third-party agent to conduct ongoing monitoring (on their behalf in accordance with the Hong Kong AML/CFT requirements) (FAQ #13).
- Electronic document verification: The SFC has added a new example of how electronic documents can be verified (FAQ #8).
- Foreign language documents: Translations do not need to be performed by a professional third party (FAQ #9).
- Identification of natural persons: FAQs #2 and #3 provides useful guidance on the identification of natural persons.
- Source of wealth: The SFC confirmed that a customer's source of wealth only needs to be identified generally for high risk customers (FAQ #11).
- High risk countries: It is only mandatory for firms to take enhanced due diligence measures (i.e. the additional CDD measures in 4.9 of the Updated AML Guideline) for those countries specified by FATF, and currently there are only two countries in this category: Iran and the Democratic People's Republic of Korea (see the FATF Public Statements of October 2019). Those countries falling under the FATF category of "Improving Global AML/CFT Compliance: On-going Process" (which are also known as "High-risk and other monitored jurisdictions", for example, The Bahamas and Cambodia), are not on this mandatory list. This means that technically LCs only need to "take into account" that the country is on this list when risk-profiling customers "associated" with these countries and can decide for themselves whether or not to take enhanced due diligence **(EDD)** measures. Given that the SFC has provided no further guidance in this FAQ, the prudent approach would have to be to treat these two categories of countries in the same way and take EDD measures (FAQ#12). If a firm wishes to have more flexibility, it will need to take extra steps to stay up-to-date on all FATF and SFC guidance on those countries and make sure that the CDD it performs on such clients is extremely robust and well-documented.

SFC guidance on remote client onboarding and account opening

On 28 June 2019, the SFC issued FAQs on account opening and a circular on remote onboarding of overseas individual clients.

Key takeaways for asset managers include:

1. Online (i.e. remote / non-face-to-face) account opening has been made easier in the sense that there is now clear guidance from the SFC as to what is acceptable, and this guidance refers specifically to types of technology. This is likely to be of particular relevance to online platform operators. The requirements are however more onerous than some market players were hoping for.

2. The requirements include the customer having to transfer an amount of at least HK$10,000 (or equivalent) to the Hong Kong intermediary from a bank regulated in one of 16 designated "eligible" jurisdictions including Singapore, Malaysia, Australia, Canada, Switzerland, the UK and the US but not including the PRC, Macau, Japan or Korea. The investor does not need to reside in that country but future transactions can only be conducted through an account which has been through these steps. Six other control measures have also been imposed. Some require sophisticated technology while others necessitate operational controls.

3. LCs wishing to open client accounts remotely will also need to have adequate control measures in place to be able to take all the following steps:

    a. identity document authentication

    b. identity verification

    c. execution of client agreement

    d. record keeping

    e. training

    f. assessments/reviews/reports/evaluations:

        i. pre-implementation assessments by independent qualified assessors

        ii. annual reviews by qualified assessors

        iii. each assessment and review should involve the preparation of a comprehensive report (which the SFC can request) which includes an explanation of potential limitations and recommendations for improvements (and management's responses thereto)

iv. regular evaluations by senior management of the performance of the adopted technologies.

4. All currently acceptable account opening approaches remain applicable.

5. Asset managers that cannot check investors' identity documents and certify copies themselves will need to rely on other certifiers. The SFC has now added chartered secretaries as qualified persons competent to certify identity documents and witness the signing of client agreements. This will ensure consistency with the list of certifiers permitted under the Updated AML Guideline.

6. The SFC has also emphasised in this regard that LCs must ensure full compliance with all relevant offshore legal requirements, e.g. a jurisdiction may restrict citizens from investing in overseas markets or cross-border capital transfers.

Takeaways from the SFC's recent AML seminars

In November 2019, the SFC delivered a series of AML/CFT seminars to the industry to present key findings and areas of improvement from the FATF's mutual evaluation of the effectiveness of the AML/CFT regime in Hong Kong (the **HK Report**), to provide an update on recent regulatory developments, and to share its inspection findings and other supervisory observations on LCs' AML/CFT practices. The seminars were instructive - senior management, and especially the Manager-in-Charge for AML, are encouraged to review the presentation materials when formulating the 2020 AML compliance plan.

The following is a summary of some key issues.

<u>What needs to be improved</u>?

Based on the HK Report the following areas need work:

1. A deeper understanding of money laundering and terrorist financing risks.

2. A stronger implementation of AML measures.

3. An enhancement of suspicious transaction monitoring and reporting.

4. A resolution to the inconsistency in Hong Kong's CDD requirements for taking on foreign PEPs versus domestic PEPs from Mainland China and other parts of China. Currently, the mandatory requirement to adopt EDD applies only to foreign PEPs.

New regulatory developments

5. New FATF standards for virtual assets and virtual asset service providers: FATF has issued new standards applicable to these assets and providers. In response, on 4 November 2019 the SFC issued guidance on the licensing framework which includes proforma licensing conditions which would typically be imposed on virtual asset fund managers.

6. Risk-based approach for the securities sector: the SFC emphasised that it may amend the Updated AML Guideline to provide further guidance on the risk-based approach, in light of FATF's Guidance for a Risk-based Approach for the Securities Sector issued in October 2018.

7. Remote client onboarding: the SFC reiterated the reason why the SFC's requirement for LCs to verify the identity of individuals is limited to those without a Hong Kong bank account. The SFC considers it may be difficult for it to conduct an investigation when verification is performed by an overseas bank.

SFC inspection findings

8. Control failures to mitigate the risks associated with third-party deposits and payments.

9. The increasing use of "nominees" and "warehousing" arrangements to facilitate market misconduct.

Other major supervisory observations

10. Ineffective senior management oversight.

11. Inadequate compliance monitoring.

12. AML systems were not subject to independent review by the internal audit team.

13. Failure to conduct proper institutional risk assessment.

14. Failures in conducting customer risk assessments (both initial and ongoing).

15. Insufficient CDD when identifying PEPs.

16. Ineffective screening – not screening Chinese names and names in reverse order.

AML/CFT is likely to be a continued focus area for the SFC in 2020. Primary responsibility for AML lies with senior management, and they can initiate a self-assessment by reference to the SFC's AML/CFT Self-Assessment Checklist (updated in April 2019), keeping in mind the HK Report and the above SFC observations. LCs should amend their existing AML/CFT and client onboarding policies, procedures and processes where necessary.

Abbreviations

5MLD	Fifth Money Laundering and Terrorist Financing
AIF	Accredited Investment Fiduciary
AIFMD	Alternative Investment Fund Managers Directive
AMF	Autorité des Marchés Financiers
AML	Anti-Money Laundering
AMLO	Anti-Money Laundering and Counter-Terrorist Financing Ordinance
CBI	Central bank of Ireland
CDD	Customer Due Diligence
CFT	Counter-financing of terrorism
CSRC	China Securities Regulatory Commission
CSSF	Commission de Surveillance du Secteur Financier
ECB	European Central Bank
EDD	Enhanced Due Diligence
EIB	European Investment Bank
ESG	Environmental, social and governance
ESMA	European Securities and Markets Authority
ETF	Exchange Traded Fund
EU	European Union
EUR	European Union
FATF	Financial Action Task Force
FCA	Financial Conduct Authority
FINMA	Swiss Financial Market Supervisory Authority
FSBC	Financial Services Business Council
FSTB	Financial Services and the Treasury Bureau
GBA	Greater Bay Area
GFC	Green Finance Committee
GFCI	Global Financial Centres Index
HKD	Hong Kong Dollar
HKEx	Hong Kong Exchanges and Clearing Limited
HKIFA	Hong Kong Investment Funds Association
HKMA	Hong Kong Monetary Authority
HKQAA	Hong Kong Quality Assurance Agency
HKSI	Hong Kong Securities and Investment
IA	Insurance Authority
ICO	Initial Coin Offerings
IPSF	International Platform on Sustainable Finance
KFS	Key Facts Statement
LGX	Luxembourg Green Exchange
LPF	Limited partnership fund (LPF)
M&A	Mergers & Acquisitions
MoC	Memorandum of Co-Operation
MoU	Memorandum of Understanding
MPFA	Mandatory Provident Fund Schemes Authority
MRF	Mutual Recognition of Funds

NAV	Net Asset Value
NCA	National Competent Authorities
OFC	Open-ended fund company
PEP	Politically Exposed Persons
RMB	Renminbi
SBM	Sustainable Bond Market
SFC	Securities and Futures Commission
TEG	Technical Expert Group
UCITS	Undertakings for the Collective Investment in Transferable Securities
UK	United Kingdom

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FSBC

ABOUT FSBC AND EUROCHAM

The European Chamber of Commerce in Hong Kong launched its Financial Services Business Council (FSBC) in 2010 to serve as a platform for advocacy and networking and to protect and advance the interests of its members. Members hail from the Banking, Asset Management and Insurance sectors. The FSBC engages with market participants, regulatory authorities and other stakeholders on important issues concerning the financial services industry.

Led by its Chairperson Ms. Ching Yng Choi and Vice-Chair Mr. Stratos Pourzitakis since January 2020, the FSBC actively promotes bilateral and multilateral trade relations and active engagement between key industry players.

Using its unique European perspectives in order to further enable the development of European business activities in Hong Kong, the main objectives of the FSBC include:

- Writing position papers and providing additional input to the Office of the European Union to Hong Kong and Macao for the formulation of EU bilateral policies and regulatory dialogue on financial issues with the Hong Kong and Macao respective governments, as well as providing feedback or propositions to the local authorities.

- Responding to consultation papers, i.e., issued by the Hong Kong Securities and Futures Com- mission (SFC) and the Hong Kong Stock Exchange (HKEx).

- Developing research work on finance-related issues of concern in Hong Kong.

Initiated in 1997, the European Chamber of Commerce in Hong Kong (ECC) is a non-governmental business interest group. The ECC is a ‘Chamber of Chambers’ with its membership comprising 16 European Chambers based in Hong Kong. The appointed representatives of these chambers make up the ECC board of directors.

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