FSRG Hong Kong Asset Management Trends and Opportunities 2021

December 2021

WELCOME!

The Financial Services Research Group (FSRG) was established in 2021 by a group of financial services and business professionals to support the development of the Hong Kong's financial markets and to accelerate Hong Kong's leadership in the rapidly evolving areas of green finance, sustainable investment and global asset management.

FSRG draws on the expertise of the local business and financial communities, together with international best practice and a deep understanding of global trends, to make an important contribution to Hong Kong's successful future as Asia's premier financial hub.

Asset Management is one of the three pillars of focus for FSRG. Hong Kong's asset management sector is continuously evolving, as companies seek to respond to systemic changes in the industry, while moving to take advantage of new opportunities. As new competitive forces emerge in the region, Hong Kong must keep ahead of these fast moving dynamics in order to maintain its position as a leading fund management hub.

In this inaugural FSRG Hong Kong Asset Management Trends and Opportunities paper, industry experts share their insight on key developments on mutual funds, private funds, ESG, Bond Connect and Wealth Connect in the Greater Bay Area.

Enjoy the reading!

Ching Yng Choi
FSRG Board Member & Treasurer

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Chapter 1: Asset management trends

Turning the page on the unprecedented 2020, everyone is hoping for a return to normal in 2021 and 2022. Despite the challenging environment created by the COVID-19 pandemic, the asset management industry has taken the past years' experience to adapt, and in some ways, reinvent itself. Many trends have been seen in the sector, such as the wider digital transformation, the growing awareness and adoption of the Environmental, Social and Governance (ESG) model, constant efforts on regulatory reform, diversification on products structure and offering, the surge of the virtual assets and digital currencies. The list goes on. No doubt, the industry as a whole is always looking to develop, improve, and shape itself based on these five key focuses: Technology, Efficiency, Diversity, Alpha, and Beyond Alpha.

What cannot be overstated are the geopolitical tensions that arose alongside the pandemic, with emphasis on the relationship between China and the US. Unfortunate events such as Hong Kong's 2019 social unrest really diminished the growth of the local economy. While the economy is slowly but surely recovering, the damage has already been done.

Nonetheless, as one of the world's leading financial centres, the asset management industry has showed resilience and is building a rapidly evolving landscape for the industry to thrive. As per the Survey [1] conducted by the Hong Kong Investment Funds Association (HKIFA), among senior industry executives, the sentiment was that there may be tough times still before us, but a positive outlook is expected for the future of Hong Kong's asset management industry, especially driven by the openness of the market, robust regulatory framework, and close ties with Mainland China – not to mention the rapid development of the Greater Bay Area (GBA).

As the leading asset management hub, the figures demonstrate the rationale of the forward-looking view: USD 89.9 billion in gross retail fund sales in 2019 while net retail fund sales for 2019 also hit USD 14.4 billion. The World Bank ranked Hong Kong in third place regarding the ease of carrying a business, which a place to invest [2]. From the Securities and Futures Commission's (SFC) latest Asset and Wealth Management Activities Survey [3], the industry AUM has increased by 20% year on year to HK$28,769 billion (US$3,694 billion) in 2019. In the meantime, the net fund inflows is at

HK$1,668 billion (US$214 billion), and there has been a 10% increase in the number of Type 9 licensed corporations in Hong Kong – 1,808 as of the end of 2019.

In this paper, we identify what we believe will be some of the key asset management firms. We would like to bring attention to those that stand out amongst the competition creating opportunities, and making prudent portfolio investment allocations.

1. **Digital transformation**

Digital transformation has been a constant trend for the past decade in the asset management industry. One of the upsides that the pandemic has brought is that it expedited the adaptation and acceptance of digitization of operations as well as data implementation. While this was already a trend in the industry, this swift adaptation was definitely a necessity. The whole industry is making the move to digitize operations and to streamline the process of gathering, sorting, analysing, and processing the data through various tools such as cloud computing or scripting.

Such trends in the technological space cannot be realized without the application of advanced technologies on the whole of the process – covering the front, middle, and back office. These technologies touch every aspect of our industry; from portfolio construction to trade inputs and executions, and from risk management to administration.

In addition to the cost consideration for middle and back-office operations, digital tools have played an increasingly important role in the daily efficiency of the everyone's work processes. Familiarity with video communication solutions such as Zoom, Webex or Microsoft Teams, has become a necessity for all office workers of the post-COVID-19 business world.

Managers kept up with these tech trends by creating or adopting digital concepts as well as tools to manage money/clients, optimize the portfolio build-up, improve investor experiences, and streamline the

overall process. Leveraging robot advisory systems, cloud computing, machine learning, as well as other artificial intelligence technologies, most managers are making their best effort to “go digital” and embrace big data. The benefit of scaling-up processes is shown in the increase in performance and the reduction of costs, which benefits from both growth of the assets and the economies of scale.

At the time of the digitization, real-time speed and value are cores of the asset management business. Whoever can best leverage those two metrics will be seen as outstanding amongst other portfolio managers and advisors. As there are not a great number of the managers who can afford to or have the capacity to create their own internal digital system, outsourcing is also a new trend. This allows sector pioneers to focus on what they are good at, investing, and for their partners to apply their technological expertise to achieve greater returns.

As with all good things, the mass adoption of technology in asset management comes with its own risks, namely, cybersecurity threats. In the world of big data, safety is a critical component of the asset management; investors prefer secure platforms or applications as opposed to its figures on return among the market.

2. The rise of the ESG

ESG is the new normal for the asset management industry. Many major market players have embraced the standards and incorporated them into their investment guidelines, such as Goldman Sachs, Vanguard, and BlackRock.

Investors are requesting ESG-friendly features for the products they wish to buy. This can include issues such as consideration of climate changes impacts, for instance.

Regarding ESG implementation, the Hong Kong regulator has amended the Fund Manager’s Code of Conduct by asking fund managers to include climate-related risks considerations in

the investment processes, and to make appropriate disclosures to investors.

This global trend is also influencing China and the entire Asia Pacific region driving asset managers to include ESG into their investment criteria and to begin to measure its impacts by incorporating the analytics, rating and consequences on investment return.

The pioneers who incorporate ESG into their investment portfolios may gain a competitive edge. As we all face a “new normal”, talent is a considerable issue for the industry to take seriously. As per the recent KPMG report on the future of Hong Kong’s fund management industry, there is an identifiable shortage in the local labour market, in particular with ESG expertise.

Filling the gap in Hong Kong already seems challenging, while for each country to follow the exact standards would take time too. In the year of 2021, we have already seen an increase in the recruitment of professional with relevant skills in ESG knowledge and management.

3. Regulatory reform

Innovation in the fund management industry is always accompanied by regulatory reform; they each have an influence over the other and regulatory reform can provide opportunity. In fund management, this can mean regulation and compliance should be handled internally, but handling these matters externally is always an option.

Reforms usually focus on regulation of traditional risks, such as marketing, eligibility, suitability, fees, product structure, but also impact in portfolio management, trading, valuation, custody, use of leverage, funding capacity, solicitation, recordkeeping, technologies etc.

Regulatory efforts were brought to some innovative sectors as well, such as cryptocurrencies. Due to the impact of the pandemic, both investors and managers have gained an increased appetite for digital assets and virtual currencies, a form of investment which has yet to be accepted as part of the mainstream. From the United States to Hong

Kong, Singapore to Europe, this new commodity class has become the centre of regulatory attention.

In Hong Kong, the SFC has introduced numerous initiatives to keep an open but fair local market, to maintain its growing and premier position: Open-ended Fund Company (OFC) and its amendments, Limited Partnership Fund (LPF) regime, tax treatment for Carried Interests, Cross-border distribution between Hong Kong and Mainland China, additional license regime on 100% digital asset management etc. These have all added to the range and variety of products and services available to individual and institutional investors.

Furthermore, globalisation is bringing regulators to work together and to cooperate more on international matters, such as Anti-Money Laundering (AML) and Counter- Terrorism Financing (CTF). Regulators try to adopt the world-wide recognized standards to support cross-border transactions and also set the guideline for a safe financial environment. Hong Kong regulators have been increasing the number of Memorandum of Understanding (MOU) signed with regulators in different regions, such as the Mutual Recognition of Funds (MRF) signed with Luxembourg regulator on the UCITS distribution in Hong Kong. China is loosening restrictions on Joint-Ventures and wholly-owned financial institutions.

Regulators are also competing with each other on winning market share on the international stage by increasing the attractiveness of their product structures, policies, tax regimes, subsidies, etc. The regulatory environment is a vital factor for managers looking to raise capital in a market. In Hong Kong, managers can now obtain extra flexibility of fund vehicles, compared to the Cayman Islands or Luxembourg.

Investors are the primary demographic that the regulators aim to protect in a complex and changing financial market. More sophisticated investors would enjoy the variety and diversity of the many alternatives from the market while investing. When it comes to retail investors, their safety has been secured by the understanding on the products, suitability as well as disclosure of the managers.

4. Diversification

The asset management industry is rapidly commoditizing and investors take costs seriously. Asset managers look to distinguish themselves through their products and user experiences. Interaction with investors becomes an important thing to consider as well.

Investors' eyes are already "beyond alpha", which can be translated to a high-quality diversification. With more customized products brought to the market, the investors would likely take the occasion to pursue both capital return and appreciation.

As per PWC's publication- "Asset Management 2020: a brave new world", alternative assets are becoming more mainstream, passives are core and Exchange Traded Funds (ETFs) proliferate.

The paper mentioned that by 2020, 35% of assets managed in the industry will be alternatives and passive products combined. The separation between alpha and beta take centre stage when investors start to adjust their investment allocation to passive products in order to enjoy low fees and broad beta market exposure.

Regarding alternative investments, Merger and Acquisition (M&A) strategies were at the top of the minds of the asset management industry in 2021. This is evidenced by Morgan Stanley's purchase of Eaton Vance, Franklin Templeton's merger with Legg Mason, and a number of other similar mega-mergers in 2020. Major players such as JP Morgan, Goldman Sachs, and others have publicly stated that they are ready for shopping for asset managers. The industry has identified that reaching US$1trillion in assets under management is key for success. The "Go big or go home" attitude has given asset managers a strong argument for consolidating with a larger firm to access resources or risk selling off a minority to another platform or to survive alone. Consolidation becomes a way to improve economies of scale and to decrease operational costs and increase margins, this seems to be the trend in the coming years and decades.

2021 could be seen as a special year as the crypto sector has stood well against the COVID-19 pandemic. This pandemic has even become a key driver for digital transformation and the emergence of the mainstream crypto markets. The combined market capitalization of more than 9,500 crypto assets available on more than 377 exchanges was around USD2.3 trillion in early 2021. Traditional cryptocurrencies in Bitcoin and Ethereum still sit strong at the top of the crypto markets, with 41.2% and 20.3% market share respectively, while decentralization finance (DeFi) and Non-fungible tokens (NFT) are changing the face of investments and finance as we know it. It is important to note that these assets are still highly volatile and it is extremely difficult to assess the intrinsic value of these digital commodities through traditional means.

Jean-Luc Gustave, GDA Capital

Certainly, when the shadow of the pandemic fades away, the industry would like to go back to "business as usual" as defined in pre-pandemic times, but we have to admit that a number of fundamental shifts are happening to change the whole landscape of the industry.

Lily Wang,
Managing Director, Finex Hong Kong Limited

[1] https://assets.kpmg/content/dam/kpmg/cn/pdf/en/2020/06/vision-2025-the-future-of-hong-kong-s-fund-management-industry.pdf.
[2] https://www.info.gov.hk/gia/general/201910/24/P2019102400512.htm.
[3] 'Asset and Wealth Management Activities Survey 2019', SFC, August 2020, https://www.sfc.hk/web/files/ER/Reports/
AWMAS_2019_EN.pdf

Update on Mutual Funds available in Hong Kong

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1. Description of the Hong Kong mutual fund market

Hong Kong is an international asset management and fund distribution centre. It has over 2,000 retail unit trusts, mutual funds and Exchange Traded Funds (ETF) authorized by the Hong Kong Securities & Futures Commission (SFC). In addition there is an unspecified number of private funds, hedge and alternatives funds, most of which are unauthorised by the SFC and there are a number of Real Estate Investment Trusts (REITS).

Mutual funds are not required to be established and domiciled in Hong Kong to gain SFC authorization, indeed a majority of authorized funds are UCITS products established in Europe. There have historically also been unit trusts and mutual funds domiciled in the UK, Cayman Islands, Bahamas and Bermuda and Channel Islands of Guernsey and Jersey, that were made available to investors in Hong Kong.

Getting a precise estimate of the aggregate size of the Hong Kong authorized funds industry is complicated by the inclusion of the UCITS funds, as none provide separate statistics for Hong Kong investors.

The size of the fund industry in Hong Kong is estimated to be US$ 340 bn, composed by US$184 bn in HK domiciled SFC-authorized funds (as at 2020 year end) while the cross border funds are estimated by Broadridge at US$200 bn. Although in some documentations (SFC, HKIFA), it is mentioned that in Hong Kong, there are US$1.8 trn in cross border funds. Our understanding is that the number includes the outstanding issuance of the registered funds in Ireland & Luxembourg, not the part really distributed to Hong Kong investors.

Both Irish and Luxembourg domiciled UCITS are widely sold in the retail funds space in Hong Kong with Irish and Luxembourg UCITS funds accounting for possibly over 75% of the net asset value of schemes authorised by the SFC for sale to the retail public in Hong Kong (see Table 1).

Table 1

SFC Authorised Unit Trusts and Mutual Funds by Origin							
	As of 31 March 2021					As of 31 March 2020	
	Umbrella Funds	Sub Funds	Single Funds	Total	Total NAV (US$ million)	Total	Total NAV (US$ million)
Hong Kong	147	688		835 (40%)	190,909 (10%)	762 (38%)	134,835 (11%)
Luxembourg	47	987	1	1,035 (49%)	1,399,343 (75%)	1,032 (51%)	884,452 (72%)
Ireland	26	210	2	238 (11%)	275,782 (15%)	222 (11%)	204,098 (17%)

2. How funds are regulated

Investment funds which are not authorized by the SFC for public offering cannot be marketed to Hong Kong retail investors, unless an exemption applies. Typically, hedge and alternatives funds are not SFC authorized and thus only made available to high net worth investors, and usually only via private bank arrangements. Authorised unit trusts and mutual funds however, can be made widely available, by banks that have the necessary regulatory licenses as well as insurance companies, investment advisers and wealth managers, all of whom are required to be fully and appropriately licensed by the Regulators for the purpose. In addition, in some instances, institutional investors such as pension funds may also use mutual funds.

The SFC is empowered under section 104(1) of the Securities and Futures Ordinance ("SFO") to authorize collective investment schemes. The authorization may be granted subject to such conditions as the Commission considers appropriate. This Code on Unit Trusts and Mutual Funds ("UT Code") establishes guidelines for the authorization of collective investment schemes in the form of unit trusts or mutual fund corporations and sets out practices in relation to the former Code on Unit Trusts and Mutual Funds published pursuant to the SFO.

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. It is also objectively calculated, rules based and 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.

For fund distribution in Hong Kong, there are four key regulators; SFC, Hong Kong Monetary Authority, Insurance Authority and the Mandatory Provident Fund Schemes Authority. ETFs also need to be approved by the Hong Kong Stock Exchange (HKEx), before being listed on the Exchange.

3. What are the types of funds allowed?

The main types of fund structures offered in Hong Kong are unit trusts and corporate funds. Funds offered in Hong Kong, whether publicly or privately, can be established in Hong Kong or offshore. Funds can be established in Hong Kong either in trust form as a unit trust or corporate form as an open-ended fund company. ETFs can be established in either format.

SFC authorized investment funds can also obtain a listing approval under Chapter 20 of the Rules Governing the Listing of Securities on The Stock Exchange of Hong Kong Limited to trade [4].

UNIT TRUST

Trusts are a common law concept and the legislative source of law on trusts in Hong Kong is the Trustee Ordinance (Cap. 29 of the Laws of Hong Kong). A unit trust is a form of collective investment scheme constituted under a trust deed, which enables a number of investors to pool their assets and have those assets professionally managed by an independent manager. The trust vehicle pools the money of investors and invests in assets with a specific objective, such as investing in equities markets. The investment manager purchases assets, such as equities, and pools these in a fund. The fund's investors are issued with units of the fund and become the beneficiaries, i.e. unit holders. The investment manager has sole investment power over the underlying assets which are held in trust by the trustee on behalf of the unit holders who have a beneficial interest in the fund.

Publicly offered unit trusts must be authorized by the SFC and are subject to the requirements of the SFC Products Handbook including the UT Code. Hong Kong unit trusts can also be marketed in Hong Kong in circumstances in which it does not constitute an offer to the 'public'. Public means the public of Hong Kong and it is generally considered that an offer to less than 50 potential investors will not amount to a public offer requiring SFC authorization.

OPEN ENDED FUND COMPANIES

OFC's are incorporated under Part IVA of the SFO which was implemented on 30 July 2018 to allow open-ended funds to be set up in Hong Kong in corporate form. Before the OFC regime, many of the funds offered in Hong Kong were incorporated offshore, typically as Cayman Islands exempted companies, given the popularity of corporate fund structures. A key objective of the OFC regime is to encourage asset managers to establish more funds domiciling in Hong Kong. In its 2021-22 budget, the Hong Kong Government highlighted its recent proposal for new legislation to facilitate the re-domiciling of offshore based private equity funds and hedge funds back to Hong Kong for registration as

Open-Ended Fund Companies ("OFCs") or limited partnership funds ("LPFs") and proposed a new subsidy to set-up or re-domicile OFCs in Hong Kong, whether as hedge funds or mutual funds, in the coming 3 years.

Unlike unit trusts, an OFC is a separate legal entity with a board of directors; each director owes fiduciary duties and statutory duties of care, skill and diligence to the OFC.

A public OFC can be an ETF if it meets the UT Code's requirements for ETFs.

There are 96 OFCs and sub-funds registered authorized by SFC established by 31 investment managers. The first OFC was incorporated in Aug 2019 [5].

We await to see the market traction for Cayman funds or Hong Kong unit trust to convert into OFCs.

LIMITED PARTNERSHIP

The limited partnership fund ("LPF") was introduced under The Limited Partnership Fund Ordinance (Cap. 637) ("the Ordinance") to attract private investment funds (private equity and venture capital funds) to set up and register in Hong Kong. An LPF is a fund that is structured in the form of a limited partnership which will be used for the purpose of managing investments for the benefit of its investors. LPF fund regime commenced on 31 August 2020 [6].

UNDERTAKINGS FOR COLLECTIVE INVESTMENT IN TRANSFERABLE SECURITIES (UCITS)

A collective investment scheme authorized under the relevant national legislation of a member state of the European Union implementing the "Council Directive 85/611/EC of 20 December 1985 on the coordination of laws, regulations and administrative provisions relating to undertakings for collective investment in transferable securities (UCITS)".

UCITS funds often operate with an umbrella fund structure, within which there may be many sub-funds. Some of these sub-funds can also be offered to the public of Hong Kong. Under the SFO, documents offering investment products to the public in Hong Kong must be authorized by the SFC, unless otherwise exempted.

As of 21 October 2021, there are 1272 UCITS authorized by SFC for distribution in Hong Kong. Luxembourg-domiciled UCITS funds account for the largest proportion, or 47%, of Hong Kong's retail fund market.

A scheme will be required to appoint a Representative in Hong Kong if its management company is not incorporated and does not have a place of business in Hong Kong. The scheme has to maintain the Representative throughout the period it is authorized in Hong Kong.

MANDATORY PROVIDENT FUND

The Mandatory Provident Fund (MPF) is a compulsory pension fund designed by the Hong Kong Government as a major protection scheme for all employees not otherwise covered by the Occupational Pensions Schemes that had previously been offered. The objectives of the MRF are to provide for basic retirement needs under the "third pillar" format. It started to operate in December 2000.

As at the end of December 2020, the total MPF assets amounted to about HK$1.14 trillion (US$146bn).

The Pension and Employee Benefits Committee ("the Committee") of the Actuarial Society of Hong Kong ("ASHK") consists of pension actuaries of major MPF providers in Hong Kong. The Committee initiated a study of the MPF market size projection over the next 20 years, from 2020 to 2040.Projected 2040 MPF market size is HK$3.6 to HK$4.1 trillion, which is close to 3.5 times of that of 2020 [7].

The MPF consists of Master Trust Schemes, Industry Schemes and Employer Sponsored Scheme with 409 Constituent funds and Approved Pooled Investment Funds (APIF) available.

EXCHANGE TRADED FUNDS

ETF are open ended funds traded like a stock that track the performance of a benchmark index. Hong Kong launched its first ETF (The Tracker Fund of Hong Kong) in 1999 and since then ETFs have become increasingly popular asset class in the Hong Kong market.

Hong Kong was also the first in the world to offer ETFs on underlying assets in RMB.

As of 30 September 2021, there are 143 ETFs listed on HKEX, including a number of Exchange Traded Products that are known as Leverage/Inverse Products (L/I) where they are managed to provide a return that might be a daily multiple of the return of the benchmark index. The SFC has imposed certain limitations on the extent of the multiples offered by L/I Products, as well as on the benchmark indices that can be used for the purpose.

Some recent ETFs have been issued under OFC structure (e.g. Mirae, CSOP) Following the Covid-19 pandemic, retail appetite for ETFs is growing, encouraged by general education, so there might be some opportunities for cross listing UCITS ETFs in Hong Kong, and also for the HKEx to become the hub for the region.

There has been talk about an ETF Connect for a long time and it would be helpful to the market in general because the onshore investor can access through the ETF listing in Hong Kong for global exposures and vice versa – global investors could access Hong Kong listed ETFs through the ETF Connect to China for their onshore Asia exposure as well as the money market exposures.

In August 2020, regulators in Hong Kong and Mainland China announced the establishment of a new exchange-traded fund cross-listing framework - master feeder structure - i.e. a Hong Kong listed ETF to feed into a master Shenzhen-listed ETFs, essentially providing local investors with direct access to products on the mainland onshore market, and vice versa. There have been only a few such ETFs ; with a recent one of Huatai-PineBridge CSOP Hang Seng Tech Index ETF launched on June 1, 2021 on the Shanghai stcok exchange which shall feed into CSOP Asset Management's Hang Seng Tech Index ETF listed in Hong Kong.

Average daily turnover of ETFs and L&I Products from 1 January 2021 to 30 September 2021 was HK$7.8 billion. Market capitalisation of ETFs and L&I Products at the end of September 2021 was HK$395 billion.

The average daily turnover of ETFs for the first four months of 2021 was HK$6.5 billion, an increase of 10 per cent when compared with HK$5.9 billion for the same period last year [8].

4. Distribution of funds

In Hong Kong, mutual funds are distributed to retail investors mainly through banks, insurance companies, wealth managers and financial advisers.

Retail banks usually offer financial and banking services to the mass market. These services typically include deposits, savings, loans, credit cards, insurance and sometimes investments. In Hong Kong, retail banks remain the key distributors of mutual funds. The bulk of the funds (~78%) are sold through HSBC, Standard Chartered Bank and Citibank.

Bank's domination of the distribution channel is in part due to their important branch networks. Most banks offer "open architecture" fund selection services and this enables their customers to achieve portfolios of funds that can either receive discretionary or non-discretionary management and advice. Under the Know Your Client (KYC) requirements, bank advice on use of mutual funds ensures that portfolios can be tailored to the future needs of investors.

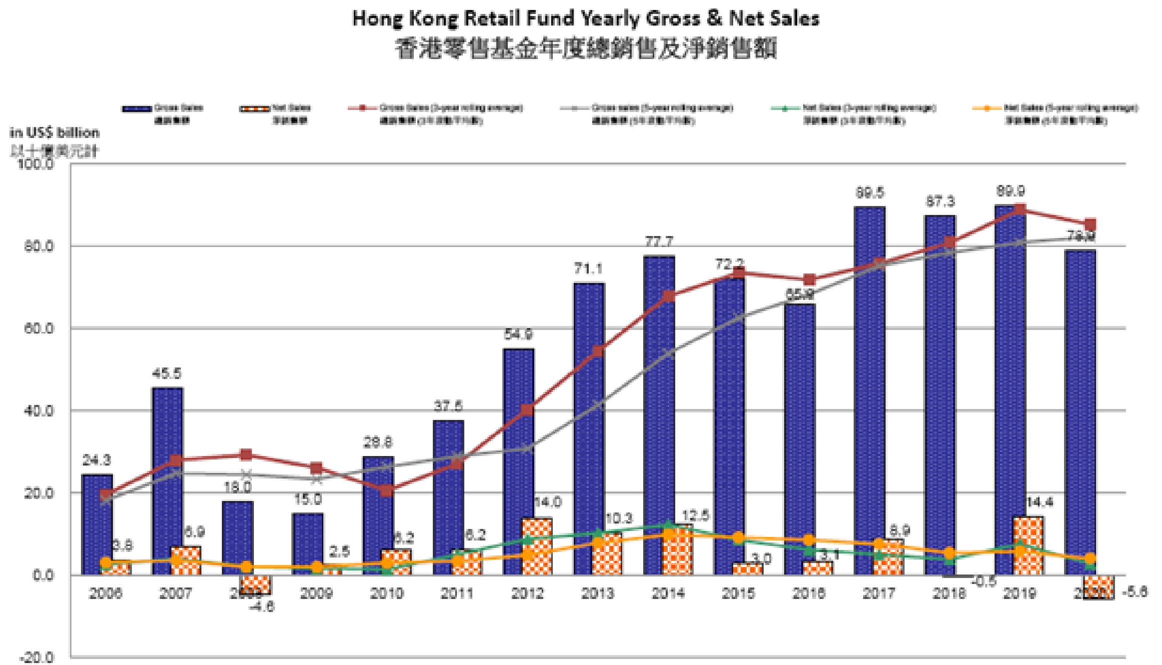
Insurance companies provide a valid alternative channel for fund distribution in Hong Kong (25%).

Mutual funds in Hong Kong are actively sold to investors by investment advisors and distributors rather than bought by investors' choice.

Investment advisors and distributors often receive commissions in the form of subscription fees and trailer/retrocession fees from the fund manager based on the sales & transaction volumes.

Size and scale of the market

As of the end of September 2021, gross retail sales by Hong Kong Investors amounted US$79.6bn.



Source : Hong Kong Investment Funds Association Sales & Redemptions Survey

The number of Hong Kong domiciled authorised funds increased to 835 (as of Mar 2021) from 762 (as of Dec 2020). The total asset under management of Hong Kong domiciled funds reached US$190.9 bn in Mar 2021.

Hong Kong-domiciled authorized funds

Number of funds by type	As at 31/3/2021	As at 31/12/2020	YoY change (%)
Bond	162 (23.5%)	136 (21.9%)	19.1
Equity	193 (28.1%)	185 (29.8%)	4.3
Mixed	71 (10.3%)	61 (9.8%)	16.4
Money Market	33 (4.8%)	28 (4.5%)	17.9
Fund of Funds[1]	86 (12.5%)	78 (12.6%)	10.3
Index[2]	142 (20.6%)	129 (20.8%)	10.1
Guaranteed	1 (0.1%)	3 (0.5%)	-66.7
Sub total	688	620	11.0
Umbrella structures	147	142	3.5
No. of authorised fund total	**835**	**762**	**9.6**

Assets Under management by type	Total NAV (US$ million) as at 31/03/2021	Total NAV (US$ million) as at 31/3/2020	YoY change (%)
Bond	39,004 (20.4%)	28,245 (20.9%)	38.1
Equity	61,839 (32.4%)	39,238 (29.1%)	57.6
Mixed	18,881 (9.9%)	14,629 (10.8%)	29.1
Money Market	8,424 (8.9%)	7,331 (5.4%)	14.9
Fund of Funds[1]	16,982 (8.9%)	13,166 (9.8%)	29.0
Index[2]	45,727 (24%)	32,168 (23.9%)	42.2
Guaranteed	52 (0%)	59 (0%)	-11.9
Total	**190,909**	**134,835**	**41.6**

Note: Unit trusts and mutual funds authorised under the Code on Unit Trusts and Mutual Funds

1. Beginning with the quarter ended 31 December 2020, the NAV of feeder funds whose master funds are authorised by the SFC has been excluded from the total NAV in the "Fund of funds" category to better reflect the total assets under management. For comparison purposes, similar adjustments have been made to the total NAV figures as of 31 March 2020 and 31 December 2019.
2. Including exchange traded funds and leveraged and inverse products.

Authorized Collective Investment Schemes

	As at 31/3/2021	As at 31/12/2020	Change (%)	As at 31/12/2019	YoY change (%)
Unit trusts and mutual funds- Hong Kong domiciled	835	810	9.44	763	6.16
Units trusts and mutual funds-non-Hong Kong domiciled	1382	1384	-1.43	1402	-1.28
Real Estate Investment Trusts	12	12	0.00	12	0.00
Investment - Linked Assurance Schemes	298	300	-0.33	299	0.33
Pooled Retirement Funds	33	33	0.00	33	0.00
MPF Master Trust Schemes	27	27	-6.90	29	-6.90
MPF Pooled Investments Funds	212	210	2.91	206	1.94
Others	13	13	-13.33	15	-13.33
Total	**2812**	**2789**	**1.92**	**2759**	**1.09**

5. Important schemes with other jurisdictions

Mutual Recognition of Funds (MRF) – MRF is an initiative driven by the SFC to promote Hong Kong as an international asset management centre. It is a bilateral regulatory framework which allows certain mutual funds of two markets to be distributed in each other's market.

The SFC has entered into MRF arrangements with China and a number of other overseas financial regulators to allow eligible funds authorised by or registered with financial regulators in those jurisdictions to benefit from a streamlined process for the purpose of authorisation for offering to the public in Hong Kong and vice versa.

Mutual Recognition of Funds (MRF) between mainland China and Hong Kong is a scheme jointly launched since 1 July 2015 by the China Securities Regulatory Commission (CSRC) and the SFC. Under the scheme, eligible Mainland and Hong Kong funds can be distributed in each other’s market through a streamlined vetting process. Currently, there are 50 Recognised Mainland funds distributed in HK under the MRF scheme.

Hong Kong-domiciled funds sold in the Mainland (northbound funds) via

the Hong Kong-China Mutual Recognition of Funds (MRF) scheme saw net inflows of RMB 2.6bn (as of Feb) in 2021 according to the latest data from China's State Administration of Foreign Exchange (SAFE). In total, northbound products had net outflows of HK$1.77bn in 2020.

A MOU has been signed between Hong Kong and following APAC countries: China, Australia, Malaysia, Taiwan and Thailand and with the following European countries: Switzerland, France, the UK, Luxembourg and the Netherlands. Through the scheme, fund managers in HK can gain access to a large pool of international investors. Inversely, investors from France, Switzerland, the UK, Luxembourg, and the Netherlands can increase their exposure to Hong Kong markets benefitting from the expertise of local fund managers. For European asset managers, the MRF complements the UCITs framework.

Each MRF scheme specifies the type of funds that can be passported from one country to another, fund manager's eligibility, investment restrictions, ongoing disclosure requirements, application process, etc. In general, the funds to be passported to another country (host jurisdiction) must be authorised for retail distribution in the home country (home jurisdiction).

As of 31 October 2021, only 5 Luxembourg UCITS have been approved by SFC under the MRF Scheme between Hong Kong and Luxembourg.

MRF operates on the principle that, in respect of a fund that has been authorised by or registered with the relevant authority in one jurisdiction (home jurisdiction), it is generally deemed to have complied in substance with the relevant requirements of the other jurisdiction (host jurisdiction), and thus it will enjoy a streamlined process for the purpose of authorisation for offering to the public in the host jurisdiction.

The management firm of the fund shall ensure investors of both the home jurisdiction and host jurisdiction receive the same treatment and that treatment should be fair, including in respect of investor protection, exercise of rights, compensation and disclosure of information.

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Sustainable Investment in Asia Asset Management

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Introduction

Asset managers are increasingly recognising the potential impacts of ESG factors on asset valuation and are setting out to integrate such factors into their portfolios.

The 26th Conference of the Parties (COP) held in November has focused attention on sustainability risks, especially climate change. There is a growing sense of emergency on the back of COP26 and the UN's Intergovernmental Panel on Climate Change (IPCC) 2021 report findings. The IPCC report comes as a "code red for humanity" and categorically states that human influence has warmed the planet.

The IPCC report has acted as a sobering reminder to all leaseholders of our planet, including governments, consumers, and investors that collectively we need to take action and transition to a net-zero economy. Many countries and governments continue to commit to meeting Paris-aligned targets towards limiting global warming to well below 2°C and pursuing efforts to limit it to 1.5°C. Accelerating regulation, increasing client demand and changing consumer sentiment for responsibly managed assets and products is also pushing asset managers to evolve.

Asset managers are responding by reshaping existing products by adopting an ESG or "sustainable" lens and forming new sustainable product offerings. Capital flows into ESG funds continue to rise with total assets invested in Asia-domiciled funds at US$36.3 billion at the end of June, according to Morningstar [1]. Hong Kong has been gaining pace in its sustainability evolution and has seen a steady growth in sustainable funds with US$416.5 million as of quarter two 2021.

However, despite increased capital flows several challenges remain for asset managers in making this transition a reality in Hong Kong. These include a lack of and inconsistent ESG data across issues, ever evolving standards and frameworks for ESG measurement and reporting, variability in regulatory requirements across Asia, and the need to prevent greenwashing.

In this paper, we take a look at the sustainable investment spectrum of strategies, explore the growth in sustainable assets internationally and

locally and identify ESG-related regulatory developments impacting asset managers in Asia. We discuss the asset manager domicile dilemma for Asia-based managers looking to raise capital in Europe and how asset managers can work towards getting ESG-ready.

The Sustainable Investment Strategy Spectrum

Today there is a broad range of investors with various financial risk, return and impact expectations active across different investment strategies, as seen in Figure 1. Getting on the same page with terms used to describe sustainable investment activities in asset management is important. In this paper, sustainable investment refers to any investment approach or financial service integrating ESG into the selection and management of investments. Asset managers can adopt several different strategies when developing their product approach ranging from exclusions, to best-in-class, towards ESG integration, thematic and impact investing. ESG simply stands for environmental (e.g. energy consumption, water usage), social (e.g. talent attraction, supply chain management) and governance (e.g. remuneration policies, board governance).

		Screening				
Strategies	**ESG Integration**	**Negative/ exclusions**	**Norms-based screening**	**Positive/best-in-class screening**	**Thematic investing**	**Impact investing**
	The systematic and explicit inclusion by investment managers of environmental, social and governance factors into financial analysis.	Industry sectors or companies excluded/divested to avoid risk and better align with values.	Screening out investments that do not meet minimum standards based on international norms (e.g., OCED, ILO, UN, UNICEF) and including investments that meet defined ESG criteria.	Investment in sectors, companies or projects selected for positive ESG performance relative to industry peers, and that achieve a rating above a defined threshold.	Investment in themes or assets specifically related to sustainability (e.g., gender equality, clean energy, green technology, sustainable agriculture).	Investing to achieve positive social and environmental impacts - requires measuring and reporting against these impacts, demonstrating the intentionality of investor and underlying asset/investee, and demonstrating the investor contribution.
	Corporate engagement and shareholder action: the use of shareholder power to influence corporate behaviour, including through direct corporate engagement (i.e., communicating with senior management and/or boards of companies), filing or co-filing shareholder proposals, and proxy voting that is guided by comprehensive ESG guidelines.					

Figure 1: Sustainable Investment Spectrum

Growth in sustainable investment assets

International

Global sustainable investment assets reached US$35.5 trillion in 2020, a growth of 15% on 2018 figures, according to the Global Sustainable Investment Alliance (GSIA). The U.S. and Europe continued to account for over 80% of global sustainable investing assets during 2018 to 2020.

Assets in "sustainable" funds alone worldwide hit a record high of US$1.652 trillion as of the end of December 2020, according to Morningstar. New product launches reached an all-time high in the fourth quarter of 2020, with 196 new offerings, including 37 in countries outside of Europe and the United States. In the first quarter of 2021, inflows into European "sustainable" funds totalled €120 billion, 18% more than the first quarter of 2020, according to Morningstar. Of that, €36.5 billion went to passive index and ETFs [2].

ESG integration continues to be the most common sustainable investment strategy globally, followed by negative screening, corporate engagement and shareholder action, norms based screening and sustainability themed investment – this is demonstrated by GSIA 2020 report[3]. What is evident in the international funds space is that managers are increasingly using a combination of strategies, rather than just one strategy.

Hong Kong

Hong Kong's sustainable fund flows stood at US$416.5 million at the end of quarter two 2021, according to Morningstar. Since the SFC circular on green or ESG funds in April 2019, the number of ESG approved funds has doubled. There are now 66 SFC authorised ESG funds as of September 2021. A total of 25 fund management companies are on the list, with Allianz Global Investors having the most number of ESG approved funds (nine), followed by Pictet Asset Management (eight) and Blackrock (seven), Fidelity (six), Invesco Management (five), with HSBC Investment Funds and BNP Paribas Asset Management at four each. Equity remains the largest asset class represented amongst these funds. A range of strategies are represented across the 66 funds including best-in-class, exclusions,

ESG integration and thematic funds.

Policy and regulatory developments impacting asset managers

There has been a dramatic rise in regulation influencing the sustainable investment landscape – countries and regions have set plans in place to meet their Paris Agreement goals and increased pledges to achieve net-zero emissions by mid-century. Key regulations impacting asset managers are discussed here.

Europe

- **EU SFDR**

At the forefront is the European Commission's Action Plan on Financing Sustainable Growth published in 2018. The SFDR is a key legislative initiative under the plan and has significant impacts on the sustainable investment market.

Who does SFDR apply to?
It applies to EU financial market participants (FMPs) and financial advisors. FMPs are defined as professional players in the financial market, like pension funds, asset managers (including AIFMs and UCITS management companies), insurance companies, banks, and venture capital funds, credit institutions offering portfolio management or financial advisors.

Will it apply to non-EU based managers that market their funds in the EU?
The legislation not only impacts managers in the EU, but also those selling into the EU, as well as the management of EU-domiciled funds which are marketed and distributed into Asia. It applies directly to managers who market funds into the EU under national private placement rules. It applies indirectly to managers providing portfolio management and/or investment advice services to EU firms that are subject to the rules.

What are the requirements?
The first stage of the SFDR rules came into effect in March 2021. It introduced three new concepts, namely:
o Sustainable investment
o Sustainability risk
o Sustainability factors

SFDR requires asset managers to make a number of sustainability-related disclosures, both at 'entity' and at 'product level'. Firms must now comply with the SFDR's Level 1 high-level disclosure requirements. In the first phase, funds are classified according to three categories:

- Article 6: funds that consider ESG risks as part of their investment process or have no sustainable objectives at all.
- Article 8: funds that promote environmental or social characteristics as part of a broad investment strategy.
- Article 9: funds designated as having a sustainable investing objective.

The SFDR Regulatory Technical Standards (RTS) establishes further requirements at entity and product level for Article 8 and 9 products.

As of November 2021, there is additional regulatory uncertainty because a number of the obligations under the SFDR are meant to be elaborated on in the RTS – with the date for implementation postponed from 1 January 2022 to 1 July 2022. Firms are therefore required to comply with some SFDR disclosure obligations without knowing whether those disclosures will be compliant next summer.

As a result of the SFDR setting out requirements for asset managers to incorporate sustainability risks in their investments - negative/exclusionary based screening, norm-based screening and ESG integration has become part of the expected practice of all financial products in the region.

- **EU Taxonomy Regulation**

The Taxonomy Regulation considers what can be considered "green" and what can't by establishing a list of environmentally sustainable economic activities with screening criteria.

Who does the taxonomy apply to?

- Financial market participants offering financial products in the EU, including investment funds, portfolio managers, and occupational pension providers;
- Large companies who are already required to provide a non-financial statement under the Non-Financial Reporting Directive; and

- The EU and Member States, when setting public measures, standards, or labels for green financial products or green (corporate) bonds.

Will it apply to non-EU based managers that market their funds in the EU?
Although the EU Taxonomy is not binding on non-EU financial market participants (unless they are active in EU markets), non-EU investors may use the Taxonomy to gauge whether an investment contributes to an "environmental objective," such as climate change mitigation or adaptation. Non-EU managers may use the EU Taxonomy to avoid greenwashing risks by using it as a guide and adopting the taxonomic language. In addition, it provides a useful benchmark indicator by comparing the underlying funds that are EU Taxonomy-aligned.

What are the requirements?
The EU Taxonomy obliges asset managers to provide information on how their sustainable fund aligns to the taxonomy. For products that do not have sustainable investment objectives or promote environmental characteristics, a negative disclosure must be made. Parties offering financial products in the EU will be required to make EU Taxonomy disclosures as part of pre-contractual and periodic reporting requirements that will apply to them under the Disclosure Regulation, including:

- How and to what extent they have used the EU Taxonomy in determining the sustainability of the underlying investments;
- To what environmental objective(s) the investments contribute; and
- The proportion of underlying investments that are Taxonomy-aligned, expressed as a percentage of the investment, fund or portfolio. This disclosure should include details on the respective proportions of "enabling" and "transition" activities, as defined by Taxonomy Regulation.

Hong Kong

The EU is not alone in the step-up of regulation. We have seen regulators across Asia introducing sustainability or environmental-related regulations including Hong Kong.

SFC climate-related risk requirements

In August 2021 Hong Kong's SFC amended the Fund Manager Code of Conduct (FMCC) to require fund managers managing collective investment schemes (CIS) to take climate-related risks into consideration in their investment and risk management processes and make appropriate disclosures.

What are the requirements?

- Tiers: Under the two-tier approach (baseline and enhanced requirements) - baseline requirements will be imposed on all fund managers, while enhanced standards will be imposed upon Large Fund Managers.

- Thresholds: SFC's October 2020 consultation originally proposed that Large Fund Managers be defined as those having AUM equal to or exceeding HKD 4 billion. In the final requirements, this has been amended to HKD 8 billion.

- Timelines: The final requirements and timeline for compliance has become more closely aligned to the EU SFDR timelines, helping the market as a whole to find equilibrium. The regulatory requirements become effective after the following transition periods:

*12-month transition period for Large Fund Managers to comply with the baseline requirements (ie, until 20 August 2022) and a 15-month transition period for them to comply with the enhanced standards (ie, until 20 November 2022); and
*a 15-month transition period for other Fund Managers to comply with the baseline requirements (ie, until 20 November 2022).
*All other fund managers are given 15 months as a transition period for compliance with the basic requirements.

- TCFD: SFC has adopted a balanced approach in referring to the Task Force on Climate-related Financial Disclosures (TCFD) framework. The SFC has mainly made reference to the TCFD recommendations when developing the proposed requirements for the initial roll out. The SFC highlights this approach has been adopted in order to foster the development of a more consistent framework and minimise the industry's compliance burden. Managers can also incorporate elements from other regulations where they deem them appropriate[4].

The SFC climate-related risk requirements are built across four pillars:

- Governance – includes requirements on board oversight, the management's roles and responsibilities, monitoring of progress to manage climate-related risks, human and technical resourcing, goal-setting, and action plan development.
- Investment management – managers are required to identify relevant and material climate-related risks, and where relevant factor these risks into the investment management process, incorporating climate-related data into the research and analysis process, and take reasonable steps to assessing the impact of these risks on the performance of underlying investments.
- Risk management – includes requirements to identify, assess, manage and monitor the relevant and material climate-related risks for each investment strategy and fund being managed, as well as the application of appropriate tools and metrics to assess and quantify climate-related risks. SFC clarified that managers have flexibility to adopt the type of tools and metrics they deem appropriate using either qualitative or quantitative approaches.
- Disclosure – includes requirements to describe the governance structure and the roles of the board and management, disclose the steps taken to incorporate climate-related risks into the investment management process, and describe the processes for identifying, assessing, managing and monitoring climate-related risks, including the key tools and metrics used.

Large Fund Managers will have to assess the relevance and utility of scenario analysis in evaluating the resilience of investment strategies to climate-related risks under different pathways, and implement scenario analysis within a "reasonable" timeframe. If climate-related risks are assessed to be relevant and material, they must take reasonable steps to identify the portfolio carbon footprints of the Scope 1 and Scope 2 greenhouse gas (GHG) emissions associated with the funds' underlying investments, where data is available or can be reasonably estimated, and define the calculation methodology and underlying assumptions. The SFC has taken on board TCFD's latest views from Proposed Guidance on Climate related metrics, targets and transition plans released in June 2021 when it comes to metrics.

Large Fund Managers will have to additionally describe their

engagement policy at the entity level, how material climate-related risks are managed in practice, and the portfolio carbon footprints associated with their funds' underlying investments at the fund level, including the calculation methodology, underlying assumptions and limitations.

- **Hong Kong SFC ESG-approved funds**

From January 2022, Hong Kong SFC ESG-approved funds and climate-focused funds products will have to disclose how they incorporate ESG factors, report and reference ESG criteria, showcase portfolio measurement approaches and release periodic assessments annually. The revisions come on the back of international and local regulatory developments as ESG continues to gain momentum.

"The disclosure rules most notably required managers of ESG funds to demonstrate that 70% of their fund's underlying assets were invested in ESG themes or prove to the SFC on a case-by-case basis how their fund had an ESG focus. In June 2021, the circular was updated, with strong reference to the SFDR. The SFC's new disclosure rules tightened fund name and disclosure in offering documents requirements, requiring fund managers to disclose more details on how they measure and attain their fund's ESG focus. In addition, annual assessment and reporting for ESG funds were also introduced for the first time. Existing verified ESG funds, and new ESG funds seeking ESG approval have until January 1st 2022 to review/adopt necessary requirements to their disclosure documentation" (Bretteville, 2021)

What are the requirements?
The circular provides further guidance on enhanced disclosures and reporting for SFC ESG-approved funds and contains additional guidance for funds with a climate-related focus. The key updates are outlined below.

- Disclosure in offering documents
    - To include the ESG focus of the fund through a clear description of the fund's aim, and the ESG criteria such as filters, metrics, ratings etc. used to meet the fund's focus.
    - To include the ESG investment strategy by describing the specific approach, methodology used and if an exclusions approach is employed with the associated exclusions.

- Asset allocation showcasing the expected or minimum proportion of securities aligned with the fund's ESG focus.
- Where a fund is tracking an ESG benchmark the manger must disclose details of this and how it is relevant to the fund.
- Risks or limitations must be disclosed (e.g. reliance on third party sources).
- Funds with a climate-related focus (climate funds) are required to specify the climate focus of the fund (e.g. mitigation, adaption, positive impact etc.), associated climate metrics and details of how any reference climate benchmarks aligns to the fund's focus (where the climate fund tracks a climate benchmark).

- Disclosure of additional information on websites
  - ESG funds should disclose a description of how the ESG focus is measured and monitored throughout the lifecycle of the fund, methods employed to measure ESG performance, due diligence procedures, engagement approach adopted and ESG data sources and associated data assumptions. This may be disclosed on websites or by other means.

- Periodic assessment and reporting
  - To conduct at least annually periodic assessments, to assess how the fund has attained its ESG focus.
  - This information should be disclosed to investors (e.g. annual reports) including the proportion of underlying investments aligned with the ESG focus of the fund, the proportion of the fund included/excluded as a result of the ESG-related screening, comparison of the fund's ESG factors against the reference benchmark (if any), steps taken by the manager to achieve the fund's ESG focus (e.g. proxy voting), and any data estimates used or limitations, trend analysis between prior reports.

- Ongoing monitoring
  - Managers to regularly monitor and measure the underlying investments to ensure the ESG funds continues to meet its focus.
  - If an ESG fund no longer wishes to pursue its stated ESG focus, the manager is expected to inform investors and the SFC.

How does this impact UCITS funds?

"SFC has considered the European regulations on SFDR and notes that UCITS funds will be ESG funds in Hong Kong if they incorporate ESG factors as their key investment focus. This is irrespective of whether they are classified as Article 8 or Article 9 under SFDR. Where UCITS funds meet SFDR requirements under Article 8 and 9 they will be deemed to have generally complied with the SFC requirements – however the SFC may vary the requirements as they deem fit at any time".

"UCITS funds that are compliant with the SFDR's article eight or nine disclosure rules will 'generally' be accepted by the SFC as having fulfilled the Hong Kong regulator's disclosure requirements, according to the regulator. However, a UCITS fund that demonstrates an ESG focus and investment strategy may be approved as an ESG fund in Hong Kong, even if the fund does not fall under SFDR's article eight or nine categories." [Ignites Asia]

Mainland China

Regulatory developments have created an increase in sustainable investments in mainland China, in addition to pressure from overseas investors. According to the SynTao Green Finance Policy Database, over 700 green finance policies on both national and local level have been issued.

The Asset Management Association of China (AMAC) has issued China's first self-regulation standard for asset managers through the:

- "Guidelines on Green Investment," issued in November 2018. It is a major driving force for ESG development, urging and facilitating ESG integration in asset management firms.
- Asset managers are encouraged to carry out company-wide self-assessment on their green investing practices and submit their self-checking reports to the regulator every year. This followed with the requirement of ESG disclosures from listed companies in China.

"After President Xi Jinping indicated strong policy support for sustainable investments in November 2020 by laying out the target of achieving carbon neutrality by 2060 and cutting 65% of carbon emissions by 2030, ESG investments have gained significant traction. Large players in the domestic market are reshaping their ETF products to ride the bullish investor sentiment surrounding assets that are conducive to the country's ESG goals." (Bretteville, 2021).

"'Since 2019, the AMAC has encouraged asset managers to carry out voluntary self-assessments of their green investment practices. Article 14 and 15 of the AMAC's 'Green Investment Guidelines' encourages asset managers to submit an annual self-assessment of ESG efforts including their green investment philosophy, construction of green investment systems, and green investment goals. A February 2021 report shows that 40% of asset managers voluntarily disclosed their ESG efforts. " (AMAC).

"The annual AMAC self-assessment is a series of 20 questions which asset managers can use to evaluate whether they have considered ESG factors in their strategies. Although the current level of disclosure requirements is relatively relaxed compared to frameworks such as the SFDR, it adequately suits the exploratory attitude towards ESG investing both among fund companies, and investors in Mainland China." (Bretteville, 2021).

Domicile dilemma for asset managers

In Asia, traditionally the Cayman Islands has been a go-to domicile for fund incorporations, with Cayman structures being recognised as a legitimate and important channel for capital inflows and outflows between Asian countries and further afield. However, when it comes to raising capital in Europe, the Cayman Islands is not generally the premier choice of jurisdiction for fund managers in their fund set-up particularly as it requires reliance on the private placement regime with no access to the "passport" under the Alternative Investment Fund Managers Directive. In addition, since February 2021, the Cayman Islands has been on the FATF [5] "greylist" which, although not

requiring any immediate measures to be taken by member jurisdictions, may require increased due diligence measures for Cayman entities interfacing with financial intermediaries[5]. Luxembourg and Ireland have tended to be frontrunners as a choice of fund domicile for those looking to raise a significant European investor base, with Malta arising as a more recent contender. Historically, Asian managers have struggled to access European capital before a solid track record had been established. However, the appetite for ESG and impact funds in Europe has introduced an early domicile dilemma for these managers who may look to raise capital in Europe even on a first time fund.

There are many reasons why the Cayman Islands has been so popular to date, with cost, flexibility, speed and a robust legal framework being important components. Singapore and Hong Kong have since enhanced their own private fund regimes which are increasingly competitive and are now gaining traction. The result is greater choice but this can add more time and analysis to the decision making process. For ESG funds, this question of domicile is exacerbated due to the types of investors these funds are likely to attract. Not only is there strong interest amongst EU investors for ESG funds, there is also increasing interest in Asian markets including Mainland China. European investors may require more regulated structures and other categories of investors, such as development banks, may have their own criteria. However, this can present some smaller fund managers with a conundrum due to the cost implications of such structures, particularly surrounding the appointment of a depository and the need to contract with an AIFM (alternative investment fund manager) for those looking to rely on an EU "passport" for marketing in Europe. Without early commitments from investors it can be a daunting prospect to commit to setting up a regulated European structure given the significantly higher costs (although naturally less of a concern for medium to large fund managers).

Regardless of domicile choice, fund managers can do much to ensure that the governance and management of their fund is in alignment with that of an ESG fund. Important aspects include ensuring sufficient level of investor protection and transparency as well as implementing good governance. Choice of domicile does not affect the ability for fund managers to implement the relevant level of ESG overlay when structuring the fund and drafting fund documentation.

What actions can asset managers take to get ESG fit?

There is no one-size-fits-all approach to ESG given the diversity of the asset management industry. Managers globally and locally are responding in ways commensurate to their size, nature and financial risk-return and impact goals. Some managers are looking to ramp up their ESG and climate-risk knowledge either through building in-house talent or working with external advisors.

When thinking through what steps to take to prepare for the ESG regulations managers with existing SFC ESG-approved funds or new ESG funds could consider the below actions.

- **Existing SFC ESG-approved funds:**

- should undertake a review of your fund's current disclosures in light of the updated SFC circular requirements for ESG-approved funds and the make necessary updates and revisions by 1 January 2022, and seek appropriate advice where necessary.

- **New SFC ESG funds:**

- continue to adopt the 2019 circular measures and make the necessary updates and revisions required under the updated circular by the Effective Date, and seek appropriate advice where necessary;
- complete circular compliance checks before submitting self-confirmation of compliance;
- confirmation supported with independent third party certification or fund label to demonstrate compliance. The SFC expects the independent third party or fund labelling agency as part of the certification or labelling process to review, at a minimum, the ESG fund’s primary investments to reflect the particular ESG focus which the fund represents, investment selection and ongoing monitoring process.
- Take steps now to enhance your board and senior management team's understanding of ESG and climate risk.
- Consider generally if you are clear on your disclosure and reporting obligations under the circular.
- Refresh internal procedures and training to ensure you are prepared for the updated requirements.

SFC climate-related management and disclosure requirements

When preparing and planning next steps for the Hong Kong SFC climate-related risk requirements fund managers should note that the new requirements are intended to apply to Hong Kong-based SFC licensed fund managers generally as opposed to solely products that are consider to be ESG funds.

In Hong Kong, the runway from now until baseline requirements are due helps gives managers time to assess the requirements, determine relevance and materiality and design their action plan. It also allows the local ecosystem of intermediary support to develop too, which is a positive. More and more products are coming into the market to help asset managers get ready for the requirements [6].

Managers should begin their internal review to determine what additional policies they require, what additional disclosures they are required to make to the investors and what the appropriate form for doing so is.

Regardless of the fund's jurisdiction and the local rules that apply, managers are advised to examine the true intention of what they are trying to accomplish when factoring in ESG. As stewards of capital, asset managers are in a good position to maintain dialogue and positively influence a broad range of stakeholders. It's therefore very reassuring to see the formation of industry partnerships and asset managers seeking to engage on sustainability topics with a broad range of key stakeholders beyond the companies they're invested in.

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[5] FATF recognised that Cayman has successfully implemented 60 out of 63 Recommended Actions which were outlined in a November 2018 Mutual Evaluation Report but it was explained by the FATF President, Marcus Pleyer that the Cayman Islands has been held to a higher standard compared to other offshore centres, stating that "the Cayman Islands is a major financial centre. We expect countries with higher risks to have commensurate measures against these risks and that is why the Caymans are on this so-called greylist."

[6] Ogier Global has developed ESG Align - a new compliance tool to support asset managers navigate the regulatory ESG environment.

China's Greater Bay Area development and Wealth Management Connect

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The opening up of China's Greater Bay Area (GBA) for financial services products has the potential to offer great opportunities for business development for both local and global fund managers in Hong Kong. China has declared an intent to create "Wealth Management Connect" (WMC) across the GBA which will eventually allow a wide range of financial services products cross-border access to more than 70 million people. WMC will enable use of eligible mutual funds, bank deposits, insurance products, securities and potentially pensions from Hong Kong to be sold anywhere in the GBA. For fund managers, the opportunity to sell their Hong Kong products to an economically wealthy area around 10 times the size of Hong Kong is unprecedented.

This chapter takes a look at what is proposed. At the original stage of writing (May 2021) there remained a few unknowns, as both sides are actively involved in discussing arrangements and how their local businesses and banks can participate. Since then, the WMC pilot has been successfully launched and in operation since 19 October 2021. The scheme will evolve over a period of years, with multiple phases, and gradual opening. This tends to be typical of how China has allowed the opening up of its own financial services industry.

One key point that has already emerged and will likely to continue to arise, is that the WMC scheme is expressly intended to enable support of domestic financial and fund management businesses in the GBA and Hong Kong. The objective is to provide more flows within the region and for the management, administration and accounting for that to remain within the region. Thus, for any fund management firm wishing to participate they will be compelled to create domestic businesses, probably in Hong Kong, with domestic-domiciled funds. It has been clearly stated by the Regulators on both sides of the border, that they don't wish to see use of UCITS funds from Luxembourg or Ireland as a direct form of investment. There may, in time, be the opportunity for Hong Kong domiciled funds to create fund-of-funds vehicles using UCITS, but managed in Hong Kong.

What is the Greater Bay Area (GBA)?

In 2017, China's President, Xi Jinping, announced the formation of a new economic region in southern China to be called The Greater Bay Area. The GBA encompasses an area including Hong Kong, Shenzhen, Macau, Guangdong and seven other Chinese cities, that has a population of over 70 million i.e. twice the size of California, bigger than France or the UK, with a total GDP of around the same as California. The objective of the development is ultimately to provide borderless, seamless access to a wide range of goods, services, and other economic activities, especially manufacturing, technology, design and financial services. Each major city in the GBA would become the centre for certain types of activities, thus Shenzhen may become the technology hub, Guangdong the manufacturing hub, Hong Kong the financial hub.

The GBA is not simply set up to offer cross-border financial services, but it is also to enable greatly improved access and distribution for manufacturing, technology exchange, and thus employment opportunities throughout the region. Already there is a very well-developed transportation system, roads, railways, bridges and airports to enable rapid connections to occur. The southern region of China centered around Guangdong has for many years been a magnet for people throughout China, seeking opportunities, employment and advancement. Many factories were originally set up by Hong Kong-based businesses, to provide lower cost manufacturing. This has rapidly developed to increased use of technology, with some of the world's most advanced technology businesses now headquartered in the region.

In May 2020 an announcement from the People's Bank of China (PBoC) together with the other key regulators for the banking, insurance and securities industries, has lit the blue touch paper to one of the most exciting opportunities in financial services anywhere in the world. Wealth Management Connect will eventually allow cross-border sale of financial products within the GBA. On 29 June 2020, the Hong Kong Monetary Authority and the Monetary Authority of Macao joined with the People's Bank of China to confirm the Wealth Management Connect Pilot Scheme in the GBA. In August, the PBoC and other Chinese regulators issued further guidance on what can be expected. There have been further announcements made from both sides, as they negotiate the many issues that need to be developed to make this a

success, and with a possible launch in the second half of 2021, most of the initial issues have been finalised.

Objectives of the GBA

The objective of the GBA development is ultimately to provide borderless, seamless access to a wide range of goods, services, and other economic activities, especially manufacturing, technology, design and financial services. Each major city in the GBA would become the centre for certain types of activities, thus Shenzhen may become the technology hub, Guangdong the manufacturing hub, Hong Kong the financial hub. Across the GBA there are already extensive transportation links, road, rail networks and a number of airports.

It is understood that the Chinese government believes that through regional cooperation, the already strong economic hub can become a global powerhouse, where each of the key parts of the region can participate. Clearly also, China is likely to use the GBA as an example to the whole of China on what can be achieved through greater regional cooperation.

What has been proposed for Wealth Management Connect (WMC)?

The GBA Outline Development Plan was issued in February 2019 to more formally establish the GBA. The GBA (Circular 2020-95) was issued on 14 May 2020 by the People's Bank of China (PBoC) together with the China Securities Regulatory Commission (CSRC), China Banking and Insurance Regulatory Commission (CBIRC) and SAFE, to announce 26 clauses or "opinions" for consideration, to in effect create a "Wealth Management Connect" system across the GBA that follows similar access routes to the well-established Stock and Bond Connect and Mutual Recognition of Funds (MRF) routes between Hong Kong and China.

From information received through the various consultations organized by the Regulators, they would like Wealth Management Connect to be run in parallel with other established cross-border access routes. Should it prove popular and successful it will eventually allow development of financial products for an array of wealth management

products, including bank deposits, mutual funds, ETF, securities, private equity and credit products, medical, accident and vehicle insurance products, and life insurance products. It is most likely that the development will occur in phases, depending on the success and experience of each phase. Thus, for example, Phase 1 will be limited to just bank deposits, certain types of bonds and certain mutual funds. Future phases may then add more product choices and reflect both the experience to date and market demand.

It can be assumed the wealth management products for inclusion will be all those that most people in the industry are familiar with and that have been widely available in Hong Kong for many years. Of course, it should not be forgotten that in making them available, it is intended this should be across the GBA, thus many similar products in China will become available in Hong Kong for the first time too. This potentially could lead to price competition, which may be no bad thing for consumers across the region.

Also, in China, the banks have for many years been offering their customers wealth management products although generally these are unregulated and thus not formally approved by the securities regulator. Many of these are somewhat similar to mutual funds invested into high yielding government and corporate bonds. Intrigingly, the CBIRC and CSRC, as regulators, in 2019 issued guidance in effect aiming to cease bank wealth management product development in favour of regulated mutual funds. It has been this that has fueled the massive growth in mutual funds sales in 2020 and early 2021, as bank customers wealth management products mature and are switched to regulated funds instead.

Where should fund managers focus?

The focus for fund managers undoubtedly should be on having their unit trust and mutual fund products available to be sold across the GBA. It is being made clear by the regulators on both sides of the border that only locally domiciled products can and will be eligible for inclusion. Further, rather than rely on the MRF, there is a desire to achieve an independent criteria for what funds will be allowed. These will probably be funds that have a low-to medium-risk rating, don't use leverage, derivatives or other enhancements, and will likely be "plain vanilla" and non-complex in their investment objectives.

For global fund managers, unless they have already established Hong Kong domiciled funds, they will not be able to participate in the GBA Wealth Management Connect programme, as UCITS products from Luxembourg or Dublin are excluded.

In aiming for an entirely different set of criteria from those applicable for MRF, funds can avoid some of the previous sticking points under MRF of the 50/50 split of investors, minimum age and size of fund. But a big advantage may be that it could allow greater sub-advisory opportunities or feeder or fund-of-fund products to be included, both of which can enlarge the scope of products available. These types, often called "Chapter 8 Funds", although now under Chapter 7, under the HK SFC Code on mutual funds, would be allowed to invest into other funds under regulations that apply to "unit portfolio management funds (UPMF)" that have been in existence in Hong Kong for many years. UPMF are allowed to use UCITS funds, provided the UCITS have already been authorized by the SFC, and the UPMF has a broad diversification of at least five sub-funds. But as a Hong Kong domiciled fund, it would need to not only be set up and legally established in Hong Kong, it would also need the investment management to be carried out in Hong Kong by SFC regulated personnel.

All this is likely to force many global fund managers to review their business operations in Hong Kong, and to consider setting up locally domiciled funds that can then participate in both the MRF and the WMC. To date, many global managers have deferred such decisions until they can see proven success and volume sales under the MRF scheme. Now they have a second "funds passporting" route open to them, with a possibly more compelling opportunity behind it.

Closed loop system, Restrictions

Inevitably, as has occurred with all the other China access schemes, WMC within the GBA will face some restrictions. Most of these have now been confirmed, it is expected there will be quotas for the aggregate value of investment assets allowed to flow across borders. There will be minimum thresholds set for individual investors, clearly aiming to provide these services to the higher net worth target group, but also a maximum amount per person that can be invested. It has been confirmed that the maximum quota per person will initially be set

at RMB1m (US$155,000). There will also be an aggregate quota set in the initial stages too, with a figure of RMB150billion (US$22.3bn) being widely quoted. All investing is required to be in the single name of the end investor, no joint accounts or corporate accounts allowed under WMC.

It is also expected that for Mainland investors buying Hong Kong financial products, there will be a "closed capital circulation management" policy adopted. This "closed loop" in effect will mean that an investor in China may only buy through their bank in China and only be allowed to get their money back through the same bank in China. There will not be product fungibility, thus you can't buy in Shenzhen and get money back in Hong Kong, for example. This has been the well-established route for MRF, using ChinaClear, thus most fund managers already on the MRF system will be familiar with the circumstances.

Who will do distribution?

Banks will be given priority for distribution in Phase 1. This may be due to them being the best-established route for sales of wealth management products across China already, and thus a familiar place for end-investors to go for advice. Banks on each side of the GBA are expected to work with each other to provide the facilities. Most likely, Mainland Chinese banks will seek to work with their counterparts from within the same banking group, with businesses in Hong Kong. This potentially could achieve more efficient administration. However, for those Mainland banks that don't have a Hong Kong-based counterpart, they will be required to create a new working relationship with which to work, if they want to offer WMC within the GBA.

In the consultation discussions the regulators have been having with the industry so far, they have indicated that all investors that wish to partake of WMC in the GBA will be required to have physically travelled to Hong Kong to open an account in person with the counterpart bank, before returning to their home location where they can effect the transaction. However, in the latest round of discussions, and in the light of the restrictions on cross-border travel imposed by the Covid-19 Pandemic, GBA investors will be allowed to set up investment accounts with banks in Hong Kong on a remote basis, provided they do so via their domestic GBA bank.

A restriction on this is that for those GBA residents setting up an account remotely, they will not be able to receive advice and guidance on the choice of funds made available by banks in Hong Kong, whereas those GBA residents that can and do set up accounts in person, in Hong Kong, they can be in receipt of advice and guidance on fund selection, although this must not be seen to be active sales and marketing.

How does WMC sit with other Asian fund passporting schemes?

Within the Asian region there are a number of mutual funds passporting schemes. The table below gives an indication of those, by comparison.

Mutual Recognition Schemes compared						
	France	**Switzerland**	**United Kingdom**	**Luxembourg**	**Thailand**	**China**
Date of MoU	July 2017	December 2016	October 2018	January 2019	January 2021	July 2015
Host Regulator	AMF	FINMA	FCA	CSSF	SEC	CSRC
Eligible Fund Managers	Authorized by AMF to manage publicly offered funds, and remain eligible	Authorized by FINMA to manage publicly offered funds, and remain eligible	Authorized by FCA to manage publicly offered funds, and remain eligible	Authorized by CSSF to manage publicly offered funds and remain eligible	Authorized by SEC to manage publicly offered funds, and remain eligible	Authorized by CSRC to manage publicly offered funds, and remain eligible
Eligible funds from Host to HK	French funds recognized and approved by AMF; French "covered" funds	Swiss covered funds recognized and approved by FINMA and remaining authorized.	UK Covered Funds authorized by the FCA and remaining authorized	Luxembourg Covered Funds, managed, domiciled in Luxembourg, authorized by CSSF as UCITS.	Authorized by SEC to manage publicly offered funds, and remain eligible	Authorized by CSRC to manage publicly offered funds, and remain eligible
Eligible funds from HK to Host	All HK authorized and domiciled	All HK authorized and domiciled	All HK authorized and domiciled	All HK authorized and domiciled	All HK authorized and domiciled	HK authorized and domiciled funds approved by CSRC for use
Investment types	General equity, bond and mixed funds	General equity, bond and mixed funds, feeder, fund-of-funds, money market/cash funds, index and ETFs	General equity, bond and mixed funds, feeder, fund=of-funds, index, ETFs	General equity, bond and mixed funds, feeder, fund-of-funds	General equity, bond and mixed funds,	General equity, bond and mixed funds,
Fund types not allowed	Commodity, Money Market, ETF, Index, Structured	Commodity	Commodity	Commodity, ETF, Index, Structured	Commodity, ETF, Index, Structured	Commodity, ETF, Index, Structured
Other requirements	Min. 20% French domiciled investors. Appoint a HK Rep.	Appoint a HK Rep	Appoint a HK Rep	Appoint a HK Rep	Appoint a HK Rep	Appoint a HK Rep, 1 year track record, Min. US$25m AuM, less than 50% investors from China, less than 20% invested in China
Offering documents in HK	AMF approved Prospectus plus HK KFS and Covering Document in E and/or C	FINMA approved Prospectus plus HK KFS and Covering Document in E and/or C	FCA approved Prospectus plus HK KFS and Covering Document in E and/or C	CSSF approved Prospectus plus HK KFS and Covering Document in E and/or C	SEC approved Prospectus plus HK KFS and Covering Document in E and/or C	CSRC approved Prospectus plus HK KFS and Covering Document in E and/or C
Other matters						

Four Asian Fund Passport Schemes: latest Update (July 2021)

ASEAN QCIS

- Launched August 2014, involving SG, MY, Thai, but slow take up rate.
- 11 funds (MY/SG), 1 ETF fund (Thai/SG) approved for passporting, 9 funds launched to date
- CIMB-Principal MY launched 4 funds (of 6) to date. Maybank fund (MY/SG)
- Nikko SG/MY and Phillip Cap (SG/??) have approved funds, One AM (Thai/SG) offering an ETF fund
- Philippines joining in 2021.

APEC ARFP

- Began September 2015, involving Australia, New Zealand, South Korea, Japan, Thailand, Singapore
- Singapore dropped out from "signatory list" as MAS SG upset on exclusion of tax neutral statement
- MoC signed 30 June 2016 to commence, expecting to commence by 31 December 2017
- ARFP Guidance on Host Laws issued August 2017 for 8 week consultation
- Tax Reference sub-group established to provide advice/guidance
- Other observers include Singapore and The Philippines. Attempts to get Taiwan involved failed.
- Australian ASIC issued ARFP and CCIV consultation.
- Japan joined
- Virtually no uptake to date.

MRF

- Launched 1 July 2015, involving HK/PRC
- Northbound HK to China, 32 funds to date
  - Amundi, BEA Union, BOC HK, HSBC AM, Hang Seng, JP Morgan, Schroders, Value Partners, Zeal applied for Northbound license.
- Southbound China to HK, 50+ funds submitted to SFC and authorised, to date
  - Many Mainland FMC applying to SFC
  - 24 funds actually launched.

WMC

- Initiated as part of Greater Bay Area developments in 2020
- Coordinated by PBoC and HKMA
- Locally domiciled/authorized funds only
- RMB1m per person limit for Mainland investors

Latest and/or Future Developments

Conclusion

The potential of Wealth Management Connect in the GBA is unlimited. In 2020, China's retail investors poured more than RMB1trillion (US$141bn) into the launch of over 640 new funds during the year, demonstrating their need to find more attractive investment propositions. But it is also clear many global fund managers in Hong Kong are at this stage unprepared and not able to participate, often because they have not established any locally domiciled funds that could be included. Indeed, a recent survey for the Hong Kong Investment Funds Association reported that 83% of fund managers in Hong Kong admitted they were not prepared or set up to participate in the GBA developments. This is a shame, as quite clearly any scheme that provides more opportunities must be considered attractive.

Stewart Aldcroft,
Asian Fund Management Industry Consultant

Update on Private Funds available in Hong Kong

Author

Jason Chan, Dechert

Background

Amidst the COVID-19 panademic, Hong Kong's asset management and fund advisory business has continued to grow in 2020, with a 20% year-on-year increase in AUM to HK$24,038 billion (US$3,100 billion) as of 31 December 2021[1]. In particular, AUM of private funds managed in Hong Kong, including hedge, private equity and venture capital funds, accounted for 16% of the asset management and fund advisory business in Hong Kong in 2020, with the total AUM of HK$3,808 billion (US$490 billion).

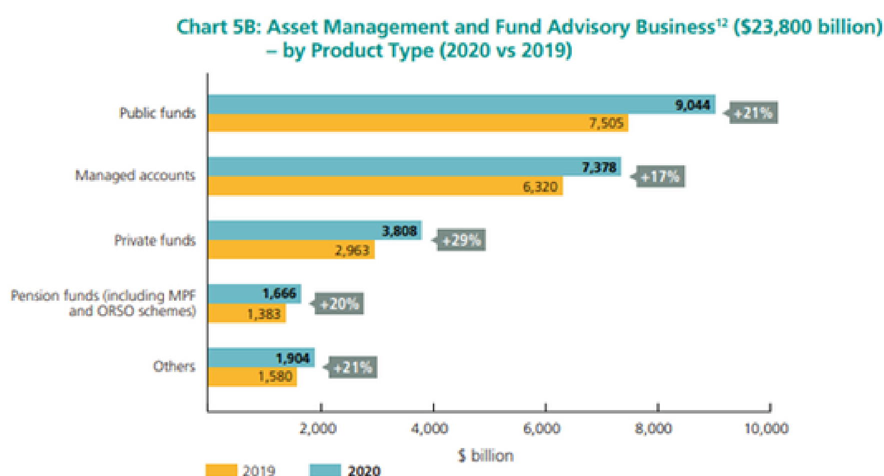


Figure [1]: Hong Kong asset management and fund advisory business by product type (2020 vs 2019) - Asset and Wealth Management Activities Survey 2020 issued by the Hong Kong Securities and Futures Commission

According to the Asian Venture Capital Journal, Hong Kong ranked second in Asia after Mainland China in 2020 in terms of the total capital under management by private equity funds (excluding real estate funds), which amounted to US$164 billion. While being Asia's asset and wealth management hub, Hong Kong's local fund vehicles have not been very popular among asset managers. This is partly due to the fact that Hong Kong fund structures were not the most manager-friendly, but also that its offshore counterparts, in particular those offered by the Cayman Islands, are much more widely accepted by international investors and are more tax efficient.

The Hong Kong government has been committed in the past few years to solidifying its position as the asset management hub in the region and in particular, it aims to develop a robust domestic private fund industry.

Therefore, we have seen a series of recent changes introduced by the Hong Kong government to bolster Hong Kong's position as a premier asset and wealth management hub. This includes the introduction of the Hong Kong limited partnership fund (LPF) regime, as well as the revamp of the open-ended fund company (OFC) regime.

To complement that, since 1 April 2019, Hong Kong has had in place an expanded "unified funds tax exemption" that exempts privately-offered funds, including private equity funds and certain hedge funds, from Hong Kong profits tax in respect of their assessable profits derived from qualifying transactions, including transactions in shares of local and overseas private companies, subject to meeting the relevant exemption conditions.

1. **Introduction of Hong Kong LPF regime**

The introduction of the Hong Kong LPF regime in August 2020 was taken place against the backdrop of various changes in the offshore fund regimes. In particular:

- **Tax Risk:** evolving international tax policy driven by the Organization for Economic Co-operation and Development (OECD) pose a great risk of tax challenge to fund structures that do not align form (the place of incorporation of the fund vehicle) with substance (the jurisdiction in which primary fund management activities take place). Double tax treaty benefits that are utilized by such fund arrangements may be challenged in jurisdictions where OECD member states reside based on evolving "Base Erosion and Profit Shifting" policies (BEPS).

- **AML Regulations:** the Cayman Islands has long been threatened with a general blacklist by international agencies, such as the OECD and the Financial Action Task Force (FATF). The Cayman Islands has recently been placed on an OECD greylist in the European Union, which has resulted in the imposition of additional reporting and due diligence requirements concerning transactions relating to Cayman Island structures in the European Union.

- **Sea of Regulatory Changes:** the landscape for private fund managers has become more complex with the latest string of regulatory changes to the Cayman Islands, including the introduction of economic substance requirements, new licensing and reporting requirements in respect of management entities, additional disclosure requirements concerning the sharing of taxation and other information, and the introduction of the requirement for certain closed-ended funds to register with the Cayman Islands Monetary Authority. These regulatory changes have introduced an element of operational uncertainty that did not previously existed, and this has also escalated related start up and registration costs for Cayman exempted limited partnerships considerably.

When viewed in totality, the attractiveness and stability of offshore structures like Cayman limited partnerships is being chipped away due to the confluence of increasing regulatory and tax risk, increasing set up and maintenance cost and increasingly onerous reporting and compliance obligations. The introduction of a jurisdiction in Asia where all vehicles and activities can be located onshore and aligned with the substance of the activities, bringing with it potential tax and cost efficiencies, provides a great alternative to Asian fund managers. This development is timely and could prove to be transformational for private equity firms headquartered outside of Hong Kong, as well as other Asia-focused managers with Hong Kong operations.

The Hong Kong LPF regime has gained traction since its introduction – more than 300 funds has been registered. According to the first annual report on Hong Kong LPFs, issued recently by the Hong Kong LPF Association, 82% of asset managers and service providers who took part in the survey intend to set up LPFs while 10% have already set up such a structure.

Advantages of the HK LPF Regime:

The new LPF regime has a number of advantages over offshore jurisdictions, including the following:

- **Streamlined Structure:** the LPF regime will provide operation benefits. The structure will be more efficient and cost effective to establish, maintain and administer, as all entities will operate under a single regime. As the need for two layers of service providers (lawyers, auditors and administrators) will be removed, this will also reduce set up and ongoing costs.
- **Cost Efficiency:** There will be lower set up and annual fees payable to the Hong Kong Registrar compared to fees payable in the Cayman Islands for a Cayman Islands exempted limited partnership.
- **Regulatory Certainty:** Most HK private fund managers will already be licensed in Hong Kong to manage a private equity fund and there is a growing number of private equity fund manager seeking to become licensed in recent years, in particular after the Securities and Futures Commission's ("SFC") circular dated January 2020 which reminded local managers that most fund management businesses would require a Type 9 (asset management) licence.
- **Tax Certainty:** As mentioned above, offshore fund jurisdictions are constantly subject to increasing challenges in relation to their tax regimes, in particular, in view of BEPS and other OECD developments. Double tax treaties are also increasingly being challenged where “commercial substance” is not demonstrated in the country of source of the investment, or the country of domicile of the entity to which realization proceeds are repatriated. The LPF regime facilitates compliance with these substance principles by aligning the location of both the fund vehicle and its manager. The fund vehicle will therefore be eligible to receive the maximum benefit of Hong Kong’s extensive double tax treaty network.
- **Carried Interest Concession:** Coupled with the tax certainty mentioned above, the Hong Kong government has introduced a tax concession for tax on carried interest effective 7 May 2020 and applied retrospectively from 1 April 2020, which a Hong Kong LPF may take advantage of.
- **Appeal to PRC Investors:** Hong Kong’s proximity to the PRC facilitates and promotes the territory’s historical role as a hub for both inbound and outbound China-related investments. It has therefore developed as a reliable international center for capital raising. Further, the LPF regime is widely expected to be more attractive to Greater China region state-sponsored managers and institutional investors. In particular, the new LPF Regime is expected to be attractive to participants in the Greater Bay Area initiative and

- the "One Belt/ One Road" initiative. It is expected (and proven to be the case) that industry participants in the Greater China region that are sovereign wealth funds or state-owned enterprises will have a strong preference to use the Hong Kong regime.
- **Popular Exit Option:** Hong Kong continues to lead the world as a major capital market in terms of IPO issuance. The IPO is a popular means of exit for many private equity funds. In recent years, private equity firms have acted as anchor investors in a significant majority of Hong Kong's IPOs.

Key features of the LPF regime

The key features of the LPF regime are set out below:

- **Fund Types:** the LPF regime is focused on private funds which are structured as limited partnerships. This typically encompasses a fairly broad range of funds including venture capital, private equity, real estate, infrastructure and credit funds as well as other funds that invest in illiquid assets. That said, the LPF regime does not preclude use by funds that invest in liquid securities like hedge funds.
- **External Capital:** at the date of registration, an LPF can admit external capital or proprietary capital, or even a combination of both. If the LPF only admits proprietary capital, it can continue to do so for a maximum of 2 years. If an LPF does not admit external capital within 2 years of registration, it can be deregistered. This is to ensure that this scheme, which will be very beneficial for the industry and which will entail tax concessions, is not used for tax avoidance – the government wants to ensure that the LPF regime will only be used for the proper purpose of establishing funds.
- **Constitution:** an LPF would be a limited partnership "fund" (i.e., a "collective investment scheme" as defined under the Securities and Futures Ordinance (SFO)) used for the purpose of managing investments for the benefit of its investors. The LPF is proposed to be constituted by at least two partners (one general partner (GP) and one limited partner (LP)) under a limited partnership agreement (LPA) with a registered office in Hong Kong and a business registration certificate. Each LPF will be governed by its LPA under the terms and conditions set out therein.

- **General Partner:** a GP may be a private company limited by shares incorporated in Hong Kong; a non-Hong Kong company registered with the Companies Registry of Hong Kong; a limited partnership (domestic or foreign); or an individual (domestic or foreign). The GP has unlimited liability for all the debts and obligations of the LPF. It also has ultimate responsibility for the management and control of the LPF.
- **Investment Manager:** the GP would be required to appoint an investment manager to carry out the day-to-day investment management functions. The investment manager should be either a Hong Kong resident at least 18 years old or a corporation registered in Hong Kong. A Hong Kong-based fund manager would conduct the day-to-day investment management functions and would therefore likely need to be appropriately licensed by the SFC to conduct such business.
- **Custody:** the GP must ensure there are proper custody arrangements for Fund assets. The term "proper custody arrangements" is not defined but, if the fund is operating under a licensed fund manager then the relevant requirements under the Fund Manager Code of Conduct issued by the SFC (FMCC) will apply – this would require the appointment of a registered trust company or regulated bank / bank affiliate in Hong Kong.
- **Audit:** the GP must appoint an auditor independent of the GP and the investment manager, and must be a Hong Kong registered auditor. If the fund is managed by Hong Kong licensed entity, then there will be specific requirements that apply under the FMCC. The standards adopted for financial reporting will be flexible – it can be IFRS, GAAP or other internationally recognized standards.
- **Fund Administrator:** There is no mandatory requirement to appoint a fund administrator and there are no prescriptive requirements for what needs to be covered in an administration agreement.
- **Responsible Officer:** the GP is required to appoint a "responsible person" to carry out anti-money laundering/counter-terrorist financing (AML/CFT) functions for the LPF. The responsible person could be a person or corporation that is: an "authorized institution" as defined under Banking Ordinance (Cap. 155); a "licensed corporation" licensed by the SFC; an "accounting professional" as defined under Anti-Money Laundering and Counter-Terrorist

- Financing Ordinance (Cap. 615) (AMLO); or a "legal professional" as defined under the AMLO. The responsible person would be required to conduct preventive AML/CFT measures as stipulated under the AMLO, including for example, conducting customer due diligence in respect of all investors (including all GPs and LPs as well as their beneficial owners) in the LPF. The name and identification number of the responsible person would need to be made known to the Registrar of Companies (RoC).
- **Registration Requirements:** LPFs would need to be registered with the RoC, which would serve as a registrar for the LPFs and maintain and publish a register of LPFs. The registration of an LPF would remain valid subject to the GP's filing of an annual return with the RoC. Further, the GP would be required to inform the RoC within a specified period of time of any changes in the registration particulars. An independent auditor would need to be appointed to carry out an annual audit of the LPF's financial statements.
- **Record Keeping Requirements:** the GP or investment manager would be required to maintain a proper record of documents or information in relation to the LPF's operations and transactions (e.g., audited financial account, particulars and beneficial ownership information as to all partners) at the registered office of the LPF or any other place in Hong Kong made known to the RoC. The financial account of an LPF would need to be made available to all partners and, as and when necessary, accessible by law enforcement officers.
- **Limited Liability:** one of the problems with the old Hong Kong limited partnership regime was that it did not set out in detail what activities limited partners can engage in without losing their limited liability protection. This is considered crucial in all fund regimes because what it does is protect the investor from being made liable on unlimited basis for debts and obligations of the fund. Including this protection means that the maximum amount investors can lose is its commitment amount. The LPF regime, on the other hand, sets out all activities that investors can engage in without losing that limited liability protection. The safe harbor activities set out under the new regime are also very broad.
- **Freedom of Contract:** The freedom to contract under the LPF regime is vast.There is freedom to agree on terms around operation of fund, admission and withdrawal of partners, rights and obligations of partners, investment scope, and financial arrangements (which

- includes capital contributions, distribution and clawback). In addition, the GP will be able to contract out of certain fiduciary liabilities that may otherwise apply – this means that if GP and investors agree, a GP's liability may be limited to those arising under the contract and not those under equity or common law.
- **Winding Up:** Once the term of a LPF has expired, the LPF regime provides a simple and flexible mechanism for voluntary winding up – this involves a notification to the RoC after the LPF is dissolved in accordance with the terms of the LPA.

The Hong Kong LPF regime has provided a viable alternative for managers when they want to establish a private equity fund, which is in-line, or arguably better, than its comparable competitors such as those provided by offshore regimes. It is somewhat opportune that the introduction of a viable Hong Kong structure comes at a time when Asia-based fund managers are considering alternate ways of structuring their operations in response to these substance requirements. This is in line with a more general shift across the globe within the industry away from offshore structures towards onshore ones.

Going Forward

The Limited Partnership Fund and Business Registration Legislation (Amendment) Bill 2021 (Bill), published in the Gazette on July 2, 2021, has been introduced with the aim of establishing a statutory mechanism for the re-domiciliation of Foreign Funds to Hong Kong as LPFs, and is expected to become law on 1 November 2021. The Bill aims to introduce a statutory re-domiciliation mechanism into the LPF regime that (1) preserves the history and continuity of the foreign funds that re-domicile to Hong Kong as LPFs with legal certainty so that existing rights will not be adversely affected; and (2) provides certainty in tax treatment to the effect that the registration of the foreign funds as LPFs do not amount to a transfer, or a change in beneficial ownership, of the assets of the re-domiciling funds so that no additional stamp duty will be incurred.

2. **OFC regime revamp**

On September 2, 2020, the SFC released the conclusions of its two-month industry consultation (OFC Consultation Conclusions) on proposed enhancements to the Open-Ended Fund Company (OFC) regime. The OFC is a variable structure fund vehicle (as opposed to current structures such as the unit trust, which have a fixed capital structure), similar to the already-popular segregated portfolio company (SPC) structure in the Cayman Islands and the variable capital company (VCC) structure in Singapore, that provides an alternative structure for fund managers to set up their hedge funds[2].

This OFC Reform was welcomed by the industry, as the market has previously considered the OFC regime to be restrictive, lacking flexibility, and not competitive with comparable structures in other developed fund centres. As of the date of issuance of the Consultation Conclusions, only five OFCs had been established in Hong Kong since its introduction on July 30, 2018. Coupled with the OFC grant scheme (described below), we foresee that the utilization of this local vehicle will gain momentum after the OFC Reform.

The OFC Reform, effective on 11 September 2020, provides several key enhancements to the OFC regime (OFC Reforms), which are expected to increase its competitiveness and rate of adoption, including:

- removing all investment restrictions applicable to private OFCs;
- expanding the scope of persons permitted to act as custodians for private OFCs; and
- other changes applicable to key operators of OFCs, such as additional requirements for the safekeeping of private OFC scheme property.

Key Features of the OFC Revamp

The key features of the OFC Reform are set out below:

- **Removal of all investment restrictions applicable to private OFCs:**

1. Previously, a private OFC must invest at least 90% of its gross asset value (GAV) in securities and futures contracts (as defined under the SFO), and/or cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts. A private OFC may also invest in other asset classes, but only up to 10% of its GAV.
2. After the OFC Reform, all investment restrictions applicable to private OFCs will be lifted. This enhancement significantly increases the investment scope for private OFCs, which will now be able to invest in Hong Kong private company shares and debentures, non-financial assets (e.g., real estate projects), or other less common asset classes (e.g. virtual assets) without restriction, subject to compliance with risk disclosure and other applicable regulatory requirements.

- **Expansion of custodian eligibility requirements for private OFCs:**

1. Previously, the custodian of an OFC (public or private) must meet the same eligibility requirements for custodians of SFC-authorized funds as set out in the Code on Unit Trusts and Mutual Funds (UT Code). These eligibility requirements essentially mean that a custodian must be a Hong Kong or overseas bank, or a trustee of a registered scheme under the Mandatory Provident Fund Schemes Ordinance.
2. After the OFC Reform, intermediaries licensed by or registered with the SFC to carry on Type 1 (dealing in securities) regulated activities in Hong Kong are also eligible to act as custodians of private OFCs, subject to further licensing, financial, regulatory and independence requirements. The SFC has clarified that the current requirements do not preclude the appointment of multiple custodians and/or sub-custodians by an OFC. Note however that this enhancement is only applicable to private OFCs, i.e. it does not apply to public funds established in the form OFCs.

- **Record-Keeping Obligations:** investment managers will be required to keep sufficient records to explain and reflect the financial position and operation of the OFC's activities in SFC

approved record-keeping premises for not less than 7 years, in such manner that will enable an audit to be conveniently and properly carried out.

- **Safekeeping Obligations for Custodians:** additional obligations are being introduced in Chapter 7 and the Appendix A of the Code on Open-Ended Fund Companies (OFC Code). These will require the custodian to, among other things:

1. ensure compliance with obligations in relation to scheme properties of a private OFC, which are largely similar to those under the Securities and Futures (Client Money) Rules and Securities and Futures (Client Securities) Rules;
2. maintain adequate internal controls and systems commensurate with the custodial risks specific to the type and nature of assets in which the OFC invests;
3. segregate the scheme property of the OFC from the assets of the custodian;
4. have sufficient experience, expertise and competence in safekeeping the asset types in which the OFC invests;
5. where sub-custodian(s) are appointed, have proper oversight over the sub-custodian(s) to ensure that the sub-custodian(s) are suitably qualified and competent, and maintain written internal control policies and procedures for the selection and ongoing monitoring of sub-custodians;
6. keep relevant accounting and other records; and
7. manage custody risks.

OFC Grant Scheme

The Hong Kong Government provides an OFC grant scheme (OFC Grant Scheme) which grants a subsidy to investment managers who have successfully incorporated an OFC or re-domiciled a non-Hong Kong fund corporation in Hong Kong as an OFC. The SFC's chief executive officer, Ashely Elder, says that “by encouraging a broader range of investment vehicles, the grant scheme will reinforce Hong Kong’s role as a leading capital raising venue and its status as an international asset and wealth management centre". In fact, since the OFC Grant Scheme's commencement on 10 May 2021, 11 new OFCs (umbrella and sub-funds) has been established as of 7 September 2021. Contrasting that with the 10 OFCs granted in the year ending 31 March 2021, the OFC Grant Scheme has already proven to be effective in encouraging managers to use this underutilized local fund vehicle.

The details of the OFC Grant Scheme is set out below:

- **Grant:**
  1. The OFC Grant Scheme will cover up to 70% of the "eligible expenses", capped at HK$1 million per OFC
  2. Applications will be processed on a first-come-first-serve basis based on the submission time of the grant application
  3. Each manager may claim expenses for up to a maximum of 3 OFCs

- **Eligible Expenses:** the OFC Grant Scheme will cover expenses paid to Hong Kong based service providers. Based on guidance issued by the SFC, the following expenses should be eligible:
  1. fees charged by law firms or legal advisers for legal work in relation to the incorporation/ re-domiciliation of an OFC, including (i) the drafting of legal documents and offering documents of the OFC and (ii) work done in relation to the authorisation of an OFC with the SFC;
  2. fees charged by auditors, accountants or tax advisors for accounting and/or tax services in relation to the incorporation/ re-domiciliation of an OFC;
  3. fees charged by fund administrators, corporate service providers or company secretaries for incorporation/ re-domiciliation services in relation to the set-up of an OFC, including work done for all filings necessary for the incorporation/ re-domiciliation or registration of an OFC;
  4. fees charged by regulatory consultants for work done in relation to the incorporation/ redomiciliation of an OFC and the authorisation of an OFC with the SFC; and
  5. fees charged by listing agents in the case of listed OFCs.
  6. However, the scope of "eligible expenses" does not cover:

§ audit fees paid to accounting firms in relation to the OFC or REIT's annual audit review; and

§ statutory fees such as registration or application fees to the SFC and expenses incurred in relation to an application for the licensing or registration of an investment manager.

- **Administration:** The OFC Grant Scheme is administered by the Hong Kong SFC.

- **Timing:**
  1. The OFC Grant Scheme is open to applications from 10 May 2021 to 9 May 2024.
  2. For private OFCs, the application must be submitted no later than 3 months after the date of the certificate of incorporation or re-domiciliation issued by the RoC.
  3. SFC will acknowledge take up within 2 business days of receipt of application material.

- **Application Process:** applications for OFC subsidy should be made on the prescribed application form on the SFC website and should include the following:
  1. certificate of incorporation or re-domiciliation issued by the Companies Registry in Hong Kong for the OFC; and
  2. copies of invoices and receipts for the expenses claimed.

- **Clawback:** If the OFC commences winding-up proceedings or applies for termination of registration within two years from the date of its incorporation or re-domiciliation, the Hong Kong Government may claw back the subsidy.

Going Forward

The legislative framework that allows overseas funds to re-domicile to Hong Kong has come into operation on 1 November 2021. Under this regime, a corporate fund established overseas is able to re-domicile to Hong Kong as an OFC, provided that it satisfies the eligibility requirements currently applicable to the registration of a newly established OFC.

The SFC has also issued a further consultation conclusion on 23 December 2020 on the customer due diligence requirements that OFCs will be subject. It is proposed that OFCs will be required to appoint a “responsible person” to carry out anti-money-laundering and counter-terrorist financing functions as required under the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), in line with the requirements for LPFs. Any changes to be implemented from this consultation will need to be effected by way of legislative amendments to the SFO.

Jason Chan, Senior Associate, Dechert

Update on Bond Connect

Author

Riccardo Millich, HSBC

China's gradual opening of its Bond market

China's onshore Renminbi credit market has grown fast over the last decade: its capitalisation has increased tenfold from RMB5 trillion in 2010 to RMB50 trillion in 2020. It has grown fast and has become more international. However, the foreign share of mainland China's bond market — the second largest in the world after the U.S. — is at 3.5% in September 2021, up from 3.2% in December, according to a recent report from HSBC Global Research. This is still low compared to markets like France or Germany where foreign ownership stands well above 60%. So the rise of China's bond market has so far been driven primarily by local investors. The next stage of its growth should see increased foreign ownership with ongoing inflows to the market as Chinese securities are increasingly represented in flagship global bond benchmarks. International investors have been looking for opportunities to enter this market and China has been making efforts to slowly open and let these investments happen.

- **DEVELOPMENT 1: QFII / RQFII**

Previously, only Central banks and monetary authorities, RMB clearing banks in Hong Kong and Macau, and participating overseas RMB clearing banks with positive offshore RMB balance from RMB cross-border business, were qualified as investors and were restrained by strict quota allocated per institution.

The first development has been the foreign investment of Chinese bonds through the QFII and RQFII and subject to quotas. The QFII scheme was introduced back in 2002 as the first channel for foreign investors to access the mainland Chinese market. Subsequently in 2011, the RMB Qualified Foreign Institutional Investor (RQFII) scheme was introduced as part of an effort to internationalise the Renminbi (RMB). So, the QFII holder would apply for the CIBM access in a separate application process through CSRC and SAFE. Both the QFII scheme and RQFII scheme have undergone various reforms over the years. Today, this channel still exists but the quota has been removed in June 2020 and the QFII and RQFII schemes were formally merged into a single Qualified Foreign Investor ("QFI"), easing the use of this channel.

- **DEVELOPMENT 2: CIBM DIRECT**

In 2016, the opening accelerated with the CIBM Direct for foreign Institutional Investors (FIIs) where for the first time, no quota or filling of investment size were required. CIBM Direct scheme created a route for international investors to access onshore bonds, complementing long-established QFII and RQFII schemes.

Under the CIBM Direct scheme, foreign institutions can trade bonds directly through banks holding a Type A licence in mainland China. The foreign financial institution only had to be registered and incorporated in the Mainland and their resulting investment products had to be in accordance with laws and regulations approved by the PBOC. This channel solicited the interest of international asset management institutions, fund management companies, securities companies, insurance companies and commercial banks.

- **DEVELOPMENT 3: BOND CONNECT**

Bond Connect was launched on 3rd July 2017. The first phase of Bond Connect was the northbound link enabling Hong Kong and overseas investors to invest in all the cash bonds available in mainland China, including government bonds, policy bonds, enterprise bonds, financial bonds, agency bonds, ABS, ...

70 offshore investors participated in the first trading day, recording 142 transactions which amounted to RMB 7.05bn. Government bonds were most actively traded, followed by policy bank bonds.

Bond connect presented significant benefits:

- Bond coupons and repayment are automatically repatriated back to Hong Kong on the date of payment
- Trading via offshore trading platforms that investors were familiar with
- No capital commitment
- No requirement to appoint an onshore custodian or Bond Settlement agent in mainland China
- No requirement to open account onshore with the China securities depositories

- Ability to transact with a Hong Kong bank for onshore RMB (CNY) to settle the bond and for hedging purposes
- Introduction of block trading: allowing investors to allocate block trades to multiple client accounts prior to the trades. This change was announced in August 2018.
- Implementation of delivery-versus-payment (DvP): in August 2018 all transactions began trading via DvP, ensuring that payment and delivery of securities occur simultaneously, thus reducing or eliminating exposure to settlement risk

LOOKING AT THE SUCCESS OF NORTHBOUND BOND CONNECT 4 YEARS ON

Bond Connect played an important part in the development and liberalisation of Mainland bond market. Since the launch of Bond Connect in 2017 the number of users and trading volume have grown significantly. According to BCCL (Bond Connect Company Ltd) as of November 2021, Bond Connect had onboarded over 3100 investors from 34 jurisdictions, compared with 288 investors in March 2018. Monthly trading turnover volume has also increased sharply from RMB 62.1bn in April 2018 to RMB 578bn in August 2021.

Comparing the trading turnover volume under the CIBM scheme and the Bond Connect, it is clear that the Bond Connect is as popular, if not slightly preferred, to the CIBM among foreign investors investing in Chinese bonds. According to HSBC Global Research, over the period from October 2020 to August 2021, an average of 55% of foreign investors' onshore China bond trades were made through the Bond Connect, and 45% through CIBM direct.

The Northbound Bond Connect contributed significantly towards improving international investors' access to onshore China bonds, thereby expediting the index inclusion process for China bonds which has had a significant impact in foreign holdings. According to HKMA, foreign holdings in the Mainland interbank bond Market jumped over 60% in the first 18 months after the first index inclusion early 2019.

This first bond index inclusion took place around two years after the launch of Bond Connect, in April 2019, when Bloomberg added China government and policy bank bonds to its Bloomberg-Barclays Global

Aggregate Index. This was followed by JPMorgan's addition of China government bonds into its Government Bond Index Emerging Markets in early 2020. Finally, in March 2021, FTSE Russell confirmed the inclusion of Chinese Government Bonds in the FTSE World Government Bond Index (WGBI) effective with the November 2021 profiles, which will be phased in over a 36-month period, bringing about further inflows of USD130 bn into China's government bond market.

Over the last four years there has been continuous improvement to the Bond Connect scheme to provide a better investment experience for users, with many of the changes made alongside similar improvements in the CIBM Direct scheme. These include a block trading function which allows investors to allocate block trades across individual accounts prior to submitting orders, or the extension of the settlement cut-off times.

Other than these common improvements across both schemes, there have also been some standalone efforts to make Bond Connect a smoother investment channel. For example, when Bond Connect was first launched, Tradeweb was the sole e-trading platform, but Bloomberg was added as an additional platform in November 2018 and MarketAxess end of September 2021, to provide more operational flexibility to users. The number of market makers in the Bond Connect scheme has also increased from 20 at the launch of the scheme to 56 now, allowing for a more efficient pricing process. Even with the improvements in recent years, there are still expectations for more. For example, market participants are hoping to be able to gain access to the onshore repo market and be able to trade derivatives, like interest rates swaps, via the Bond Connect.

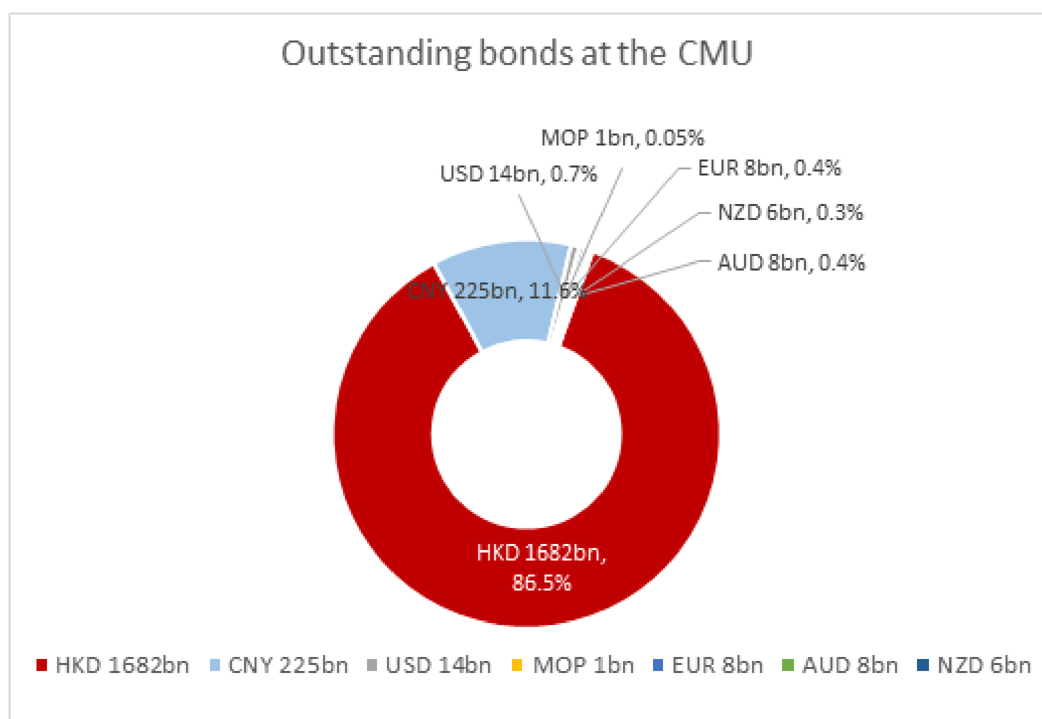
THE SOUTHBOUND BOND CONNECT

The People's Bank of China (PBoC) and the Hong Kong Monetary Authority (HKMA) have jointly announced that the Southbound Bond Connect be launched on 24 September 2021, in a further push to liberalize capital flows. This scheme allows eligible mainland China institutional investors to invest in Hong Kong's bond market, worth over HKD2trn, through connections between the Mainland and Hong Kong financial infrastructure services institutions. 41 mainland banks and 173

qualified domestic institutional investors (QDII) were approved for trade in all existing bonds in Hong Kong. As of end-August 2021, there were 173 QDII investors with USD150bn of investment quota.

To manage the magnitude of the cross-border flows, the PBoC has set a daily quota of RMB20bn and an annual quota of RMB500bn for the Southbound Bond Connect.

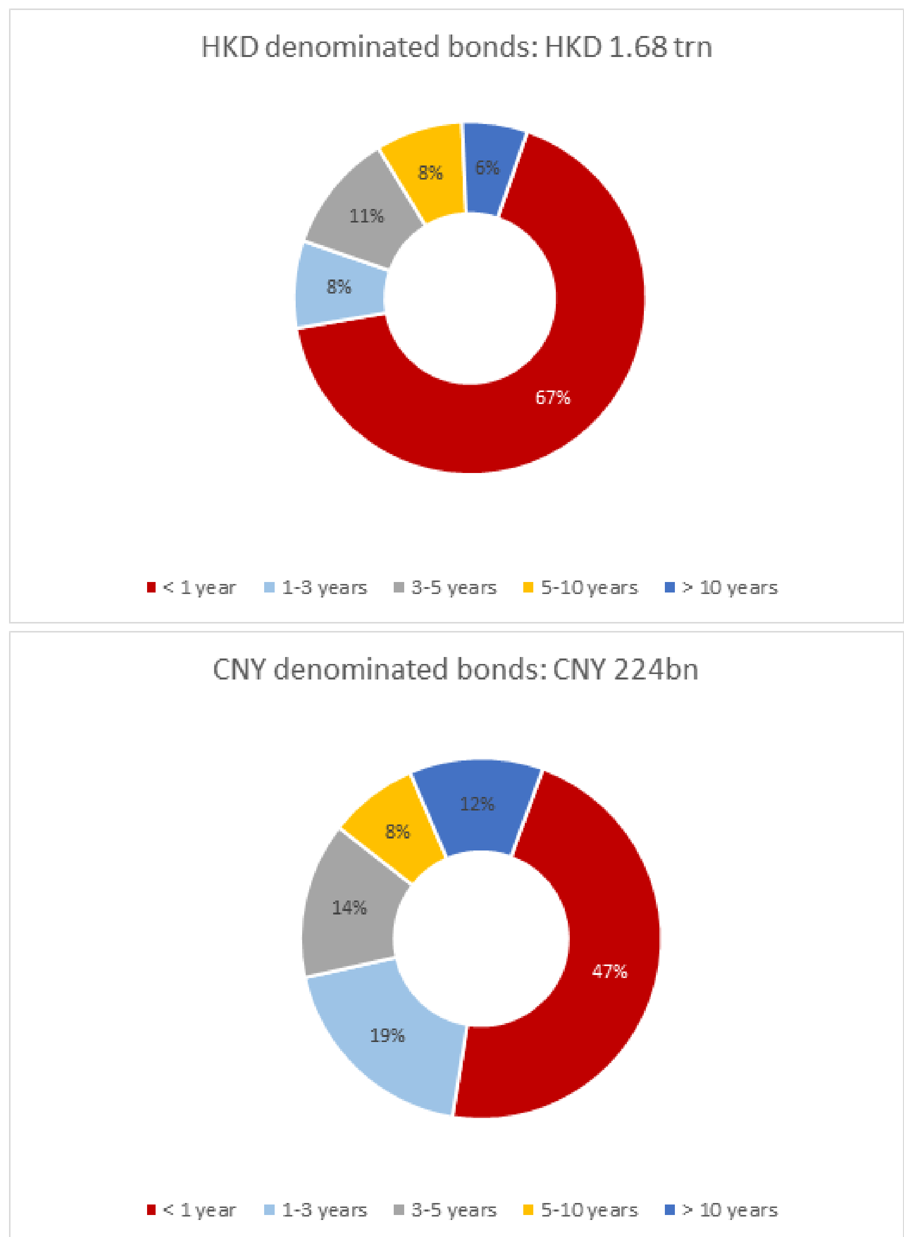
What qualifies:
The outstanding size of Hong Kong's bond market stands at HKD2.3trn (USD295bn), with the bonds available in seven different currencies (HKD, RMB, USD, MOP, EUR, AUD and NZD – see below). The bulk of bonds is denominated in HKD (HKD1.7trn or USD218bn) and RMB (RMB225bn or USD35bn). Due to current constraints of the trading link between the CMU and CIPS, only HKD and RMB bonds can be traded in the initial phase. Plans are underway to upgrade the trading system to eventually allow investments in bonds denominated in all available currencies.



According to a recent Research paper published by HSBC Global Research in September 2021 "Southbound Bond Connect – China opens up further", lower duration supply is likely better suited for banks and fund managers. For the pool of HKD bonds, 67% are short-dated Exchange Fund Bills (EFBs), which are issued by the HKMA and have a

term to maturity of 12 months or less. HKD duration supply is low, with longer-than-10yr bonds accounting for just 6% of outstanding HKD-denominated bonds. As for CNY-denominated bonds, the largest concentration of the bonds is in the 1-3yr maturity bucket (i.e. 47%) while longer-than-10yr duration supply is only RMB17bn (USD2.6bn), or 12% of the outstanding stock.

The bias towards lower duration is likely to make the Southbound Bond Connect more attractive to investors such as banks' balance sheet desks and fund managers. Insurance companies are still more likely to stay with the onshore bond market where duration supply is readily available via central and local government bonds, as well as policy bank bonds.



Source: CMU, HSBC

Bond yields in Asian dollar bond market vs RMB bonds

Bond yields of sub-investment grade issuers in the Asian dollar bond market have been higher in the last few years than those of onshore RMB bonds by the same issuer, not taking into consideration currency risk. This is mainly because credit differentiation in the offshore Asian dollar bond market is deeper. Domestic investors may find high-yield Asian dollar bonds attractive from a yield pick-up perspective, especially those issued by property developers that have gone through deep correction this year.

Among the Dim Sum Bonds available for the Southbound Bond Connect, credit bonds represent only 30% of the outstanding amount, and are issued by 36 credit names. The valuation of these bonds is in line with the CNY bonds issued by the same issuer in China's domestic market. Dim Sum Bonds may thus not represent an opportunity to gain extra return for China's domestic investors, but bonds issued by entities from the Greater China area and from abroad could provide value in terms of diversification.

Another step forward for capital account liberalization:

According to Eddie Yue, Chief Executive of the Hong Kong Monetary Association, "Southbound Trading under Bond Connect further deepens mutual access between the Mainland and Hong Kong bond markets and enhances the linkage between financial infrastructure of the two places. Once again, it signifies that Hong Kong's financial markets serve as a secure and reliable channel and gateway for the Mainland's opening up". This launch comes shortly after the official launch of Cross-boundary Wealth Management connect, which shows that China is sticking firm to its stance of deeper integration with the rest of the world.

"Opening-up and cooperation is the inevitable trend in the integrated development of global capital markets," China Securities Regulatory Commission (CSRC) Chairman Yi Huiman told a conference organised by the World Federation of Exchanges.

China is studying further measures, including expanding the scope of the stock connect scheme linking mainland China and Hong Kong and improving the Shanghai-London Stock Connect program, Yi said in a speech posted on CSRC's website.

Capital account liberalization still has substantial room to run as China's external assets and liabilities have only reached about 50% and 40% of GDP, respectively. They are much lower than the developed markets like the Euro Area, the US and Japan, which have positions topping over 100% of GDP according to an article by HSBC Research in May 2021 "The rising wealth of China".

According to HSBC Global Research southbound Bond Connect also serves strong market demand. As Chinese investors become more sophisticated, their demand for access to more diverse financial products increase as well, among which includes global bonds. This helps to reduce risk in Chinese investors' portfolios and grant them access to other relatively newer products such as green bonds which have a longer history in foreign capital markets. Moreover, this may also benefit China's financial sector development as it presents some healthy competition for China's bond market and encourages a closer alignment to international standards such as through credit ratings. In all, the launch of the Southbound Bond Connect follows the steps of continued capital account liberalization, which is a trend we expect to continue in the coming years.

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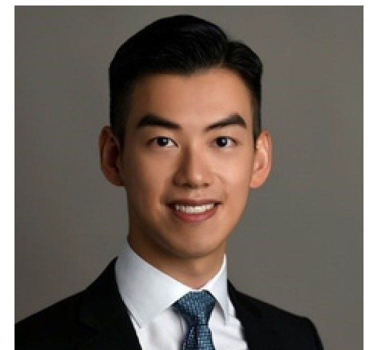
Jason Chan's practice focuses on investment funds formation transactions, including hedge funds, crypto funds, private equity funds, real estate funds and retail funds. He also has experience advising on a diverse range of ongoing compliance, legal and regulatory matters related to the financial services industry in Hong Kong, with a particular focus on the regulatory and licensing requirements for fund managers and the rapidly evolving regulatory landscape for participants in the virtual assets ecosystem.



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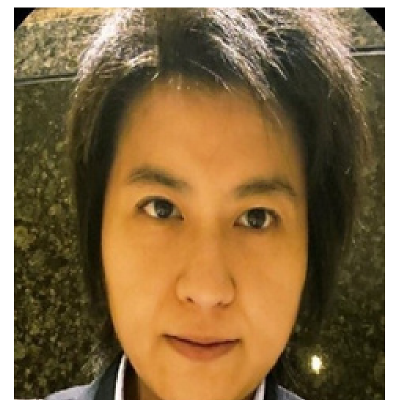

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