金杜观察
KWM INSIGHTS

金杜律师事务所
KING&WOOD MALLESONS

2021年6月/总第08期
June 2021 Issue 08

LAW AND PRACTICE IN THE GREATER BAY AREA III

King & Wood Mallesons　KWM Institute

金杜律师事务所
KING&WOOD MALLESONS

KWM INTERNATIONAL CENTER

In response to the national GBA development strategy, KWM established the KWM International Center in the GBA on 28 April 2018 to better serve the clients and continuously promote its international development strategy. Backed by KWM Shenzhen, Guangzhou, Hong Kong and Sanya offices, KWM International Center will closely follow the market demand in the GBA, connect and release the KWM global network resources and focus on the business areas with strong market demand including the "Belt and Road"/"Going Global", high-end financial services, private equity/venture capital, capital market, unicorn, intellectual property protection, and cross-border dispute resolution.

KWM Hong Kong office currently has nearly 240 lawyers and other legal professionals. Many partners and lawyers are licensed to practice law in multiple jurisdictions and well versed in cross-border transactions. In addition to provision of services under the laws of Hong Kong SAR, Australia, the UK, the US and other jurisdictions, KWM Hong Kong team deeply understands the needs of Chinese enterprises in respect of culture and operation/management and is able to leverage the extensive international experience to provide all-round services in all aspects of banking and financing, corporate, private equity, M&A and commercial affairs, competition, trade and regulation, international fund, securities and capital market, dispute resolution and litigation/arbitration, construction disputes, projects, energy and resources, real estate, etc.

KWM has two offices in South China – Shenzhen office and Guangzhou office. The Shenzhen office was established in 1998 and has over 200 lawyers and other legal professionals; the Guangzhou office was founded in 2002 and gathers more than 160 lawyers and other legal professionals. These two offices provide a full range of legal services covering foreign investment, overseas investment, M&A and restructuring, banking and project financing, listing, wealth management and trust, international and domestic dispute resolution, bankruptcy & liquidation, IP and regulatory compliance, etc., and have received recognition from the market and the industry for their high quality and professional legal services. KWM Shenzhen and Guangzhou offices have advised on numerous representative and high-profile projects and cases in the GBA area and across China, and are committed to providing one-stop and comprehensive legal services for clients during the implementation of the GBA Outline Plan.

As an international law firm with over 2,900 lawyers in 29 locations around the world, KWM is able to provide legal services covering laws in PRC, the UK, the US, Hong Kong SAR, Australia, Germany, Italy, etc. and our presence and resources in the world's most dynamic economies are profound. Leveraging exceptional legal expertise, KWM is ready to assist clients to unleash all their growth potentials in Asia and the world beyond by advising both Chinese and foreign clients on a full spectrum of domestic and cross-border transactions.

CONTENTS

Financial Markets

Funds

Dispute Resolution

IPO & Listing

Compliance

Investment Frontier

In this publication, any reference to Hong Kong, Macao and Taiwan shall be construed as a reference to the Hong Kong Special Administrative Region of the PRC, the Macao Special Administrative Region of the PRC and the Taiwan region of the PRC.

PREFACE

On 18 February 2019, the Central Committee of the Communist Party of China and the State Council issued the *Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area* (the "Outline"). The Outline states that "as one of the most open and economically vibrant regions in China, the Greater Bay Area (GBA) plays a significant strategic role in the overall development of the country. The development of the GBA is not only a new attempt to break new ground in pursuing opening up on all fronts in a new era, but also a further step in taking forward the practice of 'one country, two systems'."

As a leading international law firm headquartered in Asia, we are always committed to opening doors and unlocking opportunities for our clients as they look to Asian markets to unleash their full potential. As early as July 2017, King & Wood Mallesons (KWM) established a GBA execution team, and in April 2018, we decided to establish the KWM International Center in the GBA. As a strategic move, KWM International Center builds on the firm's offices in Shenzhen, Guangzhou, Hong Kong and in Hainan to connect and unleash KWM's global resources, actively participate in the Belt and Road projects, and seize the opportunities presented by the development of the GBA and the Hainan Free Trade Port, striving to build an important growth pole for KWM's future development.

Since November 2018, KWM has published the *Law and Practice in the Greater Bay Area (I) and (II)*, comprising more than 30 articles on topics such as introduction to the GBA, review of the Outline, infrastructure, finance, capital markets, corporate compliance, intellectual property, dispute resolution, and corporate mergers and acquisitions. We hope that the publications can help our clients and partners better understand the relevant regulations and policies in the GBA and grasp the market opportunities in the area.

According to the Outline, the GBA is strategically positioned as a vibrant world-class city cluster, a globally influential international innovation and technology hub, an important support pillar for the Belt and Road Initiative, a showcase for in-depth cooperation between the Mainland and Hong Kong SAR and Macao SAR, and a quality living circle for living, working and travelling.

We have noticed that, according to the strategic positioning defined in the Outline, a transportation circle is taking shape with one-hour access between major cities in the GBA, two-hour access from major cities to prefecture-level cities in Guangdong Province, and three-hour access from major cities to neighboring provincial capital cities.

According to relevant departments, the total operating mileage of railways in the GBA has so far exceeded 2,200 km, of which the high-speed rail and urban rail transit mileage reached 1,200 km and 1,000 km, respectively. By 2025, the railway networks in operation and under construction in the GBA will reach 4,700 km, fully covering the GBA central cities, node cities and key metropolitan areas such as Guangzhou and Shenzhen. In addition, boundary crossing facilities have been built for operation in the GBA, and the "co-location arrangement", a "joint boundary control system" and other innovative customs clearance modes have been implemented. As the GBA cities accelerate the construction of transportation infrastructure, the efficiency of customs clearance has been continuously improved, and the area sees more frequent internal exchanges and closer connections.

In terms of science and technology innovation, the *Outline of the 14th Five-Year Plan for National Economic and Social Development of the People's Republic of China and the Long-Range Objectives Through the Year 2035* introduced this year proposes to support the formation of an international innovation and technology center in the GBA; strengthen the coordinated development of industries, academia and research institutes in the GBA; improve the "Two Corridors and Two Poles" framework system which consists of the Guangzhou-Shenzhen-Hong Kong and Guangzhou-Zhuhai-Macao Innovation and Technology Corridors and the Shenzhen-Hong Kong Loop and Guangdong-Macao-Hengqin Innovation and Technology Poles; promote the construction of an integrated national science center, and facilitate the cross-boundary flow of innovation factors.

In terms of finance, in May 2020, the People's Bank of China (PBOC), the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission and the State Administration of Foreign Exchange issued the *Opinions on Financial Support for the Development of the Guangdong-Hong Kong-Macao Greater Bay Area* (the "Opinions"). The Opinions provides four general principles, namely, serving the real economy, promoting cooperation for mutual benefit and win-win situation, being market-oriented, and preventing systemic financial risks. The Opinions also puts forward relevant opinions and specific measures in respect of enhancing the convenience of financing in the GBA, expanding the opening up of the financial industry and deepening the financial cooperation between the Mainland and Hong Kong or Macao, facilitating the interconnection between financial markets and financial infrastructure, improving the innovation of financial services in the GBA, and preventing cross-boundary financial risks. In June 2020, the PBOC, the Hong Kong Monetary Authority and the Monetary Authority of Macao issued the *Joint Announcement on Launch of Cross-boundary Wealth Management Connect Pilot Scheme in Guangdong-Hong Kong-Macao Greater Bay Area*. The "Cross-boundary Wealth Management Connect" (Cross-boundary WMC) allows eligible Mainland, Hong Kong and Macao residents in the GBA to make use of the channel provided by the scheme to invest in diversified wealth management products across the boundary. The Cross-boundary WMC is an important initiative to improve the financial cooperation between the Mainland, and Hong Kong and Macao. It will help build a quality life circle in the GBA and facilitate cross-boundary investment by individual residents. It will also promote the opening-up of the Mainland's financial markets as well as the mutual social and economic development of the Mainland, and Hong Kong and Macao.

Furthermore, relevant Mainland authorities have also introduced many specific initiatives to implement the Outline in areas such as culture and tourism, transportation, postal services, taxation, medicine, and qualification accreditation of professionals. These initiatives will surely provide strong support for interconnection and integration among cities in the GBA.

We will continue to focus on the developments of the GBA and help our clients and partners seize business opportunities in the GBA and Asia.

Wang Lixin

The Hong Kong Monetary Authority Launches the Green and Sustainable Finance Grant Scheme

KWM Hong Kong DCM team

On 4 May 2021, the Hong Kong Monetary Authority (HKMA) announced the details and eligibility criteria for the three-year Green and Sustainable Finance Grant Scheme (the HK New Scheme). This article seeks to describe the HK New Scheme and makes a comparison of the Hong Kong scheme with Singapore's previously implemented Global-Asia Bond Grant (G-ABG) scheme and Sustainable Bonds Grant (SBG) scheme. As these schemes involve the listing of bonds on local exchanges, the listing requirements for bonds issued to professional investors in the two exchanges are also included here for your reference.

I. The HK New Scheme, the G-ABG scheme and the SBG scheme

The HK New Scheme aims to support the issuance of green and sustainable bonds and loans to further enrich the ecology of green and sustainable finance in Hong Kong. The HK New Scheme was created by integrating the Pilot Bond Grant Scheme and the Green Bond Grant Scheme, filling the gap left by the expiry of the latter two schemes. The HK New Scheme, which lasts for three years, consists of two tracks, covering: (1) half of the eligible expenses (e.g. arrangement, legal, audit, and listing fees) per green and sustainable bond issuance (capped at HKD 2.5 million and HKD 1.25 million), respectively, where the bond, its issuer or its guarantor(s) possess a credit rating; and (2) the grant amount for external review fees is capped at HKD 800,000 per bond issuance.

The Monetary Authority of Singapore (MAS) started to implement the G-ABG in 2020. The G-ABG scheme is a continuation and extension of Singapore's previously implemented Asian Bond Grant Scheme (ABG) after its expiry. Compared with the first part of the HK New Scheme, the G-ABG scheme is not limited to green and sustainable bonds. In addition, the Sustainable Bond Grant Scheme (SBG) was launched in February 2019 and later extended and renewed in November 2020. Qualifying issuers may receive grant under both the G-ABG and SBG schemes, or apply for grant under either one of them.

By comparison, the first part of the HK New Scheme is more similar to the G-ABG scheme in terms of grants for bond issuance expenses, while the second part of the HK New Scheme is similar to the SBG scheme. We have prepared a summary comparison of the two accordingly for your consideration.

	Grant for bond issue under the Green and Sustainable Finance Grant Scheme (Track 1 of the HK New Scheme)	Global-Asia Bond Grant (G-ABG)
Eligible issuers	First-time green and sustainable bond issuers are issuers[1] that have not issued green and sustainable bonds in Hong Kong in the rolling five-year period prior to the bond's pricing date[2].	First-time[3] companies and non-bank financial institutions with an Asian Nexus[4]
Qualifying criteria	Having procured pre-issuance external review services related to the bond issue that is provided by a HKMA-recognised external reviewer	N/A (need not be green or sustainable bonds)
Number of grants	Each issuer can apply for a grant for at most two green and sustainable bond issuances.	Each issuer may obtain a grant for each issuance of bonds with an initial principal amount of either less than or more than USD 1 billion (or its equivalent in another currency) on a one-time basis
Grant amount	50% of the eligible expenses (including fees to or in relation to Hong Kong-based arrangers, Hong Kong based legal advisors, Hong Kong-based auditors and accountants, Hong Kong-based rating agencies, SEHK listing and CMU lodging and clearing), up to the following limits: • HKD 2.5 million where the bond, its issuer or its guarantor(s) possess a credit rating by a rating agency recognised by the HKMA; or • HKD 1.25 million where none of the bond, its issuer or its guarantor(s) possess a credit rating by a rating agency recognised by the HKMA	50% of the eligible expenses (referring to business spending made to Singapore-based providers, including fees to or relating to arrangers, auditors, credit ratings, legal listing agent, and listing)[5], up to the following limits: • SGD 800,000 where the initial principal amount issued is at least USD1 billion (or its equivalent in another currency) where the qualifying issuance is rated by a credit rating agency regulated by the MAS; or SGD 400,000 where the qualifying issuance is unrated • SGD 400,000 for all other issuances where they are rated by a credit rating agency regulated by the MAS; or SGD 200,000 for all other issuances where they are unrated
Maturity	N/A	At least 1 year
Qualifying issuance size	Having an issuance size of at least HKD 1.5 billion (or the equivalent in foreign currency)	The initial principal amount issued is at least SGD 200 million (or its equivalent in another currency) [6]
Qualifying currencies	N/A	Refer to all Asia local currencies[7] and the G3 currencies (USD/EUR/JPY)
Arrangers and relevant expense allocation requirements	Issued in Hong Kong: A bond is considered issued in Hong Kong if half or more of the involved lead arranger(s) are recognised arrangers.	More than half of the gross revenue from arranging the issue is attributable to Financial Sector Incentive (FSI) companies in Singapore
Listing as well as lodging and clearing criteria	Being lodged with and cleared by the Central Moneymarkets Unit (CMU) operated by the HKMA in its entirety, or being listed on the Stock Exchange of Hong Kong Limited (SEHK)	Being listed on the Singapore Exchange (SGX)

[1]In the HK New Scheme, the term "issuer" denotes the entity issuing a bond and the entity's associate(s). The term "associate" refers to (i) a person/corporation over which the issuer has control; (ii) a person/corporation which has control over the issuer; or (iii) a person/corporation that is under the control of the same person/corporation as the issuer.

[2]Issuers who have issued only non-green and sustainable bonds during the five-year period will still be eligible.

[3]This includes issuers who have not filed a Return on Debt Securities (RoDS) in the five calendar years from 2012 to 2016.

[4]This include issuers (i) with global headquarters in Asia; (ii) with business operations or projects in Asia; or (iii) who are issuing in any Asian local currency, etc.

[5]In the case of a SGD-denominated issuance, credit rating fees shall be funded at a level of 100%.

[6]Or where the grant applicant will qualify for the SGB, a programme size of at least SGD 200 million with an initial principal amount issued of at least SGD 20 million (or its equivalent in another currency).

[7]This refers to local currencies of Asian countries including ASEAN, China, India, South Korea, Japan, Australia and New Zealand.

	Grant for bond issue under the Green and Sustainable Finance Grant Scheme (Track 1 of the HK New Scheme)	Global-Asia Bond Grant (G-ABG)
Other major criteria	Being, at issuance, issued in Hong Kong to (i) 10 or more persons or (ii) less than 10 persons none of whom is an associate of the issuer.	The bond issued is declared as a Qualifying Debt Security (QDS), requiring that the debt securities must meet the "substantially arranged in Singapore" conditions. It is rated by a credit rating agency regulated by the MAS if the currency of the issuance is SGD.
Valid period	3 years (starting from 10 May 2021)	5 years (from 1 January 2020 to 31 December 2024)

	Grant for external review costs under the Green and Sustainable Finance Grant Scheme (Track II of the HK New Scheme)	Sustainable Bond Grant Scheme (SBG)
Eligible issuers	Green and sustainable bond issuers and loan borrowers, including first-time and repeat issuers and borrowers	A company or financial institution based onshore or offshore, excluding sovereign issuers
Qualifying criteria	Having procured pre-issuance external review services related to the bond issue that is provided by a recognised external reviewer	Having a pre-issuance external review or rating done which demonstrated alignment with any internationally-recognised green, social, sustainability and sustainability-linked bond principles or standards[8] Where the issuance is a sustainability-linked bond (SLB), the SLB issuer has committed to undertake the post issuance external review or reporting annually for the first 3 years or up to the tenure of the SLB, whichever is earlier
Number of grants	No limits	No limits
Grant amount	100% of eligible expenses (pre-issuance external review (including, for example, certification, second-party opinions, verification, ESG scoring/rating, assurance, consultation to develop the green and sustainable bond/loan framework, and post-issuance external review or reporting), capped at HKD 800,000 per bond issuance/loan.	100% of eligible expenses (including the costs incurred in respect of pre-issuance external review or rating done which demonstrated alignment with any internationally-recognised green, social, sustainability and sustainability-linked bond principles or standards, and post-issuance external review or reporting for allocation and impact done annually for the first 3 years or up to the tenure of the bond, whichever is earlier), capped at SGD 100,000 (or its equivalent in another currency)
Maturity	N/A	At least 1 year
Qualifying issuance size	Having an issuance size of at least HK$200 million (or the equivalent in foreign currency)	Having either an initial principal amount issued of at least SGD 200 million (or its equivalent in another currency) or a programme size of at least SGD 200 million with an initial principal amount issued of at least SGD 20 million (or its equivalent in another currency)

[8]This includes International Capital Market Association's Green/Social/Sustainability-Linked Bond Principles and their Sustainability Bond Guidelines, the ASEAN Green/Social/Sustainability Bond Standards as well as Climate Bonds Standard, but excludes national green/social/sustainability/sustainability-linked bond guidelines or standards.

	Grant for external review costs under the Green and Sustainable Finance Grant Scheme (Track II of the HK New Scheme)	Sustainable Bond Grant Scheme (SBG)
Qualifying currencies	N/A	N/A
Arrangers and relevant expense allocation requirements	Issued in Hong Kong: A bond is considered issued in Hong Kong if half or more of the involved lead arranger(s) are recognised arrangers.	More than half of the gross revenue from arranging the issue is attributable to Financial Sector Incentive ("FSI") companies in Singapore.
Listing as well as lodging and clearing criteria	Being listed on The Stock Exchange of Hong Kong Limited (SEHK); or being lodged with and cleared by the Central Moneymarkets Unit (CMU) operated by the HKMA in its entirety	Being listed on the SGX
Other major criteria	Being, at issuance, issued in Hong Kong to (i) 10 or more persons or (ii) less than 10 persons none of whom is an associate of the issuer.	The bond issued is declared as a QDS, requiring that the debt securities must meet the "substantially arranged in Singapore" conditions. More than half of the gross revenue from the pre-issuance external review or rating as well as the post-issuance external review or report done, as the case may be, is attributable to Singapore-based service providers. The issuance has part of the sustainability advisory and assessment work performed by financial institutions done in Singapore where applicable.
Valid period	3 years (starting from 10 May 2021)	From 24 November 2020 to 31 May 2023

II. Comparison of bond listing locations

The two Singapore schemes and the HK New scheme all have requirements on listing locations. For the convenience of readers, we have outlined the listing rules of the SEHK and SGX below.

SEHK amended its bond listing rules in 2020, which came into effect on 1 November 2020, including the following key changes:

- The definition of "Professional Investor" was amended to include high net worth investors and other professional investors, while a professional investor waiver application would no longer be required;
- Raising issuers' (excluding State Corporations and guarantors) minimum net assets requirement from HKD 100 million to HKD 1 billion;
- Narrowing the definition of "State corporation" to exclude regional and local state-owned enterprises;
- Introducing a minimum issuance size of HKD 100 million (not applicable to tap issuance);
- Requiring publication of listing documents on the Exchange's website on the listing date (e.g. offering circular and pricing supplement);
- Requiring that the front cover of a listing document must contain a statement on the intended investor market in Hong Kong (i.e. Professional Investors only);
- Establishing new continuing obligations rules that require issuers and guarantors to disclose events of default, insolvency and winding-up petitions and to publish quarterly announcements of the developments after trading in their listed debt securities has been suspended.

The following table sets forth a comparison of the amended SEHK listing rules and the main SGX listing requirements:

	SEHK	SGX
General listing rules	An issuer must have net assets of HKD 1 billion, and must have produced audited accounts for the two years before the listing application made up to a date at most 15 months before the intended date of the listing document, unless the issuer is any company which is directly or indirectly controlled or more than 50% of whose issued equity share capital is beneficially owned by, and/or by any one or more agencies of, a State (which does not include any regional or local authority) or its shares are listed on the SEHK or another stock exchange or it meets other specific conditions. If the issuer fails to meet such conditions, the guarantor shall satisfy the above requirements. The issuer shall be a wholly-owned subsidiary held directly or indirectly by the Guarantor. Listed debts securities are sold to professional investors only.	A smaller scope of review for debt securities offered to institutional and qualified investors
Disclosing criteria of listing documents	An offering circular should disclose information that is customarily expected by the intended investors and, in the case of bonds with special product features, how such features differ from those of ordinary bonds and the impact of other terms on investors' rights. Such disclosure must include a prominent and legible disclaimer statement required by the SEHK.	Companies should disclose information that is generally expected to be available to institutional investors. An offering circular shall contain a disclaimer statement and several other statements.
Major continuing disclosure requirements	Issuers are required to disclose inside information, material information about debt securities, replacement of trustees, amendments to trust deeds, and redemption and cancellation of debt securities that are required to be disclosed under the rules of the SEHK; issuers are required to disclose events of default, insolvency and winding-up petitions, and to publish quarterly announcements of the developments after trading in their listed debt securities has been suspended; issuers are required to respond to or make announcements clarifying the SEHK's inquiries about unusual price and volume fluctuations or possible fraudulent market transactions. The issuer shall submit to the SEHK financial reports of the issuer or the guarantor (if any) for each financial year and for the first half of each financial year.	The issuer shall disclose any information that may materially affect the price or value of the debt securities or the investor's investment and transaction decisions, and shall make public announcements on the redemption, cancellation, interest payment and replacement of trustee of the debt securities in a timely manner.
Listing fees[9]	Listing fees: HKD 10,000 to HKD 90,000 payable upon the application of the listing of the debt securities depending on the issuance size and the term of such debt securities. HKD 24,000 payable to the Securities and Futures Commission (SFC) for application of waivers. Issuers do not need to pay an annual fee after listing. Listing agency fee: approximately USD 10,000.	Listing fees: SGD 25,000 (including the handling fee of SGD 10,000 and the listing fee of SGD 15,000) payable upon the application of the listing of the debt securities. Issuers do not need to pay an annual fee after listing. Listing agency fee: approximately SGD 10,000.
Whether listing documents need to be published	Yes	Yes

Thanks to Zhou Jiayang for his contribution to this article.

[9]Supposed to be issued in a single tranche.

SFC's Consultation Paper on bookbuilding and placing activities in ECM and DCM transactions

Hong Kong capital markets team

On 8 February 2021, the Securities and Futures Commission of Hong Kong (the "SFC") issued a consultation paper[1] (the "Consultation Paper") which, if enacted as proposed, would have a far-reaching impact on the way in which public offerings of equity and debt securities are made in Hong Kong. Comments to the Consultation Paper was open through 7 May 2021. The Consultation Paper was issued exactly one week after the end of the consultation period (1 February 2021) for a consultation paper by The Stock Exchange of Hong Kong Limited (the "SEHK") that dealt with increasing the profit requirement for the Main Board.[2] That earlier consultation paper by the SEHK generated much debate from certain market participants and we expect that the Consultation Paper will likewise invite significant discussion in the industry.

Unless otherwise specified in this alert, the proposals in the Consultation Paper apply both to equity capital market ("ECM") and debt capital market ("DCM") transactions.

I. Background

The Consultation Paper seeks to address specific inadequacies identified by the SFC in bookbuilding and placing activities, including, among other things:

- The lack of a transparent and robust price discovery process through bookbuilding by intermediaries, e.g., inflated or opaque demand caused, in part, by the actions of intermediaries;
- The lack of alignment between the sponsors' incentives and liabilities, particularly in the case of large IPOs, leading, in some cases, to compromised due diligence enquiries;
- The lack of specific requirements governing the conduct of bookbuilding or placing activities, whether in ECM or DCM. The SFC recognized the need to be consistent with global standards befitting Hong Kong's stature as one of the world's largest capital raising centers. In that regard, the Consultation Paper was prepared in light of recently-issued reports by the International Organization of Commissions ("IOSCO"),[3] and incorporates certain IOSCO principles.

II. The proposals

Under the Consultation Paper, the SFC has formulated a new paragraph 21 (the "Proposed Code") in the *Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission* (the "Code of Conduct") that would apply to intermediaries conducting bookbuilding and placing activities in Hong Kong. The SFC also proposed, in the ECM context, a "coupling" of the role of the syndicate head and the sponsor of an offering ("Sponsor Coupling").

The key proposals[4] under the Proposed Code include the following:

- Defining intermediaries as capital market intermediaries ("CMIs") and further defining the head of syndicate to be the overall coordinator (the "OC"). The role of the OC is determined by the activities conducted by the OC and not its specific title. For example, in the case of debt offerings, an OC is a syndicate CMI that, solely or jointly, conducts the overall management of the debt offering, coordinates the bookbuilding or placing activities conducted by other CMIs, exercises control over bookbuilding activities and makes pricing or allocation recommendations to the issuer;
- CMIs will be expected to adhere to standards of conduct covering a wide spectrum of activities, including bookbuilding, allocation and placing, to address issues including inflated or opaque demand, preferential treatment and rebates, misleading "book messages", proprietary orders which may negatively impact on the price discovery process and orders which conceal the identities of the investors;
- The coverage of the bookbuilding process under the

[1] https://apps.sfc.hk/edistributionWeb/api/consultation/openFile?lang=EN&refNo=21CP1

[2] https://www.hkex.com.hk/-/media/HKEX-Market/News/Market-Consultations/2016-Present/November-2020-MB-Profit-Requirement/Consultation-Paper/cp202011.pdf

[3] IOSCO issued a report in September 2018 on conflicts of interest and associated conduct risk in the equity capital raising process, and issued a further report in September 2020 on the debt capital market.

[4] Please note that the proposals summarized in this alert are by no means exhaustive. You are advised to read the Consultation Paper in its entirety for a comprehensive understanding of the Proposed Code.

Proposed Code is wide. For ECM activities, it would also cover (i) units or interests listed or to be listed under the REIT Code and (ii) placing and top-up placing of shares by existing shareholder in listed issuers as the issuer and the shareholder together are responsible for appointing a CMI to assist them in the placing. For DCM activities, the Proposed Code would cover all types of debt offerings, provided that the offering involves bookbuilding or placing activities conducted by intermediaries in Hong Kong;

- The DCM practice of booking "X-orders", where the identity of investors is concealed, will be expressly prohibited. Under the Proposed Code, the identities of all investors shall be disclosed in the order book, except for orders placed on an omnibus basis;
- Syndicate membership and fee arrangements (including the fixed fee, the discretionary fee and fee payment schedule) must be determined at an early stage, through formal written agreements, to enhance accountability among syndicate CMIs and discourage undesirable behaviour. An earlier determination of roles also diminishes the likelihood of brokers without mandates "swarming" order books at the last minute and bringing in large price-insensitive orders;
- Specifically, in respect of IPOs, composition of the syndicate members (CMIs), total fee arrangement on the public offer tranche and the international tranche, the ratio between fixed fee and discretionary bonus, allocation of any fixed fee by the listing applicant to the CMIs shall be submitted four clear business days before listing committee hearing and any material changes shall notify the SFC as soon as they have been agreed;
- In DCM transactions, some issuers offer rebates to private banks to incentivise them to sell debt securities to their clients and, in some cases, the private banks pass on these rebates to clients. Under the Proposed Code, a CMI shall not offer any rebates to its investor clients or pass on any rebates provided by the issuer. Moreover, a CMI shall not enter into any arrangement that may result in investor clients paying different prices for the debt securities allocated;
- Proprietary orders may present conflicts of interest for CMIs. Under the Proposed Code, a CMI should (i) establish and implement policies to identify, manage and disclose potential conflicts of interest; (ii) establish and implement policies to govern the process of generating and making allocations for proprietary orders; (iii) give priority to investor clients' orders over the CMI's proprietary orders; and (iv) only be a "price taker" in relation to proprietary orders;
- Proper record keeping system and new policies and procedures including allocation policy shall be in place to document the bookbuilding process for not less than seven years on (i) assessments of the issuer client, share or debt offering and investor clients; (ii) audit trails from the receipt of orders through to the final order allocation; (iii) all key communications between, and among, the OCs, other CMIs or investor clients, including order book status; (iv) the intended basis of allocation for all orders with justifications and any material deviations from its allocation policy; (v) all key communications with the issuer client; (vi) rebates offered; (vii) any other preferential treatment offered; and (viii) information forming the basis of all submissions made to SEHK and the SFC.

The Sponsor Coupling proposals are designed to mitigate the incentive on the part of sponsors to compromise their due diligence enquiries to win the OC role, particularly when sponsors face fierce competition from non-sponsors who also covet the OC role. A key element in the Sponsor Coupling rules is that, in IPOs, at least one OC must also act as a sponsor. This sponsor must be independent of the issuer. In addition, other OCs must not be appointed later than two weeks after submission of the listing application.

In light of the introduction of the Proposed Code and to avoid duplicating requirements, the SFC proposes to make corresponding changes to the GEM Placing Guidelines.[5] Furthermore, to facilitate implementation of the Proposed Code, subject to the responses to the Consultation Paper, the SFC and SEHK will work together to implement changes to the Main Board Listing Rules[6] and GEM Listing Rules.[7]

III. Views Being Sought

The SFC is seeking views on the Consultation Paper, including whether the proposed measures are appropriate and proper to address the concerns identified by the SFC, and we intend to prepare a formal written response to the SFC accordingly. We understand that many of the suggestions under the Proposed Code will be a major departure from current practices.

Jason Kuo and Tony Jacobsen contributed to the preparation of this alert.

[5] https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/guideline-to-sponsors-underwriters-and-placing-agents-involved-in-the-listing-and-placing-of-gem/guidelinetosponsorsunderwritersandplacingagentsinvolvedinthelistingandplacingofgem.pdf

[6] https://www.hkex.com.hk/Listing/Rules-and-Guidance/Listing-Rules-Contingency/Main-Board-Listing-Rules/Main-Board-Listing-Rules?sc_lang=en

[7] https://www.hkex.com.hk/Listing/Rules-and-Guidance/Listing-Rules-Contingency/GEM-Listing-Rules/GEM-Listing-Rules?sc_lang=en

Cross-boundary Mortgage under the New GBA Policy

Zhao Xianlong, Peng Fu, David Mu, Xiong Mei

Zhao Xianlong

Peng Fu

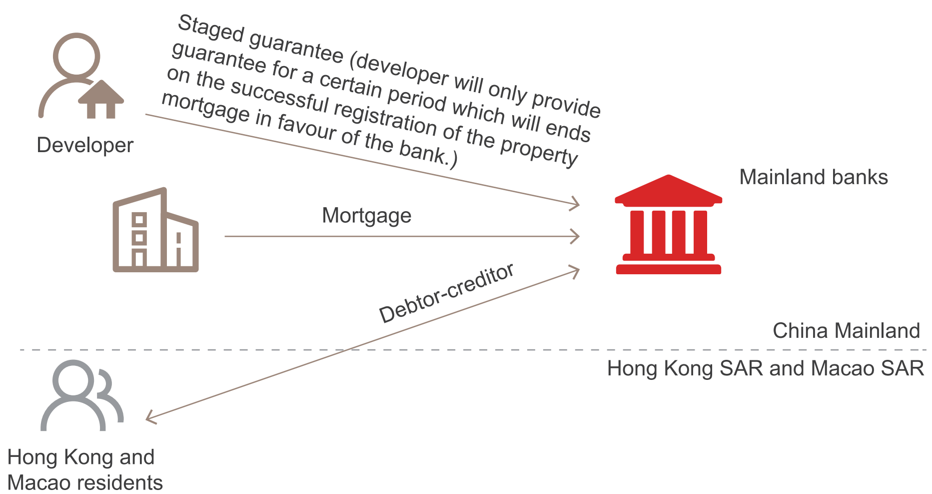
David Mu

The *Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area* (the "*Outline*") released on 18 February 2019 defines the overall strategy and scope of the development in the GBA. Section 6 of the *Outline* requires "to explore and procure that Hong Kong and Macao residents who are working and living in Guangdong enjoy the same treatment as that for Mainland residents in areas of livelihood such as education, medical care, elderly care, housing and transport". To implement the policy, the GBA Construction Leading Group discussed 16 measures at a meeting in November 2019, one of which is "to facilitate house purchases by Hong Kong residents in Mainland cities in the GBA". According to this measure, Hong Kong residents who purchase houses in such Mainland cities will be exempted from the required proof of years of residence, study or working, as well as payment of personal income tax and social security, so that Hong Kong residents will enjoy the same treatment as local residents. This measure facilitates Hong Kong residents to study, work and enjoy their retirement in the Mainland.

On 28 July 2020, the Guangdong Financial Supervisory Authority, the Guangzhou Branch of the People's Bank of China, the Guangdong Office of the China Banking and Insurance Regulatory Commission and other departments jointly issued the *Plan for Implementing Financial Support to the Construction of the Guangdong-Hong Kong-Macao Greater Bay Area* (the "80 Implementation Measures"), requiring nine municipal governments in the Pearl River Delta to "*support Mainland cities in the GBA in cross-boundary mortgage registration of real estate, and allow Hong Kong and Macao residents to mortgage their self-occupied homes purchased in such cities to overseas banks, so as to facilitate Hong Kong and Macao residents to purchase houses in such cities*". Following the introduction of the 80 Implementation Measures, real estate purchases by Hong Kong and Macao residents in Mainland GBA cities soon became a hot topic. Not only do Hong Kong and Macao residents put the plan high on their agenda, but Hong Kong and Macao banks also see it as a new orientation for their cross-boundary business expansion in the GBA. In this article, we will analyse the breakthroughs that have been brought about by the new GBA policy and the problems that await further clarification from the perspective of Hong Kong and Macao banks, so as to contribute to the future integration of the GBA financial services.

I. Past cross-boundary mortgage business

Before the introduction of the 80 Implementation Measures, Hong Kong and Macao residents purchasing houses[1] in the GBA were generally applying for a mortgage loan with banks in China Mainland[2] (including branches or parent (head) banks of Hong Kong and Macao banks in the Mainland). The release of loans and the related security measures (usually involving Mainland developers' staged guarantee/security and Hong Kong and Macao purchasers' real estate mortgage) both take place in the Mainland.



As the picture shows, the loans offered by Mainland banks to Hong Kong and Macao residents are usually based on the staged guarantee provided by Mainland developers and/or Mainland real estate mortgage. Moreover, after years of development of the Mainland housing mortgage model, Mainland banks are quite familiar with these credit enhancement methods and their legal mechanisms, especially the mortgage registration procedures and default disposal mechanisms.

In contrast, Hong Kong and Macao banks have not long been active participants in cross-boundary housing mortgage. On one hand, Hong Kong and Macao banks lack relevant knowledge of and control over Mainland credit enhancement measures, especially Mainland real estate mortgage. On the other hand, the legal requirements and practice for establishing real estate mortgage in the Mainland are also inconvenient for Hong Kong and Macao banks. For example, in the case where the mortgagee is a Hong Kong/Macao bank, in addition to submitting the materials required for general real estate mortgage (e.g., application form for real estate registration, loan contract, and mortgage contract), the bank's qualification documents that have been notarized and sent by the notary office are also required. Another qualification document that must be submitted is the approval document and certificate for the bank to set up the branch or representative office in China Mainland, or the "Financial Permit" or the certificate for qualification to carry out the housing loan business. These requirements actually make it more difficult for Hong Kong and Macao banks to obtain mortgages for general real estate in China Mainland.

II. Present cross-boundary mortgage business

(I) What improvements has the new policy made?

[1]For ease of expression, unless otherwise specified, the terms "property", "residence" and "house" all refer to ordinary residential properties, excluding commercial service properties (e.g. apartments) and any other special types of properties (e.g. houses with limited property rights, and foreclosure houses). In addition, this article does not cover the real estate purchase restriction policies in any of the nine cities in the Pearl River Delta in the GBA. If relevant discussion involves the local real estate purchase restriction policies, such local policies shall prevail.

[2]Given the differences between jurisdictions and for ease of expression, unless otherwise specified, the terms "China Mainland" and "China" in this article both refer to the Mainland of China, excluding Hong Kong SAR, Macao SAR and the Taiwan Region.

For the first time at the policy level, the 80 Implementation Measures explicitly supports Hong Kong and Macao residents to mortgage their properties purchased in the GBA to overseas banks (including Hong Kong and Macao banks), creating a new opportunity for Hong Kong and Macao banks to carry out cross-boundary mortgage business.

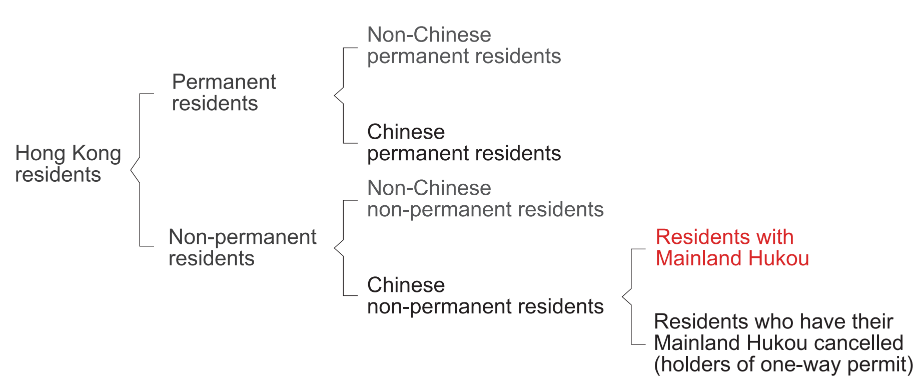
Some cities in the Pearl River Delta (e.g. Guangzhou, Dongguan, and Zhaoqing, etc.) actively responded to this policy and issued documents in the second half of 2020 to encourage Hong Kong and Macao residents to mortgage their residential property purchased within these cities to Hong Kong and Macao banks. On 4 August 2020, the Department of Natural Resources of Guangdong Province also issued the *Notice on Clarifying Matters Related to Real Estate Mortgage Registration by Hong Kong and Macao Banks in Nine Mainland Cities in the GBA* (the "Notice on Mortgage Registration in Nine GBA Cities"), further clarifying and simplifying the material requirements of Hong Kong and Macao banks in applying for real estate mortgage registration – "Simplifying the qualification materials required for mortgage registration by Hong Kong and Macao banks - starting from 1 September 2020, when applying for real estate mortgage registration at all levels of real estate registration agencies under the jurisdiction of the nine Mainland cities, Hong Kong and Macao banks shall only submit notarised and transmitted incorporation documents or registration certificates as the entity identification documents. The approval documents and registration certificates for the establishment of branches or representative offices in the Mainland and the Financial Permit will no longer be required. When it is not the first time for a Hong Kong/Macao bank to register real estate mortgage, it is not required to submit the above materials again."

The Notice on Mortgage Registration in Nine GBA Cities specifies the materials required for Hong Kong and Macao banks to apply for real estate mortgage registration in China Mainland from a policy perspective, thus solving the problem that some Hong Kong and Macao banks were unable to apply for mortgage registration due to lack of required qualification documents when trying to obtain the mortgage right of general real estate in China Mainland. Nevertheless, given that the Notice on Mortgage Registration in Nine GBA Cities was only recently implemented, and that the real estate registration authorities in the nine cities have not yet issued specific guidelines and material lists for cross-boundary mortgage registration, in case of cross-boundary mortgage registration with properties in nine cities in the Pearl River Delta in the GBA as collateral, it is recommended to enquire with the local real estate registration authority in advance to minimise the risk of failure in mortgage registration due to the lack of qualification certificates.

(II) Who are eligible clients among Hong Kong and Macao residents?

The term "Hong Kong and Macao residents" as used in the new policy is short in form but rich in connotation. It is worth our in-depth analysis from the perspective of laws and policies.

Take "Hong Kong residents" as an example. In general, people holding a Hong Kong Identity Card are deemed as Hong Kong residents, who can be roughly divided into the following categories:



Whether non-Chinese Hong Kong residents (those in grey font in the above picture, including non-Chinese permanent residents and non-Chinese non-permanent residents) can be involved in the cross-boundary mortgage business under the new GBA policy has yet to be clarified by Mainland regulators; whether the Chinese non-permanent residents who have not cancelled their Mainland Hukou (those in red font in the above picture) can be part of this program is also subject to further discussion - in the Mainland GBA cities where there are restrictions on house purchases, if the resident has already used his/her Mainland Hukou to hold real estate, he/she should be supposed not to take advantage of his/her identify as a “Hong Kong resident” to purchase local real estate beyond policy limit; if the resident has not used his/her Mainland Hukou to hold real estate, he/she is supposed to be able to purchase local real estate as a “Hong Kong resident”.

According to our consultation with the real estate registration authorities and/or the housing authorities of the nine Mainland cities, “Hong Kong residents” refer to “Hong Kong permanent residents” or Hong Kong residents holding “Mainland Travel Permit for Hong Kong and Macao Residents” (Home Return Permit). Hong Kong residents holding Home Return Permits include those with permanent residence of Chinese nationality and non-permanent residence of Chinese nationality who have their Mainland Hukou cancelled (i.e. those who hold one-way permits).

In addition, who can be recognized as eligible Hong Kong and Macao house-purchasers is still subject to different house-purchase restriction policies implemented by the nine Mainland cities. To avoid verbosity and since the focus here is on the feasibility of banks’ mortgage business, we will not go further on this issue.

(III) How do loans flow across boundaries?

As China Mainland implements foreign exchange control, property purchases by Hong Kong or Macao residents in the GBA is a business in relation to individuals’ foreign exchange capital account item. Inbound house-purchase funds are subject to the relevant foreign exchange regulations of the Mainland.

1. In whose name should house-purchase funds be remitted to China?

In accordance with the laws of China Mainland, of all the basic legal relations in a cross-boundary mortgage, a Hong Kong or Macao bank and a Hong Kong or Macao resident (the “Borrower” or “Property Buyer”) form a debtor-creditor legal relationship; the Hong Kong or Macao resident and a developer/second-hand property owner in China Mainland form a property sale and purchase relationship. From the above legal relationships, the person who is obligated to pay for the house is the Hong Kong or Macao resident. When it comes to remitting house-purchase funds into the Mainland, i.e. the Hong Kong or Macao bank remits in the name of the Hong Kong or Macao resident, the bank in this regard is the entrusted payer, rather than the obligated payer. Therefore, the property purchase in China Mainland by Hong Kong or Macao residents falls under the business of non-resident individuals purchasing properties under the *Guidelines for the Foreign Exchange Business under the Capital Account Item*. In accordance with existing regulations, house-purchase funds should be remitted to China Mainland in the name of individual Hong Kong or Macao residents rather than in the name of Hong Kong and Macao banks.

2. Who are going to receive the house-purchase funds?

Article 3 of the *Circular of the State Administration of Foreign Exchange and Ministry of Construction on Relevant Issues concerning Regulating the Administration of Foreign Exchange in Real Estate Market* and Article 6.10 of the *Guidelines for the Foreign Exchange Business under the Capital Account Item* stipulate respectively that: (i) The foreign exchange current account of a real estate development enterprise shall not keep any house-purchase funds remitted from aboard; (ii) banks shall convert the foreign exchange funds into RMB and directly remit the same into the RMB account of real estate developers/property owners (as the sellers), and shall not conduct foreign currency remittance within China Mainland for Hong Kong or Macao residents purchasing the property in China Mainland. Based on the above regulations, the house-purchase funds remitted by Hong Kong or Macao residents shall be credited to an account after conversion of foreign exchange, and shall not be directly remitted to the account of developers/property owners in the Mainland. In this regard, according to our recent consultation with the foreign exchange administrations of nine Mainland cities in the GBA and several commercial banks in Shenzhen, even after the introduction

of the 80 Implementation Measures, the remittance of house-purchase funds by Hong Kong or Macao residents still follows the principle of settling foreign exchange before transferring into the seller's account. The house-purchase funds cannot be directly remitted to the account of developers/ property owners in China Mainland in the form of foreign exchange. Instead, the bank will convert the foreign exchange into RMB and directly remit the same into the real estate developer/property owner's RMB account. Under such circumstance, whose bank account should be used to receive the house-purchase funds in foreign currencies before foreign exchange conversion? According to the preliminary research so far, the said foreign exchange administrations and commercial banks have proposed that (personal or co-managed) bank accounts (which have to be able to accept foreign currency) opened by Hong Kong or Macao residents in China Mainland or intermediate bank accounts be used to receive foreign exchange first. It's recommended that the details be determined in consultation with the bank that will be handling the business.

For example, after a borrower opens a Non-Resident Account (NRA) under the same name with a receiving bank in China Mainland, the foreign exchange will be first remitted to the NRA account. After foreign exchange conversion is completed in accordance with the law, the RMB funds will then be remitted to the domestic RMB account of the developer or the second-hand property owner. That's because it is difficult to remit foreign exchange directly to the domestic bank account.

3. Cross-border RMB or foreign exchange?

The feasibility of remitting mortgage loans into China Mainland in the form of cross-border RMB is mainly regulated by the *Notice of the People's Bank of China on Relevant Issues concerning the Individual RMB Business between Mainland Banks and Hong Kong and Macao Banks*, the *Supplementary Notice of the People's Bank of China on Relevant Issues concerning the RMB Business between Mainland Banks and Hong Kong and Macao Banks,* and the *Notice by the People's Bank of China, the National Development and Reform Commission, the Ministry of Commerce, the State-owned Assets Supervision and Administration Commission under the State Council, the China Banking and Insurance Regulatory Commission, and the State Administration of Foreign Exchange of Further Optimizing the Cross-border RMB Policies to Support the Stability of Foreign Trade and Foreign Investment.* The regulations and restrictions are as follows: (i) Hong Kong or Macao residents may remit RMB through clearing banks (subject to a daily cap of RMB 80,000 per person); (ii) the aforementioned remittance is limited to the remittance to accounts under the same name in China Mainland; and (iii) the remitted funds may only be used for nonproductive expenditure in China Mainland and may not be used to purchase financial products such as marketable securities, financial derivatives and asset management products. According to the aforementioned provisions, the remittance of house-purchase funds to China Mainland in the form of cross-border

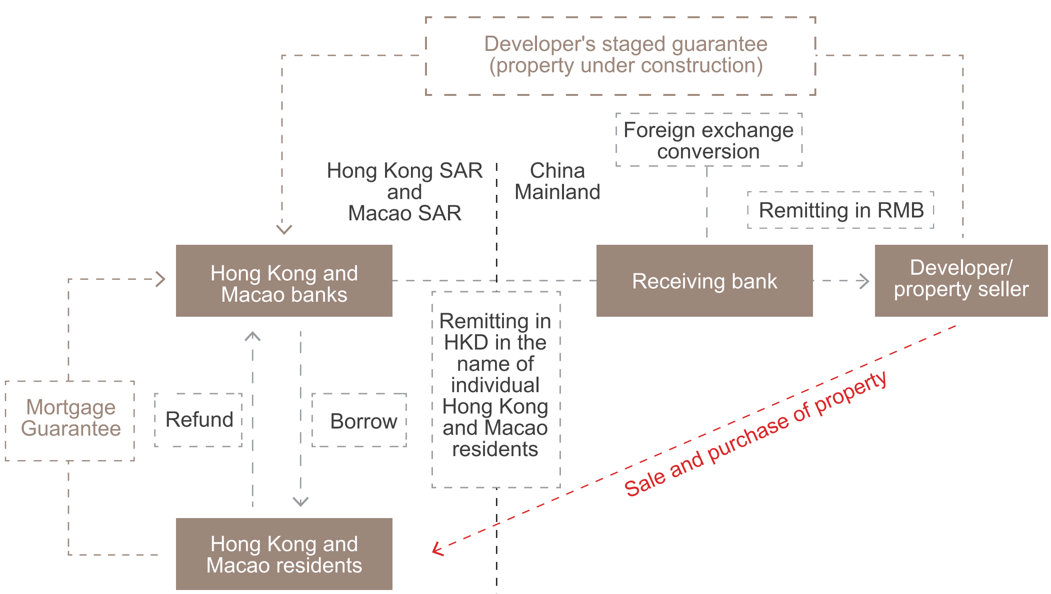
RMB is subject to restrictions on the use of funds and single-day remittance limit, making it difficult to meet the demand of remitting a large amount of house-purchase funds for property acquisition in China Mainland at one time.

Therefore, according to existing foreign exchange and cross-border RMB policies, at present, it is feasible for Hong Kong or Macao residents to purchase houses in China Mainland through foreign exchange remittance. However, it is important to note that Property Buyers may face exchange rate risks in domestic foreign exchange conversion. It is recommended that banks in Hong Kong SAR and Macao SAR consider providing necessary hedging by locking in an exchange rate for Hong Kong or Macao residents, so as to avoid the risk of RMB funds after exchange conversion in China Mainland falling short of the purchase price.

4. What is the limits of inbound and outbound remittance?

According to the basic principles of China's foreign exchange control, under a legitimate house purchase relationship, a Property Buyer may apply for remitting house-purchase funds based on a genuine house purchase contract up to the housing price shown in the contract, and use the money to pay for the house under the contract. In this regard, we consulted the foreign exchange administrations of nine Mainland cities in the GBA, and their responses are consistent: Hong Kong or Macao residents' house-purchase remittance after foreign exchange conversion to China Mainland should not exceed the amount shown in the purchase contract; if exceeds, the excess will be returned by the bank handling the conversion to where it comes from.

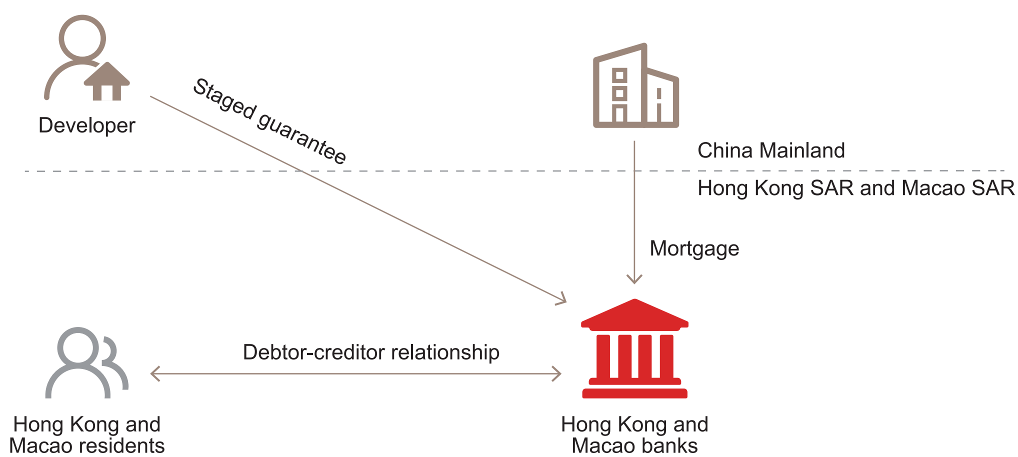
In addition, if Hong Kong and Macao residents wish to transfer their purchased domestic property in the future, in accordance with Article 6.10 of the current Guidelines for the Foreign Exchange Business under the Capital Account Item, the proceeds derived from such transfer can be remitted in a lump sum, and the maximum amount to be remitted is the balance of the transfer price of the property less relevant taxes caused by this transfer. Such RMB funds could be remitted after converting into the foreign exchange.



(IV) What other factors need to be considered for the creation of a mortgage?

Subject to the nature of properties purchased in China Mainland, the practice of creating a mortgage on them differs. This is particularly reflected in the sale of the built and sold properties (and where the previous owner needs to redeem the property) and in the pre-sale of the property under construction (i.e., uncompleted property or forward delivery properties). Taking the latter for example:

Mortgage registration of a priority notice vs. Formal mortgage registration: When pre-selling the property under constuction, registration of a priority notice could be applied for in accordance with Article 221 of the *Civil Code of the People's Republic of China*. For such pre-sale, it is unable to create the formal mortgage right in favor of the lender during the period from the date of mortgage registration of a priority notice to the completion of the property title registration as well as the mortgage registration of the property. In addition, since properties may face other risks such as seizure/pre-seizure in practice, domestic lenders usually require the developer to provide a staged guarantee as a security measure. The staged guarantee will not be released until the mortgage is formally created with registration.



Registration of offshore loans under onshore guarantee: For legal practitioners engaging in cross-border financing, the above diagram shows a common topic, i.e. as the creditor and debtor are Hong Kong or Macao residents, and the guarantor is in China Mainland, the staged guarantee provided by the domestic developer as the guarantor constitutes "offshore loans under onshore guarantee". In this case, cross-border guarantee should be registered with the foreign exchange authorities after signing the contract. Failure to register may lead the guarantor's performance funds unable to be transferred out of the country to repay the claims of Hong Kong and Macao banks.

In terms of the registration procedures for offshore loans under onshore guarantee arising from "staged guarantee" in the cross-boundary mortgage structure of the GBA, the feasibility of the above business model depends on further confirmation and clarification of whether offshore loans under onshore guarantee can be registered when the debtor is an individual Hong Kong or Macao resident.

Choice of applicable law and dispute resolution mechanism: The legal documents of loans and the property mortgage are contracts with foreign-related elements, and in principle, the parties can choose the law applicable to such kind of contracts. However, in accordance with Article 36 of the *Law of the People's Republic of China on the Application of Laws to Foreign-related Civil Relations*[3], based on the territoriality principle of the real right of immovable property and the fact that mortgage on immovable property has the attribute of security rights legally, it is recommended that mortgage on immovable property apply the law of China Mainland. If the subordinate contract (mortgage contract) takes the laws of China Mainland as the governing laws and chooses the Mainland dispute resolution mechanism (e.g. settling disputes through court proceedings in China Mainland), the main contract (loan contract), though only involves Hong Kong and Macao banks and residents, may also need to further consider whether it will continue to apply Hong Kong or Macao laws and dispute resolution mechanisms or turn to the laws and resolution mechanism of China Mainland.

[3]Article 36 of the *Law of the People's Republic of China on the Application of Laws to Foreign-related Civil* Relations: For the property rights of immovable assets, the laws of the place in which the assets are located shall apply.

(V) How to dispose of domestic mortgaged properties in case of default?

As the mortgaged property is located in China Mainland, in a loan default, Hong Kong and Macao banks, as creditors, need to familiarize themselves in advance with the ways to execute the mortgaged property and collect disposal proceeds. According to the law of the location of the mortgaged property (the law of China Mainland), in general, the disposal of the mortgaged property can be generally divided into: disposal by consensus of the parties (self-remedy) and judicial disposal.

In terms of self-remedy, if the parties agree to auction or sell the mortgaged property[4], they may consider remitting the proceeds from the disposal of the mortgaged property after completing tax declaration and immovable asset title transfer registration through the route specified in "repatriation of funds from the transfer of domestic property" under Article 6.10 of the *Guidelines for the Foreign Exchange Business under the Capital Account Item*.

It is necessary to discuss judicial disposal in combination with the dispute resolution mechanism chosen in the relevant cross-boundary mortgage legal documents. In a relatively simple case where a judgment or arbitral award in force in China Mainland is obtained, the creditor may apply to the court where the immovable property is located for enforcement; in the case where a judgment or arbitral award in force in Hong Kong SAR or Macao SAR is obtained, their recognition and enforcement in China Mainland also need to be considered. In the case of Hong Kong SAR:

In accordance with the *Arrangements of the Supreme People's Court on the Reciprocal Enforcement of Arbitration Awards by China Mainland and the Hong Kong Special Administrative Region,* the *Supplementary Arrangements of Supreme People's Court on Reciprocal Enforcement of Arbitration Awards between the Mainland and the Hong Kong Special Administrative Region* and the *Civil Procedure Law of the People's Republic of China*, for an arbitral award made under the Hong Kong Arbitration Ordinance, if a party fails to perform the arbitral award, the other party may apply for enforcement to an intermediate people's court in China Mainland where the respondent is domiciled or where the property is located. In addition, according to the *Arrangement of the Supreme People's Court on Mutual Assistance in Preservation in Arbitration Proceedings between the Courts of the Mainland and the Hong Kong Special Administrative Region*, there is a bilateral arrangement between Hong Kong SAR and China Mainland on mutual assistance in preservation in arbitration proceedings. If the parties choose to resolve loan disputes by arbitration in Hong Kong SAR, the creditor may apply to the courts in China Mainland for preservation (i.e. judicial seizure/freezing/attachment) of the property purchased by the Property Buyer and his other properties in China Mainland (if any) before the arbitration award is made in Hong Kong SAR.

Nevertheless, things are different for obtaining a valid judgment in a Hong Kong court. In accordance with the *Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region Pursuant to Choice of Court Agreements between Parties Concerned Interpretation* and Article 281 of the *Civil Procedure Law of the People's Republic of China*, an application for recognition and enforcement of a final judgment rendered by a Hong Kong court may be made to an intermediate people's court with jurisdiction in China Mainland if the following conditions are met: (i) the parties have agreed to the exclusive jurisdiction of the Hong Kong court; (ii) the Hong Kong judgment is about payment of a monetary sum.

Although the *Arrangement of the Supreme People's Court and the Government of the Hong Kong Special Administrative Region on Reciprocal Recognition and Enforcement of Judgments in Civil and*

[4]In accordance with the *Opinions of the Ministry of Construction, the Ministry of Commerce, National Development and Reform Commission, the People's Bank of China, the State Administration for Industry of Commerce and the State Administration of Foreign Exchange on Regulating the Access to and Administration of Foreign Investment in the Real Estate Marke*t (No. 171 [2006] of the Ministry of Construction) and the *Notice of the Ministry of Housing and Urban-Rural Development, the Ministry of Commerce, the National Development and Reform Commission, the People's Bank of China, the State Administration for Industry and Commerce and the State Administration of Foreign Exchange on Adjusting the Policies on the Market Access and Administration of Foreign Investment in the Real Estate Market* (No. 122 [2015] of the Ministry of Housing and Urban-Rural Development on August 19, 2015): A branch, sub-branch or representative office of an overseas institution in China (except for an enterprise that has been approved to engage in real estate operation) or a foreigner that has worked or studied in China for more than 1 year may purchase a property for self-use or self-accommodation. Subject to the aforementioned provisions, in the event that the mortgaged property needs to be disposed of, the Hong Kong and Macao banks may not be able to dispose of it by agreeing with the Property Buyer to discount its value and transfer it to the name of the Hong Kong and Macao banks. Due to the limitation of space, we will not discuss the disposal of the mortgaged property at a discounted price in this article.

Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region (issued on 18 January 2019) removes the restrictions for applying for recognition and enforcement by courts in China Mainland under the aforementioned arrangements, this arrangement has not yet come into force. It remains to be seen whether this arrangement will then be able to better support the cross-boundary mortgage business described in this article when it comes into effect.

It should be noted in particular that there is no arrangement concerning mutual assistance in interim measures in aid of judicial proceedings between Hong Kong SAR and China Mainland. If the parties chose to resolve loan disputes by filing lawsuits with a Hong Kong court, the creditor will then NOT be able to apply to the courts in China Mainland for preservation (i.e. judicial seizure/freezing/attachment) of the property purchased by the Property Buyer and his other properties in China Mainland (if any) before the commencement of, or during the litigation in the Hong Kong court.

In addition, according to the *Provisions on the Foreign Exchange Administration of Cross-border Guarantees* and the *Provisions on Foreign Exchange Control for Cross-border Guarantees*, such mortgaged property arrangement in favor of offshore banks is one of other forms of cross-border guarantees. Therefore, upon completion of judicial disposal, the guarantor or creditor may apply directly to the relevant bank in China for remitting such disposal proceeds from judicial enforcement outbound. After the bank examines the authenticity and compliance of the guarantee performance and retains necessary materials, the guarantor or creditor can handle the relevant foreign exchange purchase, conversion and cross-border payments.

III. Future cross-boundary mortgage business

Hong Kong and Macao banks' cross-boundary mortgage services are part of an important initiative by China to support the development of the GBA, with the following advantages:

(i) Hong Kong and Macao Property Buyers will be able to enjoy more favorable financing costs. Since the introduction of the Loan Prime Rate (LPR) in China Mainland, most Mainland banks have converted the pricing benchmark of individual property loans to LPR. According to the recent data released by the People's Bank of China, the 1-year LPR is 3.85%. In comparison, the interest rate of Hong Kong dollar mortgage is generally less than 3%, which has certain competitive advantages, and Hong Kong and Macao residents are stickier to Hong Kong and Macao banks.

(ii) Cross-boundary mortgage is a new business for Hong Kong and Macao banks. Banks there can use it to broaden their business areas and obtain more interest income from loans and other cross-boundary value-added business opportunities.

(iii) Cross-boundary mortgage helps developers in China Mainland to expand their customer base and to attract Hong Kong and Macao residents to purchase residential property in the nine Mainland cities in the GBA.

We understand that as of January 2021, a small number of Hong Kong banks have provided cross-boundary mortgage services for Hong Kong and Macao residents to purchase properties in the GBA. By contrast, the majority of Hong Kong and Macao banks have not yet launched such business as their business models are still in the stage of legal research and projection.

Despite many questions to be clarified, we believe that the cross-boundary mortgage business in the GBA has a very bright future. King & Wood Mallesons has already advised a number of Hong Kong and Macao banks and provided research services on cross-boundary mortgage business, as well as updated the format of loan documents and immovable asset mortgage documents for Hong Kong and Macao banks, in order to prepare for the future development of cross-boundary mortgage business in the GBA. We look forward to working with you to promote the final implementation of this beneficial policy.

Cross-border asset transfer under the new GBA policy

Yang Xiaoquan, Zhong Xin, Zhou Jie, David Mu, Du Rui

Yang Xiaoquan

Zhong Xin

Zhou Jie

David Mu

The external transfer of domestic debt assets refers to the transfer of debt assets held by domestic creditors to foreign investors. Such debt assets can be divided by the nature of debt into debt assets of banks, debt assets of non-bank financial institutions and debt assets between entities or individuals. They can also be differentiated into performing debt and non-performing debt. The cross-border asset transfer has long been strictly subject to the foreign debt management system of China. On 30 March 2020, however, the *Notice on Foreign Exchange Management to Support the Development of the Guangdong-Hong Kong-Macao Greater Bay Area and the Shenzhen Pilot Demonstration Zone* ("Document No. 15") was issued by the branches of the State Administration of Foreign Exchange ("SAFE") in Guangdong province and Shenzhen city. Document No. 15 clearly states that pilot institutions in the GBA are permitted to transfer their non-performing loans of banks ("NPLs") and bank trade finance to foreign investors under the principles of controllable risk and prudent management. In addition, Document No. 15 also provides the supporting operational guidelines.

Document No. 15 can be seen as a further extension of the *Notice on Matters Relating to the Pilot Services for Cross-Border Transfer of Non-Performing Assets of Banks in the Jurisdiction of the Shenzhen Branch* issued by SAFE in 2017 and its approval for the renewal of the pilot term in 2018, the *Operational Guidelines on the Provision of Pilot Services for Cross-Border Transfer of Non-Performing Assets of Banks in Shenzhen* issued by the Shenzhen SAFE branch in 2018 and the SAFE's approval for Guangdong Financial Assets Exchange to conduct pilot cross-border business of non-performing assets ("NPAs") in 2018. The *Opinions on Financial Support for the Development of the Guangdong-Hong Kong-Macao Greater Bay Area* (the "new GBA policy") issued by the PBOC, CBIRC, CSRC and SAFE on 24 April 2020 further proposes to steadily expand the pilot services for cross-border asset transfer and explore more categories of assets available for cross-border transfers. This is also what the market is looking forward to. Compared to Document No. 15, all of the issuing authorities of the new GBA policy have escalated to the national level. We would like to take a look at whether the new pilot services for cross-border asset transfer can resolve the current dilemma and bring a new breakthrough.

I. NPAs - more permitted primary trading market participants for specific categories of banks' NPAs

If the new GBA policy allows Chinese banks to transfer their NPAs directly to foreign investors, it is necessary to make an institutional breakthrough to address the two-tier trading market issue in the disposal of banks' NPAs.

The NPAs of Chinese banks are transferred in the primary and secondary trading markets. As required by the *Administrative Measures for Bulk Transfer of Non-Performing Assets of Financial Enterprises* (the "Administrative Measures"), Chinese financial institutions, especially state-owned banks, must transfer their NPAs in bulk to financial asset management companies (the "AMCs", including the national and local AMCs), forming a primary trading market. The AMCs then dispose of the NPAs to domestic and foreign investors, forming a secondary trading market. One of the institutional reasons for the formation of the two-tier markets is that the acquisition of NPAs from Chinese financial institutions is a licensed financial transaction at the regulatory level in which institutions other than AMCs are ineligible to participate directly.

With the further opening-up of China's financial market, foreign asset management firms or investors ("foreign investors") have been allowed to invest in the primary market by establishing foreign-funded AMCs in China. But they are still not permitted to bid for or buy NPAs of Chinese banks directly in the primary market.

For certain categories of domestic NPAs, however, due to their particularity, the new GBA policy is expected to bring about some institutional breakthroughs. For example:

(i) Overseas NPLs converted from the loans granted by Chinese banks in accordance with the commercial lending principles ("foreign-related NPAs", including those in which the borrower and security assets are located outside China, or in which the borrower and core security assets are located outside China but there is a domestic guarantor): As the borrower and assets involved in foreign-related NPAs are both located abroad, foreign investors will be more interested in and capable of acquiring and managing foreign-related NPAs than AMCs. If the new GBA policy explicitly expands the participants in the primary trading market for foreign-related NPAs to include foreign investors, it will facilitate the external disposal of foreign-related NPAs of Chinese banks in Shenzhen and beyond through the agency regime of the local banks or exchanges under Document No. 15. Thus, it will enhance the efficiency of the divestment and disposal of foreign-related NPAs. In the long run, the new GBA policy will also help Chinese banks and AMCs to expand their international business and form a closed loop for cross-border financing business.

(ii) NPLs converted from proprietary foreign exchange loans granted by Chinese banks in China ("domestic foreign-currency NPAs"): Under such assets, it is difficult for the lending bank to eventually receive foreign exchange funds from the borrower. It is more likely to recover RMB funds from the borrower and then apply to the relevant SAFE office for balancing the accounts in a foreign currency. Even if an AMC intends to acquire a bank's domestic foreign-currency NPAs, its direct payment of the purchase price in a foreign currency is currently not allowed in China. If payment is made in RMB, the transferring bank will also face an institutional breakthrough to be made for balancing the accounts of the transfer consideration in a foreign currency. We note that the current policy has already allowed banks to transfer certain categories of performing trade loans across borders. Considering that the vast majority of domestic foreign-currency NPAs evolved from performing trade loans, it is unnecessary to treat the transferees differently simply because the same category of loans bears differently classified risks.

In addition, we also note that the regulators are issuing to the relevant institutions the *Opinions on the Pilot Programme for Transfer of Non-Performing Loans and the Implementation Plan of the Pilot Programme for Transfer of Non-Performing Loans of Banks* (the "new NPA policies"). Although the new NPA policies allow banks to transfer corporate NPLs in a single account and individual NPLs in bulk, the policies are still tending to limit the transferees of single-account corporate NPLs to AMCs. If the new GBA policy not only relaxes the restrictions on the direct transfer of the above two categories of NPAs to foreign investors, but also does not limit the number of the accounts, it will be more conducive to the market-based disposal of such NPAs. In particular, it will help facilitate the disposal of foreign-related NPAs with complex structure and involving multiple jurisdictions as well as address the business needs of foreign investors to purchase from a single account in general.

II. NPAs - more permitted categories of NPAs and institutions

The new GBA policy will provide a stronger impetus to the market if, in addition to Chinese banks and AMCs, more domestic financial institutions, such as trust companies, and factoring companies, financial leasing companies, guarantee companies and micro-loan companies actually under the local financial regulatory system, are allowed to transfer NPAs to foreign investors.

The Administrative Measures also recognise trust companies as the permitted transferors. The credit assets of Chinese banks are state-owned financial assets. The trust NPLs generated under the pooled (single) fund trust schemes of trust companies, however, are trust property. It is inappropriate to restrict the transfer of trust NPLs as long as the principal or beneficiary under the trust contract agrees on such transfer. The attitude of the regulators, of course, is crucial to the recognition of trust companies as participants in the external transfers.

Banks and trust companies are explicitly governed by the Administrative Measures issued by the Ministry of Finance and China Banking Regulatory Commission while factoring companies, financial leasing companies, guarantee companies and micro-loan companies are substantially regulated by local authorities. In comparison, it is theoretically less difficult to make a breakthrough in the policy concerning the locally regulated companies than the above two nationally regulated categories of entities. Whether permissions may be given to local financial entities, and if yes, to what categories of such entities and to which regions, under the new GBA policy depend to a considerable extent on the attitude of local financial regulators in the GBA. At present, factoring companies and financial leasing companies in the Shenzhen market are already transferring their performing factoring and financial leasing assets to foreign investors. Accordingly, we believe that there is a greater possibility that these two categories of entities will be permitted to transfer their NPAs to foreign investors. It is expected that micro-loan companies and guarantee companies are allowed under the new GBA policy to transfer their NPAs across borders.

Apart from the breakthrough of the existing policies, the subsequent scale of foreign debt is to be further considered by the regulators. This practical issue will be addressed through macro-prudent management in accordance with Document No. 15 and other applicable instruments. In accordance with the similar existing regimes, we expect that a certain categories of permitted financial entities or all those in a certain region will be allowed to transfer their NPAs across borders within the quota, not foreign debt quota, granted based on their business data and certain macro-prudential factors.

III. NPAs - filing of foreign debt quota with the National Development and Reform Commission ("NDRC")

The external transfer of NPAs is not only subject to the foreign debt management of the SAFE, but also relates to the application of the *Notice of the National Development and Reform Commission on Accelerating Reform on the Administration of Filing and Registration of Foreign Debts Issued by Enterprises* ("Document No. 2044").

The external transfer of NPAs by AMCs has become much easier in terms of the acquisition of foreign exchange income and the subsequent clearing and remittance after the introduction of the *Measures for the Administration of Foreign Debt Registration and the Notice on Issues Relating to Foreign Exchange Management in Disposal of Non-Performing Assets to Foreign Investors by Financial Asset Management Companies*, as part of the initiatives in foreign exchange management to facilitate such external transfer. Furthermore, Document No. 15 has further simplified the relevant foreign exchange procedures by allowing a third-party agency to be in the picture.

However, there has been no breakthrough on the filing of foreign debt quota in the Document No. 2044. In accordance with the Notice of the *National Development and Reform Commission on Effectively Conducting the Reform of Foreign Debts Management in the Transfer of Debts to Foreign Investors*, Document No. 2044 shall apply to the transfer of non-performing debts by domestic financial institutions to foreign investors, which gives rise to their external liabilities. Domestic financial institutions may not apply to the competent foreign exchange authorities for registration of foreign debts and the transfer of funds until receipt of the registration certificate from the NDRC.

If it is intended to include other financial institutions as the permitted transferors under the new GBA policy, consideration will have to be given on how to meet the filing requirements as set out in Document No. 2044. To that end, is it possible that NDRC grants the Shenzhen NDRC branch a separate annual foreign debt quota for the NPAs in the GBA to facilitate the relevant filing by the domestic entities transferring their NPAs to foreign investors under the new GBA policy?

IV. Performing assets - external transfer of domestic performing debt assets

If domestic performing debt assets become externally transferable under the new GBA policy, it will be a major breakthrough from the perspective of capital account management.

The permitted domestic performing debt assets are limited to bank debts in trade finance under the current policies. There are also external transfers of performing assets of factoring companies and financial leasing companies in the Shenzhen market.

In respect of bank debts in trade finance, the Shenzhen Self-regulatory Mechanism for Foreign Exchange and Cross-Border RMB Business issued the *Interim Administrative Requirements for Services for Cross-Border RMB Asset Transfer*. Domestic banks are thus allowed to transfer their accepted bills assets and RMB forfaiting assets to overseas banks on the premise of effectively fulfilling the three principles for business development: understanding your clients, understanding your services and due diligence. As the Mechanism is guided by the Shenzhen Central Sub-branch of the PBOC, those prescribed requirements reflect to a certain extent the attitude of the PBOC. Additionally, under the guidance of the PBOC Shanghai Head Office, the Cross-border Financial Services Professional Committee of the Shanghai Finance Society formulated *the Operational Guidelines for*

Cross-border Transfer of Domestic Trade Finance Assets in the Lin-Gang Special Area (for Trial Implementation) in March this year, which initially allows the transfer of forfaiting and risk based on domestic letters of credit trade settlement, and will also gradually make available the external transfer of other asset categories in trade finance in the future. In contrast, Document No. 15 only provides that the pilot institutions in the GBA are allowed to transfer bank trade finance to foreign investors without specifying categories of business. Can it be interpreted that the GBA will permit the transfer of all categories of bank trade finance assets across borders at once or in the short term? We do not see the filing procedures and macro-prudential management standards for cross-border transfer of trade finance assets in t*he Operational Guidelines for the Pilot Business of External Transfer of Domestic Credit Assets*, one of the annexes to Document No. 15. It will take some time for the specific rules to be implemented. From the related statements in Document No. 15, however, it should at least be assumed that the GBA has put the cross-border transfer of all categories of bank trade finance assets on its agenda.

For other performing debt assets, we understand that the change in the management of foreign debt makes the permitted external transfer of domestic performing debt assets possible. The foreign debt quota for domestic institutions under the current foreign debt management regulations has been unified, i.e., 2.5 times the audited net assets. In Shenzhen, the registration of foreign debt has also been changed from a one-by-one registration to a one-off registration for all foreign debt quota. Theoretically, as long as the amount of foreign debt transferred does not exceed the foreign debt quota available for domestic borrowers, a lenient approach can be adopted.

The external transfer of performing debt assets, if moderately permitted, under the new GBA policy may be dealt with in the following ways:

Firstly, to reduce the pressure of administrative filings under Document No. 2044, the term of the debt may not exceed one year.

Secondly, the transferors may be limited to local financial enterprises. Domestic borrowers will be possibly allowed to make repayments to foreign investors only in the original currency of the debt, in accordance with the principle of "the same currency of withdrawal and repayment" under the foreign debt management system.

Thirdly, the domestic borrower should be an institution that adopts a one-time foreign debt quota registration to facilitate the management of foreign exchange.

Conclusion

Under the new GBA policy, regardless of the innovation and breakthrough for cross-border asset transfers, it is unlikely that there will be any change to the subject prohibited to borrow foreign debts under the current foreign debt management regulations and the non-permitted categories of NPAs of Chinese financial institutions pursuant to the Administrative Measures. Private non-performing debts between enterprises may currently be acquired and transferred to foreign investors by AMCs. Nor will such debts be unlikely to become permitted. In terms of the mechanism, it is likely that the authenticity review and “anti-money laundering, anti-terrorist financing, anti-tax evasion” obligations will be placed on the AMCs.

The restrictions on single-account transfers of corporate NPLs and bulk transfers of individual NPLs have already showed a sign of relaxation under the new NPA policies. The institutional arrangements for external transfers of cross-border assets under the new GBA policy come at an opportune time. Perhaps the institutional breakthroughs and innovations for external transfers of cross-border assets under the new GBA policy will go far beyond our understanding and expectations in this article. This is also what the market is looking forward to.

Wealth Management Connect (Southbound) under the new GBA policy

Yang Xiaoquan, Zhong Xin, Du Rui

Yang Xiaoquan

Zhong Xin

The *Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area* (the "Outline"), a fundamental document guiding the development of the GBA, was officially released on 18 February 2019. The Outline defines the scope of the GBA, pointing out the connectivity systems applicable to the three places as well as their respective key areas of development. On 14 May 2020, the People's Bank of China (PBOC), China Banking and Insurance Regulatory Commission (CBIRC), China Securities Regulatory Commission (CSRC) and State Administration of Foreign Exchange (SAFE) jointly issued the *Opinions on Financial Support for the Construction of the Guangdong-Hong Kong-Macao Greater Bay Area* Yin Fa [2020] No. 95 (the "Opinions"), proposing 26 measures in five aspects to promote the implementation of the Outline financially.

The cross-boundary wealth management connect scheme (Wealth Management Connect) is not a new measure proposed by the Opinions, since the Outline already put forward "cross distribution of wealth management products" in 2019. "Mainland residents can open accounts in Hong Kong via Mainland banks, and account holders can use renminbi to directly invest in or use foreign exchange to invest in overseas financial products, including stocks, bonds and paper gold. Following the completion of investment, conversion and remittance can only be made in renminbi, and domestic funds can only be withdrawn domestically," said early reports, citing a source. Cross-boundary fund flow management will refer to the practice of Stock Connect, where funds are managed in a closed loop. The Opinions further clarifies that, residents of the Mainland cities in the GBA can invest in eligible investment products distributed by banks in Hong Kong and Macao by opening designated investment accounts with these banks (Southbound Wealth Management Connect), and residents of Hong Kong and Macao can invest in eligible wealth management products distributed by Mainland banks in the GBA by opening designated investment accounts with these banks (Northbound Wealth Management Connect). This points out where the scheme should head for at the beginning.

For Mainland residents, the annual quota of collection and settlement of foreign exchange is capped at USD 50,000. There are exemptions, however. Individuals in new business forms such as cross-border e-commerce and cross-border procurement (under current account) and those investing in stocks, funds, bonds and other financial products in overseas secondary markets (under capital account) through the Qualified Domestic Institutional Investor (QDII) mechanism are not subject to such quota. Around 2015, the Chinese government wished to allow residents of six pilot cities to invest directly in offshore assets within an annual quota of RMB 1,000,000 under a new QDII2 program, which failed to be implemented for various reasons.

Although the Wealth Management Connect does not mean all restrictions on the direct investment of GBA residents in products offered in overseas secondary markets are completed lifted, it is still an important complement to Mainland residents' investment in overseas secondary markets via the QDII mechanism. Unlike QDII, Wealth Management Connect customers will receive direct wealth management services from banks in Hong Kong and Macao, rather than making overseas investment indirectly by buying the capital management products/wealth management products developed by Mainland QDII institutions. This will undoubtedly provide GBA residents with more options for investment and financial management as well as asset allocation in both local and foreign currencies. The policy surely has a positive impact, but it takes time to have it implemented. This article focuses on Southbound Wealth Management Connect, discussing and identifying its highlights of innovation and potential obstacles.

I. Qualifications of investment entities for Southbound Wealth Management Connect

As a regional financial development initiative, Wealth Management Connect should focus on bringing benefits to GBA residents.

We expect that regulators will set criteria for what constitutes a GBA resident by referring to factors such as household registration, social security contributions, and living and residency records in the GBA.

What comes next, following the identification of GBA residents, is how to define a qualified investor. We discuss it in the next section since it is related to the types of wealth management products.

In addition, residents inside and outside the GBA are subject to different policies and treatment, and Wealth Management Connect products are designed to be sold to individual residents of the nine Mainland cities in the GBA. It will be difficult to prevent residents outside the nine cities from purchasing such products through borrowed quota, channels and accounts. The potential civil disputes as a result also call for early attention from relevant authorities.

II. Whether product standards will be set

The Guiding Opinions on Regulating the Asset Management Business of Financial Institutions (the "Guiding Opinions"), the Measures for the Supervision and Administration of the Wealth Management Business of Commercial Banks and the Measures for the Administration of Wealth Management Subsidiaries of Commercial Banks have fully regulated wealth management products offered by domestic banks in terms of fund-raising methods, product classification and targeted markets, leverage ratio of products, criteria for qualified investors, and sales modes.

The rules and standards for wealth management products distributed by banks in Hong Kong and Macao are different from those of the Mainland. The question is whether it is necessary to set standards for GBA residents to subscribe to wealth management products distributed by banks in Hong Kong and Macao, or whether it is possible to entirely rely on the regulation and product rules of Hong Kong and Macao financial regulators on those wealth management products. (For instance, the Hong Kong Securities and Futures Commission, the competent regulatory authority for investment products in the Hong Kong market, and the Hong Kong Monetary Authority, the competent regulatory authority for deposit business, both have imposed very specific authorisation or registration, product classification, suitability assessment, information disclosure and other regulatory requirements on different products). If we refer to the basic principles of financial connectivity mechanisms such as Shanghai-Shenzhen/Shanghai-Hong Kong Stock Connect and Bond Connect, Mainland residents in the GBA should also follow the rules introduced by Hong Kong and Macao financial regulators when subscribing for and investing in Hong Kong and Macao wealth management products and managing their investment positions in Southbound Wealth Management Connect. We also expect that Chinese regulators will put forward relevant provisions on the range and standards for Southbound Wealth Management Connect products from the perspectives of foreign exchange management scale, consumer protection and stability.

In this regard, we understand that in order to implement Southbound Wealth Management Connect as soon as possible, the scheme may focus on wealth management products publicly offered by banks in Hong Kong and Macao in the early stage. Such products may be those that have no investment threshold or complex product structure, or those whose underlying or associated assets are standardised products, including financial instruments such as funds, bonds and investment products with low risk ratings, and RMB and foreign currency deposits. The reasons are:

(i) Publicly offered products target standardised assets, meeting the investment preferences of the vast majority of individual investors; and

(ii) There is no excessive purchase threshold for publicly offered products, so personal use of foreign exchange can be controlled.

We believe it is not likely that privately offered wealth management products will be made available in the short term. Apart from consumer protection and other considerations, another important reason is that new GBA policy still focuses on promoting Qualified Domestic Limited Partner (QDLP) and Qualified Domestic Investment Enterprise (QDIE), which tend to find outbound investment possibilities for non-standard assets such as overseas private equity funds and unlisted equity investments. We would be happy if there could be more Southbound Wealth Management Connect products available.

III. Sales and funding pathways of wealth management products distributed by banks in Hong Kong and Macao

The subscription, investment, transfer, sale, liquidation, repatriation of funds of Southbound Wealth Management Connect products and management of positions of other products are not possible without the support of bank accounts and banking services. In February 2019 when Wealth Management Connect was first introduced, the Outline confirmed the proposal of "closed-loop management of funds". And there are two possible ways of its implementation:

(1) Referring to the "cross distribution of wealth management products" proposed in the Outline, which relies mainly on the account management system of banks in the nine cities to provide services such as product promotion, sales and fund clearing. Such banks act as agents for banks in Hong Kong and Macao (issuers) to lead business operations. In this way, Mainland regulations on capital inflow and outflow and territorial protection of Mainland investors will also be more

effective, and Mainland bank accounts are where cash flow takes place. This is a more convenient approach in terms of account opening and account management. However, when selling Hong Kong and Macao wealth management products on a commission basis, banks in the nine cities have higher requirements on whether they should comply with the sales requirements of both the Mainland and Hong Kong and Macao and on how to divide responsibilities.

(2) Relying on the practices of offshore banks to provide complete Southbound Wealth Management Connect services. The advantage of this approach is that banks in Hong Kong and Macao can complete relevant promotion, sales, disclosure, and management procedures under the local regulatory framework, provided that Mainland residents in the GBA open bank accounts with Hong Kong and Macao banks in advance. Under the current regulatory framework, however, it is difficult to open an account remotely in practice.

On the one hand, theoretically, remote account opening by Hong Kong and Macao banks with the help of the attestation services provided by their Mainland branches or affiliates ("Account Opening Attestation Banks") is, to some extent, likely to be taken as illegal cross-boundary financial service. Wealth Management Connect, if implemented in this way, may be regarded as a formal permit for Hong Kong and Macao banks to provide cross-boundary financial services for Mainland residents. On the other hand, Account Opening Attestation Banks can only open accounts in Hong Kong and Macao for Mainland residents holding long-term visas. This regulatory requirement is awkward in a sense. That is especially the case when the one-hour living circle in the GBA has already taken shape. Mainland residents who hold long-term visas can directly open accounts in Hong Kong and Macao without going through the attestation procedure of Account Opening Attestation Banks. The requirement is contrary to the original intention of the Opinions and the Outline to provide convenience and benefit to the people.

Therefore, we expect that Southbound Wealth Management Connect will consider the pros and cons of the above two approaches from the perspectives of product sales, capital flow and account management. The regulatory and banking cooperation of the three places will thus be strengthened.

From the perspective of sales, regulators need to be more tolerant of cross-boundary business of each other's financial institutions (Mainland regulators should not easily deem Hong Kong and Macao banks' financial services to Mainland customers illegal, and Hong Kong and Macao regulators should take an inclusive approach to the sales promotions of Mainland agency banks. Together they strive to promote business development by seeking common ground). Banks must emphasize business cooperation and information sharing (banks in Hong Kong and Macao in particular, should provide more business training for their Mainland agency banks, and endeavor to ensure maximum efficiency of compliance risk control by keeping their respective differences).

From the perspective of account opening, regulators should reassess risk factors in cross-boundary business (including asset safety and foreign exchange regulation), relax the conditions for Mainland residents in the GBA to open accounts in Hong Kong and Macao through a Mainland attestation bank, and make full use of virtual banking, e-banking and other new technologies to deal with and prevent traditional risks. On this basis, as far as subscription funds and proceeds remittance are concerned, it is necessary to strengthen business cooperation between Mainland banks and Hong Kong and Macao banks to ensure that onshore and offshore accounts under the same name are relevant in a closed loop, thus satisfying the requirement of "closed-end operation".

IV. Foreign exchange purchase quota of Mainland GBA residents for cross-boundary wealth management products

In our opinion, whether the cross-boundary wealth management connect scheme will continue the USD 50,000 annual quota is related to the types of wealth management products initially available. If Mainland GBA residents are allowed to buy publicly offered wealth management products from banks in Hong Kong and Macao as we anticipated, there are chances that they may use the above-mentioned foreign exchange quota directly or be provided with a separate quota of USD 50,000, which is more in line with the actual income of most Mainland residents in the GBA. Another option is to set two-way net inflow/outflow quotas with corresponding closed-end capital operations and macro control, with reference to the management mode of the previous Shanghai-Hong Kong Stock Connect/Shenzhen-Hong Kong Stock Connect or Mutual Recognition of Funds.

Conclusion

Despite restrictions in its early implementation, Southbound Wealth Management Connect will undoubtedly expand Mainland residents' direct access to services of Hong Kong and Macao financial institutions, without having to invest in Hong Kong financial products indirectly through QDIIs. For the same reason, allowing GBA residents to invest in these different financial markets puts forward higher requirements on the way to improve the financial risk management system, strengthen financial regulation cooperation and consumer protection in the three places.

As long as risks are under control, we believe that GBA financial markets will gradually establish smooth passages, allowing more Southbound Wealth Management Connect products to be available to Mainland residents in the GBA.

Analysis of the Wealth Management Connect Framework

Minny Siu, Richard Mazzochi, Cindy Shek, Yu Leimin, Agnes Chan

Minny Siu

Richard Mazzochi

Cindy Shek

Yu Leimin

Agnes Chan

I. Background

Cross-boundary Wealth Management Connect ("**Wealth Management Connect**") will soon operate across the **GBA**.

The Hong Kong Monetary Authority ("**HKMA**"), the People's Bank of China ("**PBOC**") and the Monetary Authority of Macao have unveiled the framework ("**Joint Framework**") in June 2020 for the Wealth Management Connect pilot scheme[1]. Later in February 2021, the PBOC, HKMA and other institutions signed a Memorandum of Understanding to clarify the scope of responsibility of relevant institutions regarding the supervision and cooperation of the GBA Wealth Management Connect. Recently in May 2021, the Guangzhou Branch of PBOC, Shenzhen Central Sub-branch of PBOC, China Banking and Insurance Regulatory Commission ("**CBIRC**") and other Chinese regulatory institutions have issued the draft "Implementation Arrangements for the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area (Draft for Solicitation of Comments)" ("**Implementation Rules**")[2].

The wealth management market has longed for the individual investor version of the qualified foreign institutional investor and the qualified domestic institutional investor schemes since 2015[3]. As mentioned in our Greater Bay Area publication issued in June 2020[4], the GBA Wealth Management Connect was initially proposed by the Central People's Government of the People's Republic of China in November 2019[5], and then supported by a joint opinion issued by the PBOC, CBIRC, China Securities Regulatory Commission ("**CSRC**") and State Administration of Foreign Exchange ("**SAFE**") in May 2020[6]. Following the successful launch of the Stock Connect in 2014 and the Bond Connect in 2017, the Wealth Management Connect is the latest access channel to the suite of Connect schemes linking the capital markets in China Mainland and Hong Kong SAR.

This article synthesises important information about the Wealth Management Connect in the Joint Framework and the Implementation Rules.

[1] HKMA, "Joint Announcement of the People's Bank of China, the Hong Kong Monetary Authority, and the Monetary Authority of Macao on the Launch of the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area" (dated 29 June 2020), available at https://www.hkma.gov.hk/eng/news-and-media/press-releases/2020/06/20200629-4/.

[2] Implementation Arrangements for the Cross-boundary Wealth Management Connect Pilot Scheme in the Guangdong-Hong Kong-Macao Greater Bay Area (Draft for Solicitation of Comments) (《关于 < 粤港澳大湾区"跨境理财通"业务试点实施细则（征求意见稿）> 公开征求意见的通知》) (dated 6 May 2021), available at http://guangzhou.pbc.gov.cn/guangzhou/129142/129156/3833128/4243943/index.html (Chinese only).

[3] For more details, please refer to our publication entitled "KWM Connect - China Stock Connect and Mutual Recognition of Funds" (June 2015), available at https://www.kwm.com/en/hk/knowledge/downloads/kwm-connect-crossborder-investment-hk-china-20150630.

[4] King & Wood Mallesons, "Something for everyone: New plans to support the development of the Greater Bay Area unveiled" (dated 8 June 2020), available at https://www.kwm.com/en/hk/knowledge/downloads/new-plans-to-support-gba-unveiled-20200608.

[5] Press release of the HKSAR Government entitled "CE attends meeting of Leading Group for Development of Guangdong-Hong Kong-Macao Greater Bay Area (with photos/videos)" (dated 6 November 2019), available at https://www.info.gov.hk/gia/general/201911/06/P2019110600764.htm?fontSize=1.

[6] Opinions on Financial Support for the Development of the Guangdong-Hong Kong-Macao Greater Bay Area jointly issued by the PBOC, CBIRC, CSRC and SAFE (" 中国人民银行 中国银行保险监督管理委员会 中国证券监督管理委员会 国家外汇管理局关于金融支持粤港澳大湾区建设的意见 ") (dated 14 May 2020), available at http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4023428/index.html (Chinese only).

II. Wealth Management Connect – Southbound and Northbound

According to the Implementation Rules, the Wealth Management Connect is defined as follows:

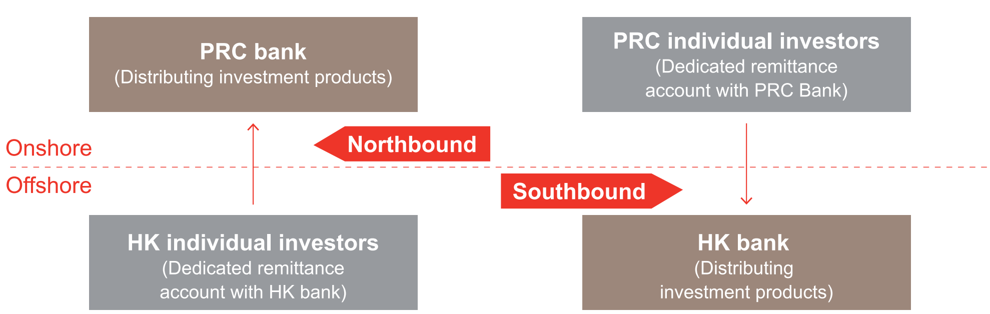
What is "Wealth Management Connect"?

It is an arrangement under which eligible individual residents in the GBA carry out cross-boundary investment in wealth management products distributed by banks in GBA. This is established through a closed-loop funds flow channel of the regional banking system, including:

(a) *Southbound route* - for individual residents of the Mainland cities in the GBA to access offshore wealth investment products distributed by banks in Hong Kong (and Macao) (i.e. Mainland investors investing in Hong Kong/Macao); and

(b) *Northbound route* - for individual residents of Hong Kong and Macao to access onshore PRC wealth investment products distributed by banks in the GBA (i.e. offshore investors investing in Mainland China).

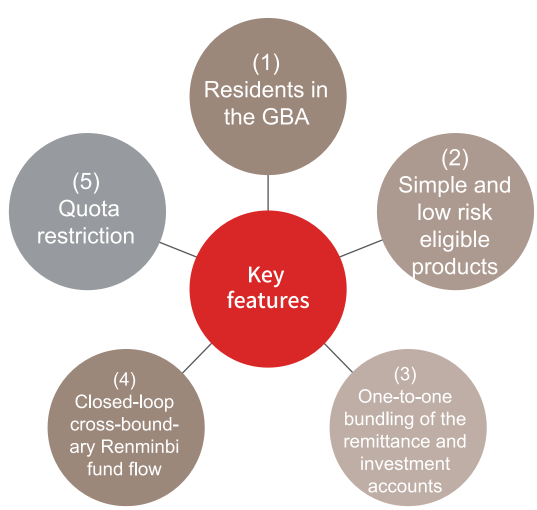
The diagram below illustrates the southbound and the northbound investment flows contemplated under the Wealth Management Connect.



III. Key features

Key features of Wealth Management Connect are highlighted below:

Key features of Wealth Management Connect

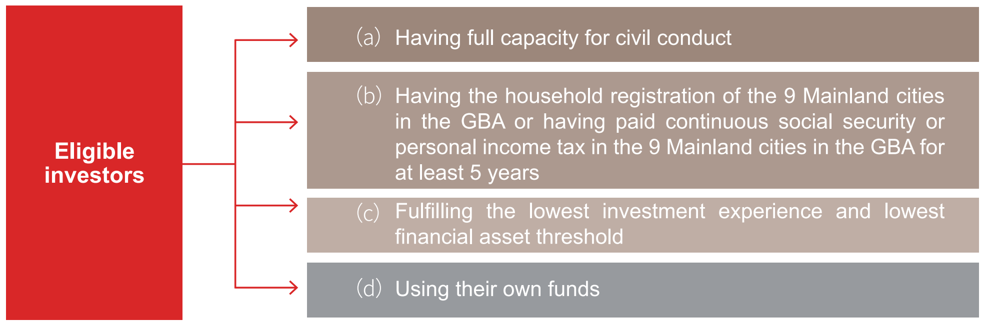


(I) Scope of eligible investors – residents in the GBA

Eligible individuals in China Mainland and Hong Kong SAR can personally (and not in joint names) make cross-boundary investments through the Wealth Management Connect.

Southbound route

Eligible Mainland investors must fulfil at least four requirements as illustrated below.



According to the Implementation Rules, eligible Mainland investors must meet the following requirements:

1) having full capacity for civil conduct;
2) having the household registration of the 9 Mainland cities in the GBA or having paid continuous social security or personal income tax in the 9 Mainland cities in the GBA for at least 5 years;
3) having more than 2 years of investment experience and having a household financial net asset end-of-month balance of not less than Renminbi 1 million in the last 3 months, or having a household financial asset end-of-month balance of not less than Renminbi 2 million in the last three months; and
4) using their own funds to purchase investment products.

Northbound route

Eligible Hong Kong investors must meet the relevant requirements set by the Hong Kong financial regulators. At present, the Hong Kong financial regulators have not yet announced the relevant rules. We expect that all Hong Kong resident identity card holders will be eligible Hong Kong investors.

(II) Eligible investment products – simple and low risk products

Southbound route

The scope of the investment products in the southbound route is regulated by the Hong Kong financial regulators. At present, the Hong Kong financial regulators have not yet announced the relevant rules. We expect that during the initial stage of the Wealth Management Connect, low-risk wealth management products with a simple structure (such as mutual funds) are more likely to be included as eligible investment products under the southbound route, whereas high-risk products with a complex structure may only be included for trading at a later stage.

Northbound route

According to the Implementation Rules, the scope of investment products under the northbound route (i.e. onshore Chinese wealth management investment products available for Hong Kong residents to invest) include:

1) Non-guaranteed net worth wealth management products (except cash management financial products) issued by Mainland Chinese financial companies (including wealth management subsidiaries of banks and joint venture wealth management companies controlled by foreign companies), and assessed by the issuer and the Mainland agency bank[7] to be of "level 1" to "level 3" risk;

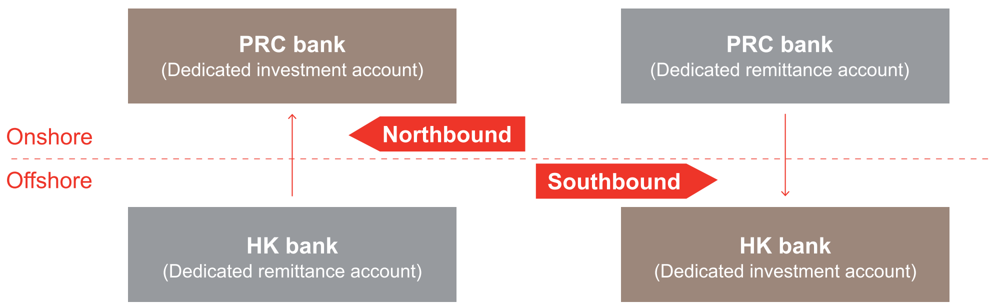
[7] "Mainland agency banks" refer to the Mainland banking financial institutions in the GBA that sell investment products under the northbound route as agents.

2) Publicly offered securities investment funds assessed by the Mainland public fund manager and the Mainland agency bank with a risk rating of “R1” to “R3”.

(III) Account opening and bundling – one-to-one bundling of the remittance and investment accounts

Investors must open a new local account or use an existing local account as the dedicated remittance account. After a local commercial bank has reviewed the requisite application documents, investors may open a dedicated investment account with a designated bank in Hong Kong SAR or China Mainland (as the case may be). As illustrated below, the dedicated investment account should be bundled with the dedicated remittance account with a bank in Hong Kong SAR or China Mainland (as the case may be).

One-to-one bundling of the designated remittance account and the designated investment account

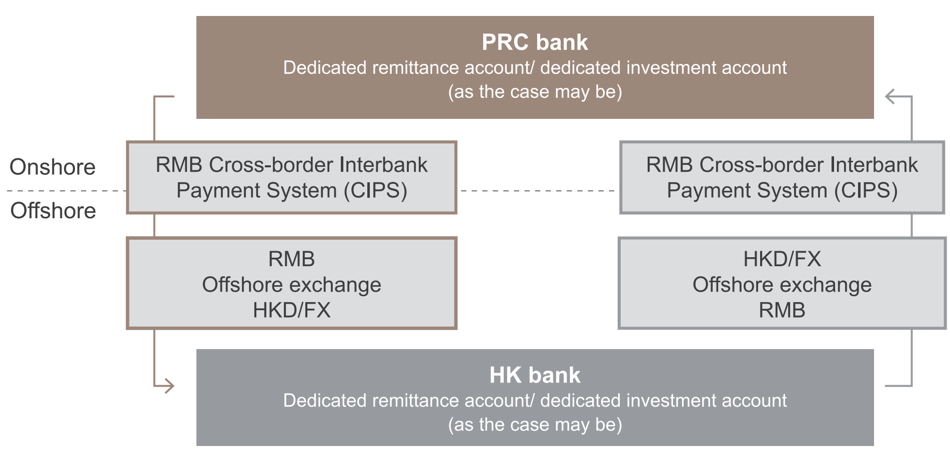


(IV) Closed-loop mechanism of cross-boundary funds flow

The Joint Framework and the Implementation Rules provide that the cross-boundary flow of funds between China Mainland and Hong Kong SAR will be implemented through the one-to-one bundling of the dedicated investment account and the dedicated remittance account subject to closed-loop mechanism and quota management.

According to the Implementation Rules, all cross-boundary remittances of the Wealth Management Connect should be conducted in Renminbi, and any FX/CNY currency conversion must be conducted in the offshore market. The following diagram shows the closed-loop mechanism of cross-boundary funds flow through the Renminbi Cross-border Interbank Payment System (“**CIPS**”).

Closed-loop system of cross-boundary funds flow under the Wealth Management Connect



We summarise the relevant Implementation Rules as follows:

1) Investors may use Renminbi for cross-boundary remittances subject to the aggregate and individual investor quotas prescribed by the regulators from time to time;
2) Funds deposited in the dedicated investment account can only be used to purchase eligible investment products. If the wealth management product is denominated in Hong Kong dollar or other foreign currencies, Renminbi will be converted into an appropriate currency in the offshore market;
3) Investors cannot withdraw money from the dedicated investment account; and
4) Realised investment proceeds will be converted into Renminbi and remitted through the CIPS for cross-boundary remittance.

Currently, the relevant Hong Kong financial regulators have not yet announced the relevant cross-boundary remittance rules. We expect that the rules of the Hong Kong financial regulators will be consistent with the Implementation Rules.

(V) Quota restriction

The cross-boundary fund flows under the northbound and southbound Wealth Management Connect are subject to aggregate and individual investor quotas prescribed by the regulators from time to time. In accordance with Articles 41 and 46 of the Implementation Rules, the current aggregate and individual investor quota are tentatively set at 150 billion yuan[8] and 1 million yuan respectively[9].

Conclusion

The fund industry has anticipated that the number of HK fund customers will increase 10-fold due to the Wealth Management Connect[10]. The Wealth Management Connect will foster financial integration and create greater connectivity between Hong Kong SAR and China Mainland. It will "further consolidate Hong Kong's role as an international financial centre and the world's offshore Renminbi business hub". Eddie Yue, the Chief Executive of the HKMA, pointed out that[11]:

> *[the] WMC will create a much greater customer base and generous room for growth for Hong Kong's financial services industry. …. it will drive the development of the entire financial services value chain, encompassing product development, distribution, asset management and related professional and support services, …. expand the catchment area of our wealth management industry, providing greater incentives for global financial institutions to set up and expand their presence in Hong Kong to serve Mainland investors.*

[8]Net inflow of funds for northbound route = cumulative inflow of funds for northbound route – cumulative outflow of funds for northbound route; Net outflow of funds for southbound route = cumulative outflow of funds for southbound route – cumulative inflow of funds for southbound route.

[9]Net personal funds inward remittance for northbound route = cumulative inward remittance for northbound route – cumulative outward remittance for northbound route; Net personal funds outward remittance for southbound route = cumulative outward remittance for southbound funds– cumulative inward remittance for southbound route.

[10]South China Morning Post, "Hong Kong wealth managers can't wait for new Connect programme, with Singapore ready to pounce on city's troubles" (dated 22 June 2020), available at https://www.scmp.com/business/banking-finance/article/3089974/hong-kong-wealth-managers-cant-wait-new-connect-programme.

[11]HKMA, inSight "Wealth Management Connect Scheme in the Greater Bay Area" (dated 29 June 2020), available at https://www.hkma.gov.hk/eng/news-and-media/insight/2020/06/20200629/.

Developments for Hong Kong insurance linked securities

Minny Siu, Angus Sip, Cindy Shek

Minny Siu

Angus Sip

Cindy Shek

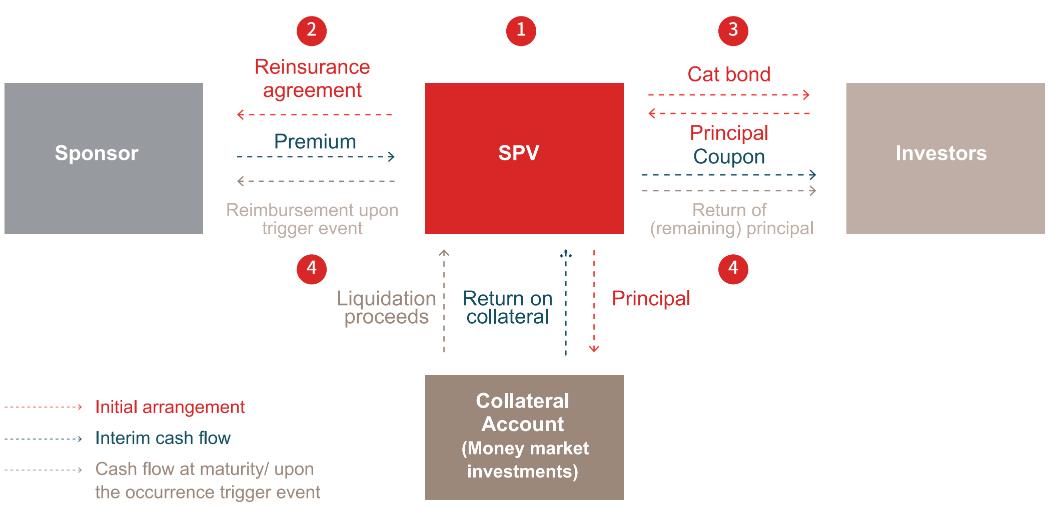
The Hong Kong Government has introduced legislative amendments to facilitate the issuance of insurance linked securities (**ILS**) in Hong Kong SAR. The Insurance (Amendment) Ordinance 2020[1] (**Ordinance**) and the Insurance (Special Purpose Business) Rules[2] (Cap. 41P of the Laws of Hong Kong) (together, the **Amendments**) provides the legal framework for the issuance of ILS in Hong Kong, and has come into force on 29 March 2021. Further, to attract issuers and sponsors of onshore and offshore institutions to issue ILS in Hong Kong, the Hong Kong government announced a two-year Pilot Insurance-linked Securities Grant Scheme followed by more details regarding that scheme on 3 May 2021 released by the Insurance Authority (**IA**).

With privileged access to the China Mainland market and the "Belt & Road"[3], "Greater Bay Area"[4] and "Wealth Management Connect"[5] initiatives as broader policy drives, Hong Kong SAR is well-positioned to tap into the growing opportunities in China Mainland's reinsurance market where Mainland Chinese insurance companies are likely to take advantage of the newly proposed regime to issue ILS in Hong Kong. This is also supported by the 16 policy measures introduced by the Mainland Government after the third meeting of the Leading Group for the Development of the GBA[6], one of which explicitly provides the support for Mainland insurers to issue catastrophe bonds in Hong Kong and Macao SAR.

This article examines the newly introduced ILS regulatory regime in Hong Kong.

I. What is an ILS?

ILS is a financial instrument that allows protection buyers (who are usually insurers or reinsurers who are commonly known as sponsors) to transfer their insured risk to the capital markets investors through securitisation.



[1] https://www.legco.gov.hk/yr19-20/english/ord/2020ord017-e.pdf
[2] https://www.elegislation.gov.hk/hk/cap41P
[3] https://www.kwm.com/en/hk/knowledge/insights/chinas-belt-and-road-overview-20170522
[4] https://www.kwm.com/en/hk/knowledge/hubs/greater-bay-area
[5] https://www.kwm.com/en/hk/knowledge/insights/gba-series-wealth-management-connect-20200706
[6] https://www.info.gov.hk/gia/general/201911/06/P2019110600764.htm

How does ILS work?

1. In a typical ILS transaction, a sponsor (typically an insurer) will arrange for the establishment of a special purpose vehicle (SPV) for ILS issuance.
2. The sponsor will then transfer its insurance risk to the SPV through a reinsurance agreement between them.
3. The SPV then issues ILS (for example in the form of a catastrophe bond) to investors in the capital market to finance the full amount of the risk assumed by the SPV under the reinsurance agreement.
4. Repayment or return to the investors is linked to the underlying insurance risk – any claims made by the SPV to the sponsor triggered under the reinsurance agreement will be subsumed in the payout to the investors.

II. Why are ILS attractive?

Given the increase in climate change-related catastrophic events, there has been an increasing demand in catastrophe bonds, one of the most popular forms of ILS. Global issuance of ILS has grown substantially in recent years, reaching approximately US$11 billion in 2019[7].

ILS are attractive to insurers and institutional investors alike for a number of reasons:

Insurers

- ✓ ILS allows insurers to spread and alleviate risks
- ✓ ILS is another form of raising capital

Institutional investors

- ✓ ILS has an attractive yield profile
- ✓ ILS is an alternative solution to traditional assets
- ✓ ILS has a natural decorrelation from other financial asset class, as such act as a significant risk reducer in investment portfolios

III. What are the Amendments about?

In a Legislative Council discussion paper in relation to its initiatives to promote the development of the insurance industry in Hong Kong[8], the Hong Kong Government noted that the purpose and nature of ILS business, which is essentially the transfer of insurance risks to the capital markets, were very different from the conventional insurance and reinsurance businesses regulated under the Insurance Ordinance (Cap. 41) (IO) before the Amendments came into force.

In particular, applying the previous stringent regulatory requirements under the IO (such as the capital and solvency requirements, reporting requirement, corporate governance requirement, etc.) to ILS business makes issuance of ILS in Hong Kong extremely costly and cumbersome, if not impractical. Accordingly, the Hong Kong Government has recognised the need to create a unique regulatory regime under the IO for ILS.

IV. "Special purpose insurer"

Against this backdrop, the Amendments seek to provide for the regulation of "special purpose insurer" (SPI), a new type of authorised insurer which is set up solely for the purpose of carrying out a new class of insurance business, namely the "special purpose business".

What is a "special purpose business"?

It is designed for the SPI to acquire insurance risk from another insurer/ reinsurer under a reinsurance agreement and then issuing ILS to investors to fully collateralise the risk acquired.

[7] The Artemis Catastrophe Bond & Insurance-Linked Securities Deal Directory.

[8] LC Paper No. CB(1)175/19-20(07) dated November 2019 entitled *"The Government's Initiatives to Promote the Development of the Insurance Industry in Hong Kong"*.

Authorisation as a SPI is subject to the following requirements:

Under the Amendments, the IA is empowered to specify the form in which an SPI submits information to the IA, and modify or vary the reporting or corporate governance requirements under the IO in relation to an SPI. Due to the Amendments, the regulatory requirements under the IO have been relaxed with respect to a SPI such that a light touch regulatory regime has been introduced to promote Hong Kong as an attractive domicile for issuing ILS.

V. Restrictions on the sale of ILS

Under the Amendments, the IA will also be empowered to formulate rules to restrict the sale of ILS, such as prescribing requirements relating to the financial condition, solvency and sophistication of ILS investors. Given the nature of the underlying risks of investing in ILS and the potential losses that may arise upon the occurrence of a designated trigger event, it is intended that ILS should only be allowed to be sold to certain qualified institutional investors (such as Mandatory Provident Fund Schemes, occupational retirement schemes and authorised retail funds) and not ordinary retail investors.

VI. What's next?

The new ILS regime came into effect on 29 March 2021 and brought about significant business opportunities emerging in Asia's insurance market. The IA has subsequently issued the "Guideline on Application for authorisation to carry on Special Purpose Business" (GL-33)[9] which took effect on 30 June 2021, so as to provide further granular details and requirements on how a prospective SPI can apply with the IA for authorisation to carry on special purpose business. Together with the recent GBA initiatives to facilitate cross-border insurance investments, the new ILS initiatives will facilitate further connections and integration of market players in China Mainland and Hong Kong, leveraging off their respective expertise and knowledge.

[9]https://www.ia.org.hk/en/legislative_framework/files/GL33EN.pdf

Merger of two Bond Markets in China? - from a foreign perspective

Stanley Zhou, Minny Siu, Stella Wang, David Mu

Stanley Zhou

Minny Siu

Stella Wang

David Mu

The People's Bank of China ("PBOC") and the China Securities Regulatory Commission ("CSRC") published a joint announcement[1] and a press release[2] on 19 July 2020 with the aim to build up an Onshore Infrastructure Connect between the China Interbank Bond Market ("CIBM") and the Exchange-traded Bond Market ("ETBM"), which is viewed as an important step to merge the two markets into "one" unified onshore bond market.

While the offshore investors are exploring the potential opportunities and waiting to see the detailed rules to implement the joint announcement, a consultation paper (the "Consultation Paper")[3] published by the PBOC, the CSRC and the State Administration of Foreign Exchange ("SAFE") on 2 September 2020 proposes an even brighter future for the foreign market participants. Another consultation paper[4] was released by the PBOC and the SAFE on 21 September 2020 to come up with regulations supporting the abovementioned Consultation Paper from the perspective of cross-border fund management.

This paper seeks to provide a high-level introduction to the above joint announcement and the Consultation Paper, and we hope to join hands with our offshore clients in becoming part of the reforms.

I. Two bond markets in China

It may be a long story that how the two markets were formed and developed but the summary table below may help you understand what they are.

[1]http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4058970/index.html
[2]http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4058966/index.html
[3]http://www.pbc.gov.cn/goutongjiaoliu/113456/113469/4080874/index.html
[4]http://www.pbc.gov.cn/tiaofasi/144941/144979/3941920/4100044/index.html

	CIBM		ETBM	
Key regulators	PBOC/NAFMII		CSRC	
Market share	Above 90%		Less than 10%	
Trading platform	CFETS		Shanghai Stock Exchange	Shenzhen Stock Exchange
Trading model	• Bilateral negotiation: akin to block trading; • RfQ: investor to ask market maker; • Click: investor to click on existing quotes of market maker; • X-bonds*: akin to matching system		• Order matching system; • Block trading; • RfQ	
Depository / clearing house	CCDC	SHCH	ChinaClear (aka CSDCC)	
Investors	Wholesale: institutional investors		Retail: institutional + individual investors	
Foreign access channels	• QFII/RQFII; • Bond Connect; • CIBM Direct		• QFII/RQFII	
Key PRC law	PRC PBOC Law		PRC Securities Law	

*Not available for all foreign access channels below.

II. Possible reasons for the "merger"

There could be a wide range of reasons behind the initiative to "unify" two bond markets, and we just list out some core background factors driving this reform.

(I) Serving the real economy

Chinese financial markets are required to spur and serve the real economy in recent years, to which the ETBM is believed to be closer for that purpose because of a larger base of non-financial issuers.

Traditionally, onshore banks (acting for proprietary business or wealth management products ("**WMP**")) can only access the CIBM.

Onshore banks have been allowed to invest int the ETBM bonds for WMPs since August 2019, and a bigger ETBM is expected.

(II) Creating a level playing field

In the past, two markets were subject to two different sets of laws and rules in respect of bond issuance, registration and depository, settlement and clearing, etc. This gave rise to different standards to be applied in dispute resolutions and other controversial topics, such as whether CIBM bonds are securities under the PRC Securities Law.

In 2018, the PBOC, the CSRC and the National Development and Reform Commission ("**NDRC**") once published a joint opinion with the attempt to have the CSRC exercise unified enforcement powers in the CIBM and the ETBM.

The Supreme People's Court published the meeting minutes on the adjudication of bond disputes ("**Bond Dispute Minutes**"[5]) on 15 July 2020, which are meant to set forth unified principles, standards and guidelines for bond disputes in both the CIBM and the ETBM.

The joint announcement tries to create a level playing filed for bonds in both markets which enables courts to apply unified principles, standards and guidelines more easily and naturally.

[5]Only the Chinese version is available at http://www.court.gov.cn/fabu-xiangqing-241671.html.

(III) Forming a unified "price discovery" mechanism

The press release relating to the joint announcement indicated that a "unified" market can grow only after capital moves between the two bond markets freely. This will help to establish a better "price discovery" mechanism by taking advantages of all types of pricing mechanisms and trading models across the CIBM and the ETBM and increase the efficiency the monetary policies and macroeconomic regulation measures to influence the real economy.

III. What does the "merger" look like?

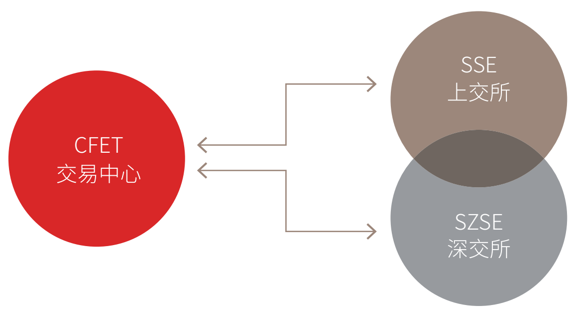
This section lists out below the key take-aways of the joint announcement for the purpose of understanding its potential impacts on foreign participants.

(I) Trading Connect and Clearing Connect

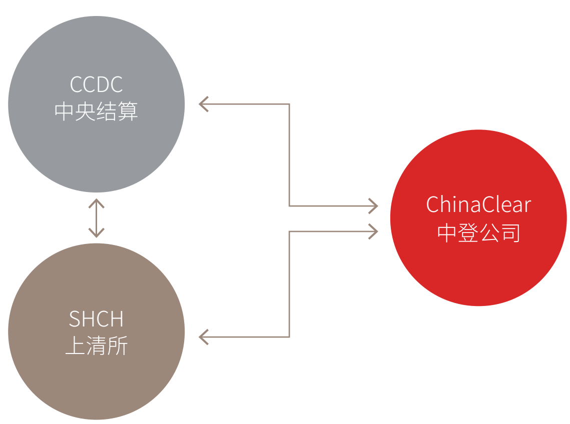
As can be seen in the summary table in paragraph 1 above, the CIBM and the ETBM operate in complex trading and clearing systems, pillared by different financial infrastructures.

The key to the "merger" is "Onshore Infrastructure Connect" as contemplated in the joint announcement, comprising:

- Trading Connect: refers to joint efforts to be made by the trading platforms of the CIBM and the ETBM for offering "unified" bond trading services.



- Clearing Connect: refers to joint efforts to be made by depository and clearing houses of the CIBM and the ETBM for offering various services relating to bond issuance, registration, clearing and settlement, payments, etc.



(II) Nominee account structure in Clearing Connect

In respect of the joint clearing and settlement services among different depository and clearing houses in the Clearing Connect, a nominee account structure is contemplated in the joint announcement.

This is innovative in the onshore markets but not new if you are familiar with the Mainland – HK Bond Connect / Stock Connect regimes.

In particular, we expect that any one among the CCDC, SHCH and ChinaClear will open a nominee account with other two joint clearing and settlement services:

- CCDC will open nominee accounts with SHCH and ChinaClear;
- SHCH will open nominee accounts with CCDC and ChinaClear;
- ChinaClear will open nominee accounts with CCDC and SHCH.

Booking records of each infrastructure (CCDC / SHCH / ChinaClear) will be valid proof of the bond holdings of beneficial investors behind the scene.

We will further discuss this exciting reform trend later.

(III) How can onshore banks access the ETBM after the "merger"?

Onshore banks (except onshore rural commercial banks) can choose either of the followings to access the ETBM:

- existing approach: through their bond accounts opened with ChinaClear directly; or
- new approach: leveraging the CCDC / SHCH nominee accounts opened with ChinaClear through the Onshore Infrastructure Connect.

IV. Possible impact on foreigners? – more than meets the eye

The joint announcement and the Consultation Paper will surely bring long-term impact to the onshore bond markets and its participants. Considering the types of overseas clients that may be interested in this topic, we are looking into the potential impacts from three different angles.

(I) From foreign issuers' perspective

There have been Panda Bonds issued on both the CIBM and ETBM. The following table lists out the major Panda Bond / Mulan Bond[6] issuers.

	CIBM	ETBM
Issuers include:	IFC, ADB, BOCHK, HSBC, SCB, South Korea, Province of BC, etc.	Yuexiu Transport Infrastructure, China Merchants Group, GLP, ChinaGas Holdings, BEWG, RUSAL, etc.

The NAMFII published the guidelines (trial) for issuing Panda Bonds in the CIBM in January 2019 while the issuance of Panda Bonds in the ETBM still follows a set of rules originally applicable to domestic bond issuers. We envisage that different rules for Panda Bond issuance may be aligned in the future.

(II) From foreign-invested trustees' perspective

Unlike international bond market, bond trustee is not a widely accepted or established concept for all onshore bonds.

One of the key and encouraging messages from the SPC's Bond Dispute Minutes is that bond trustees will be the major plaintiffs in bond disputes. This is expected to become the mainstream of the lawsuits, compared with past cases where bondholders sued individually.

This reform could change the landscape of the bond trustee business in China. Class actions filed by trustees in some recent cases (such as PKU Founder' default) outplayed traditional actions filed by individual investors. New guidelines have been published by the NAFMII to eliminate the gap between the enforcement practices in two markets.

International professional trustees should be looking into this opportunity.

[6]SDR denominated bonds issued by World Bank in China are called Mulan Bonds.

(III) From foreign investors' perspective

1. Expanded types of eligible overseas institutional investors

Compared with the previous PBOC notice approving the CIBM Direct channel in 2016, the Consultation Paper expressly proposes to allow more type of overseas institutional investors, including foreign futures companies and trust companies.

This could be an exciting point to explore as many offshore issuers (including orphan SPV issuers for off-balance sheet notes) are interested in offering repackaging notes underlied by onshore assets (including bonds in the CIBM and the ETBM). Whether the expanded scope of the eligible investors will include those repackaging note-issuers or the arranger banks of the repackaging notes, is still unknown.

It is worth noting that overseas institutional investors acting for and on behalf of overseas products under their management are no longer required to file with the PBOC.

2. Using existing CIBM access channel to access ETBM

There were fewer programmes for foreign investors to access the ETBM before the Consultation Paper is published.

The Consultation Paper conceives of a combined structure for foreign investors to access the ETBM by leveraging off the existing Bond Connect / CIBM Direct and the Onshore Infrastructure Connect contemplated in the joint announcement, without creating another cross-border access channel.

Current programmes	CIBM	ETBM
Foreign access channels	• QFII/RQFII; • Bond Connect; • CIBM Direct	• QFII/RQFII

After	CIBM	ETBM
Foreign access channels	• QFII/RQFII; • Bond Connect; • CIBM Direct	• QFII/RQFII; • Bond Connect + Onshore Infrastructure Connect; • CIBM Direct + Onshore Infrastructure Connect

We believe that a foreign investor which has already filed with the PBOC for investing in the CIBM can leverage off the nominee accounts opened by the CCDC / SCH with the ChinaClear so as to have the ETBM trade cleared and settled.

3. Internationally accepted custodian structure

One of the key changes in the Consultation Paper is to propose, in addition to the current settlement agent role of onshore banks, a custodian bank role, which is believed to be more acceptable to foreign investors.

Moreover, the Consultation Paper suggested that CIBM bonds purchased by overseas institutional investors through onshore custodian banks will be held in those custodian banks' omnibus accounts. Overseas institutional investors will be recorded as beneficiary owners by means of book entry and on the basis of "segregation".

This could be a ground-breaking reform measure because traditionally CIBM bonds were held in bond accounts opened directly with the CCDC and/or SCH in the name of the investors through the settlement agent. This new proposal could pave the way to a multi-layer settlement regime in the CIBM market that could be promoted in the future to align with the international practice. Of course, it could also bring challenges to the existing legal regime in relation to the settlement, registration (for both transfer and security).

V. Next step?

The FTSE announced on 25 September 2020 the inclusion of Chinese bonds in its flagship World Government Bond Index (WGBI) as scheduled, which will come into force on 1 October 2021. By far, Chinese bonds have been included in all three major bond indices, indicating the recognition of world index providers and overseas investors for China's endeavors to open the domestic bond market.

New trend of financial development in Macau SAR: highlights from the First Policy Address of the New Chief Executive

James Zeng, Zhang Zhujun

James Zeng

On 20 April 2020, Ho lat Seng, the new Chief Executive of the Macau Special Administrative Region (Macau SAR), delivered his first Policy Address for the Fiscal Year 2020 (Policy Address) entitled “Forging Ahead Towards New Horizons” at the Legislative Assembly.

Ho lat Seng put forward the administrative priorities in 2020: “Fighting the pandemic, safeguarding employment, stabilising economy, caring for people’s livelihoods, implementing reform, and facilitating development”. In particular, Macau SAR will speed up development of financial software and hardware infrastructure, develop a modern financial services industry, and establish Macau as a financial services platform between China and Portuguese-speaking countries.

First, perfect the supporting systems for financial services

The development of financial services industry necessitates well-established supporting systems. In his Policy Address, Chief Executive Ho announced efforts to review and amend the existing laws and regulations governing the financial sector and promote the legislative progress in areas such as the Trust Law; follow up the feasibility study of establishing a RMB-denominated securities market in Macau SAR; establish and put into operation a “Guangdong-Macau cross-border electronic direct payment system”; and carry out technical research and preparation for the data center and financial infrastructure facilities, and the Central Security Depository (CSD) system that will link Macau to the international financial market.

Macau’s financial sector, though representing a relatively small proportion of the overall GDP, has long term been regarded as a pillar industry. Restricted by its small market scale, however, Macau’s financial market lags behind that of other mature economies, far from satisfying the demand of market players at a higher level. With the optimisation of the system and the improvement of software and hardware infrastructure, Macau’s financial industry is expected to level up, attracting more market participants.

Second, promoting diversification of financial services industry

In recent years, the pace of development has accelerated in Macau's financial services industry, in particular its bond market. In 2018, Nam Kwong (Group) Company Limited launched the first financial asset trading platform Chongwa (Macau) Financial Asset Exchange Co., Ltd (MOX) in Macau SAR, which has successfully issued overseas bonds for many domestic institutions.

In the Policy Address, Ho lat Seng put forward new requirements for promoting diversification of financial services, and identified financial lease, wealth management and bond market as the main strands. The Policy Address explicitly stated that Macau SAR will strive to attract more qualified financial lease companies, endeavor to implement the Cross-boundary Wealth Management Connect Scheme to facilitate cross-border sales of wealth management and financial products, lay out financial infrastructure of the bond market, and strengthen cooperation with China Securities Regulatory Commission in supervision system, personnel training and exchange, etc.

An active bond market will not only attract more mainland enterprises, especially those in the GBA, to issue bonds in Macau SAR, but also provide a new financing channel and business platform for domestic financial institutions engaged in bond business in the country.

Third, Macau will be constructed as RMB Offshore Financial Center.

Chief Executive Ho stressed in his Policy Address that the Macau SAR would set up a cross-border RMB clearing center, promote financial institutions to expand RMB financial products, promote the use of RMB in Portuguese-speaking countries and strive for more policies and measures that support building Macau into a RMB clearing center for Portuguese-speaking countries.

Although the specific policy is still awaited, this is undoubtedly an important measure to promote RMB internationalization and Guangdong-Macau regional cooperation. Multinational enterprises can use the cross-border RMB clearing center to carry out centralised operation and management of RMB and foreign currency funds, avoid exchange rate risks and save expenses. Financial institutions and enterprises in Guangdong and Macau can rely on financial markets at home and abroad to efficiently allocate and use financial resources to promote Macau’s financial services industry.

As more and more loan projects involving Portuguese-speaking countries are selected to perform in Macau, the establishment of a RMB clearing center between China and Portuguese-speaking countries will not only facilitate free flow of capital between Chinese enterprises and Portuguese-speaking countries via Macau, but also bring more opportunities for market entities in Macau’s financial industry to expand their business in Portuguese-speaking countries spanning Europe, Africa and Latin America. Under the background of the state's efforts to promote the internationalization of RMB and Macau’s role as a China-Portugal financial services platform, speeding up the construction of a RMB clearing center for Portuguese-speaking countries will further develop Macau into an offshore RMB financial center.

In order to support Macau’s development of featured finance, the Central People’s Government has also issued a series of important policies, which will undoubtedly boost Macau's financial services industry. With the deepening of the financial development and cooperation in the GBA, the growing willingness of Macau to promote its financial services industry, and the continuous optimisation of supporting systems, Macau’s financial services industry will surely enter a brand-new stage.

Macao - a new option for Mainland leasing companies to build an overseas presence

Wang Ning, José Lupi, Chen Jie, Li Yueyang

Wang Ning

José Lupi

Introduction

Macao Special Administrative Region of China ("**Macao**"), as one of the four central cities in the development and construction of the Guangdong-Hong Kong-Macao Greater Bay Area, has a unique geographical advantage and plays an important role in the "Belt and Road" construction.

At the end of 2018, the National Development and Reform Commission (the "**NDRC**") signed the *Arrangements between the National Development and Reform Commission and the Government of Macao Special Administrative Region for Supporting Macao in Fully Participating in and Contributing to the Belt and Road Initiative* (the "**Arrangements**") with Macao with the approval of the State Council. The Arrangements support Macao in developing financial leasing and other special financial services. On 8 April 2019, Macao issued the *Legal Regime for Financial Leasing Companies* (the "**Regime**") and the Tax Concession Regime for Financial Leasing to promote the development of financial leasing business in Macao and attract financial leasing companies to settle in Macao and carry out business. On 20 December 2019, China Banking and Insurance Regulatory Commission (the "**CBIRC**") also promulgated the *Policies and Measures to Support Macao's Economic Development Implemented by the CBIRC*, supporting "the establishment of financial leasing subsidiaries in Macao by Mainland financial leasing enterprises to develop Macao's special finance".

Based on the promulgation and implementation of the Arrangements, relevant laws and policies, etc., along with the development of international financial leasing business in Macao, Macao will become a new option for Mainland leasing companies to set up overseas leasing platform companies for outbound investment following Ireland, Hong Kong SAR and other locations.

As early as 2017, King & Wood Mallesons ("**KWM**") successfully assisted our client in setting up the first financial leasing subsidiary of a Mainland finance leasing company in Macao. As the leading counsel in the project, KWM played an important role in the successful establishment of the client's Macao subsidiary and accumulated rich practical experience.

As many Mainland leasing companies have recently shown interest in setting up leasing platforms in Macao, we preliminarily introduce the legal issues related to the establishment of financial leasing companies in Macao by Mainland leasing companies in this article.

FINANCIAL MARKETS

I. Introduction to the legal regimes of Macao concerning financial leasing companies

(I) Applicable core regulations

- On 8 April 2019, Macao introduced the No. 6/2019 Law (i.e. the Regime), which establishes a new legal regime for financial leasing companies in Macao and is also the core legal regulation applicable to the establishment of financial leasing companies in Macao. In addition, Macao also introduced the No. 7/2019 Law (i.e. the *Tax Concession Regime for Financial Leasing*), which provides the relevant tax concession for financial leasing (including tax concession in respect of stamp duty and income supplemental tax).
- The above two regulations apply to financial leasing companies and subsidiaries for financial leasing projects established in Macao. These two types of entities are "financial institutions" in nature, and are defined as follows:

Financial leasing company	A financial institution that specializes in financial leasing business
Subsidiary for financial leasing project	A financial institution wholly owned by **a bank or financial leasing company** licensed to conduct business in Macao for the purpose of holding and managing a single financial leasing project

With regard to the licensing of financial leasing companies, such companies are redefined as financial institutions which are not credit institutions. Thus, the provisions of the No. 32/93/M Macao Decree – the regime on credit institutions do not apply to the financial leasing companies, such as the restrictions on capital adequacy ratio and risk exposure to a single client.

- Two major highlights of the applicable core regulations:

  (1) Lowering the threshold for setting up financial leasing companies in Macao; and

  (2) Relaxing the regulatory requirements for financial leasing companies by the Macao Government.

We will further introduce the thresholds for the establishment of financial leasing companies in Macao and the related regulatory requirements in the following paragraphs.

(II) Requirements for the establishment of financial leasing companies

A financial leasing company shall be established in the form of a limited liability company (LLC) or a joint stock company (JSC), and the requirements for the specific company form, capital and shareholders are as follows:

Organizational form	JSC	LLC
Corporate capital	The minimum capital is MOP 10 million	
Corporate capital contribution/maintenance requirements	The corporate capital shall be paid in full in cash at the time of the company's establishment and shall not be less than MOP 10 million during the establishment and existence of the company	
Number of shareholders	Not less than 3 shareholders	Not less than 1 shareholder[1] and not more than 30 shareholders
Board of directors	A JSC's board of directors shall consist of at least three members	A LLC may have no board of directors
Company's management personnel	There shall be at least one management personnel permanently resident in Macao and he/she shall have the actual authority to manage the company's business	

The introduction of the Regime has lowered the threshold for setting up financial leasing companies in Macao, which is mainly reflected in the following two aspects:

[1] A one-person company can be established with the company's name bearing the words "one-person company".

(1) The organizational form of the company is extended from the JSC to JSC or LLC. In accordance with Macao's local laws, a JSC shall have at least three shareholders, while a LLC shall have at least one shareholder. Such an adjustment leaves more flexibilities for Mainland leasing companies to deal with equity relationship and corporate organizational structure in their subsequent establishment of financial leasing companies in Macao.

(2) The capital requirement for financial leasing companies has been further reduced from MOP 30 million to MOP 10 million.

(III) Approval and licensing mechanism

The licensing mechanisms applicable to financial leasing companies and subsidiaries for financial leasing projects are different. Please refer to the following table for details:

Type of company	Licensing mechanism
Financial leasing company	1. Filing an application to the Monetary Authority of Macao ("AMCM"); 2. Obtaining prior permission given by an Executive Order of the Chief Executive after hearing the opinion of the AMCM, and the Chief Executive may set specific conditions to be observed by the financial leasing company in the executive order.
Subsidiary for financial leasing project	1. The bank or financial leasing company established in Macao should make a prior written notice to the AMCM, accompanied by a resolution of the company's administrative authority and a letter of understanding that the proposed subsidiary for financial leasing project will conduct business in accordance with the law. 2. Within one month after the establishment of the subsidiary for financial leasing project, the bank or financial leasing company established in Macao should report to the AMCM the relevant information of the subsidiary.

It should be noted that if the relevant party fails to establish a financial leasing company or commence its business within 18 months of obtaining the above-mentioned license, the license will be revoked unless there is a reasonable ground and a prior application is made to the AMCM for an extension of the licensing period.

(IV) Business scope of financial leasing companies and subsidiaries for financial leasing project

The local laws of Macao enumerate the permitted business scope of financial leasing companies and subsidiaries for financial leasing project, and further provide that, unless approved by the AMCM, no business other than those listed in the Regime may be conducted. The specific business scope can be found in the table below:

Permitted business	Prohibited business
1. Financial leasing business	No business other than those listed in the permitted business may be conducted and, in particular, no deposits or other reimbursable sums may be accepted from the public.
2. Transfer and acquisition of leased property	
3. Management of leased property	
4. Foreign exchange, interest rate swap and currency swap transactions required for business operations	
5. Other businesses approved by the AMCM	

Macao's local laws further provide that no person or entity shall engage in financial leasing business without the permission of the AMCM, nor shall such person or entity use the words "financial leasing" in the company name or expressly or implicitly state that the business of the company includes financial leasing.

(V) Registration requirements for financial leasing companies

Financial leasing companies must comply with the following special registration requirements, and may not conduct business without completing the special registration.

Special registration	Registration of changes
Special registration with the AMCM is required within three months after the establishment of a financial leasing company	In case of any change in the information contained in the special registration, a notification shall be made to the AMCM within one month after the change occurs.

For the avoidance of doubt, the above registration is a special registration requirement of the AMCM for financial leasing companies, and such registration does not affect other registrations that financial leasing companies are required to make under the local laws of Macao (for example, company registration in the Macao Commercial and Movable Property Registry (CRCBM)).

II. Approval and requirements for Mainland leasing companies to set up financial leasing companies in Macao

We briefly introduced Macao's legal system for the establishment of financial leasing companies in Macao above. We will then analyse and introduce the main requirements for the approval or filing for the establishment of financial leasing companies in Macao by Mainland leasing companies (mainly including finance lease companies and financial leasing companies) from the perspective of "outbound investment".

(I) Filing requirements of the NDRC

According to the *Measures for the Administration of Overseas Investment of Enterprises* ("the Measures"), the Measures shall apply to outbound investments made by domestic enterprises through enterprises in Hong Kong, Macao or Taiwan under their control. According to the Measures, the NDRC currently adopts two mechanisms for outbound investments by domestic enterprises: the approval system for sensitive project and the filing system for non-sensitive project. Meanwhile, under the Measures and the *List of Sensitive Sectors for Outbound Investment*, financial leasing is not included in such list.

A Mainland leasing company that intends to establish a financial leasing company in Macao is only required to go through the outbound investment reporting formalities through the NDRC's online system before launching the project. The specific requirements on the reporting subject and the examination and approval authority are as follows:

Investor and amount	Reporting authority
The investor is a centrally administered enterprise (including a centrally administered financial enterprise or an enterprise directly subordinate to the administration by the State Council or its subordinate organ, the same below)	NDRC
The investor is a local enterprise and the amount of Chinese investment is USD 300 million or above	NDRC
The investor is a local enterprise and the amount of Chinese investment is less than USD 300 million	The provincial development and reform commission at the place where the investor is registered

A Mainland leasing company should, within 20 working days after the completion of the project, submit a report on the completion of the project through the NDRC online system.

(II) Approval requirements of the CBIRC

Pursuant to the *Notice by the General Office of the Ministry of Commerce on Matters Concerning Adjustments to the Duties of Administration of Financial Leasing Companies, Commercial Factoring Companies and Pawn Shops* (Shang Ban Liu Tong [2018] No. 165), the Ministry of Commerce has allocated the responsibility for developing the rules for business operation and regulation of financial leasing companies to the CBIRC, and relevant duties shall be performed by the CBIRC since 20 April 2018. However, after such adjustments, the CBIRC has not yet issued a new Interim Measures for the Supervision and Administration of Financial Leasing Companies. If a Mainland financial leasing company intends to set up a financial leasing company in Macao, it is recommended to communicate with the Mainland regulators in advance to confirm whether it is required to obtain the approval of the CBIRC or its branches. It is also advised to communicate with the AMCM in advance to know what materials are needed and the specific requirements for the establishment of a financial leasing company in Macao.

We will only briefly analyse and introduce the approval requirements of the CBIRC for finance lease companies to set up financial leasing companies in Macao.

A Mainland finance lease company may establish a financial leasing company in Macao by way of indirect investment or direct investment, i.e. indirectly establishing a financial leasing company in Macao through its overseas specialised subsidiary (which is a project company of the overseas specialised subsidiary), or directly establishing a specialised subsidiary of the finance lease company in Macao.

1. Establishment of financial leasing specialised subsidiaries in Macao by Mainland finance lease companies (i.e. overseas specialised subsidiaries of finance lease companies)

- Pre-approval

  In accordance with the *Measures for the Administration of Finance Lease Companies*, the *Implementation Measures of the China Banking and Insurance Regulatory Commission for the Administrative Licensing Items concerning Non-Banking Financial Institutions and the Interim Provisions on the Administration of the Specialized Subsidiaries of Finance Lease Companies, a finance lease company should*, upon obtaining approval by the CBIRC, apply for the establishment of a specialised subsidiary[2] pursuant to the laws and regulations of the country or region of registration of the proposed subsidiary.

  When establishing an overseas specialised subsidiary, the finance lease company should first apply to its provincial branch office of the CBIRC, which will accept the application and conduct a preliminary examination, and the CBIRC will then review its application and make a final decision.

  A finance lease company applying for establishment of an overseas specialised subsidiary should satisfy the following criteria:

Main requirements for finance lease companies to establish overseas specialised subsidiaries
• The establishment of the overseas specialised subsidiary is required for business development needs, and there are clear overseas development strategies.
• It is in good operating conditions, sound corporate governance structure, risk management and internal control system, and meets various regulatory indicators.
• It employs a professional team corresponding to its overseas business environment.

[2]Specialised subsidiaries mean specialised leasing subsidiaries established in free trade zones and bonded areas in China as well as overseas by a finance lease company pursuant to the relevant laws and regulations to engage in financial leasing business in specific fields. Specific fields mean financial leasing business fields for which the finance lease company has operated in and the operation is relatively matured, including aircraft leasing, ship leasing and any other leasing business fields recognised by the CBRC.

Main requirements for finance lease companies to establish overseas specialised subsidiaries
• It should contribute capital using its own funds other than non-own funds such as entrusted funds or borrowed funds etc., and the equity investment balance shall in principle not exceed 50% of its net assets (including the current investment amount).
• It complies with state laws and regulations, and has no major violations or non-compliance during the past two years.
• It has certain advantages in human resource, and experience in specialised management, business development etc.
• Its internal management level and risk management and control capability align with its overseas business development.
• It is in good operating conditions, and is consecutively profitable for the past two accounting years.
• It abides by the laws and regulations, has a good regulatory rating and complies with the laws and regulations of its place of incorporation.
• It shall satisfy any other prudential criteria stipulated by the CBRC.

- Post-reporting

  The finance lease company shall, upon obtaining the CBIRC's approval, complete establishment formalities for the overseas subsidiary pursuant to the laws and regulations of the country or region of registration of the proposed subsidiary, and report to the CBIRC and the provincial CBIRC branch at the locality of the finance lease company on name, date of establishment, place of registration, registered capital, capital contribution currency, business scope authorized by the parent company, etc. of the overseas subsidiary within 15 working days from establishment of the overseas subsidiary.

2. A Mainland finance lease company establishes a financial leasing company in Macao through its overseas specialised subsidiary (i.e. a project company of the overseas specialised subsidiary)

- No pre-approval required

  In accordance with the *Measures for the Administration of Finance Lease Companies*, the *Implementation Measures of the China Banking and Insurance Regulatory Commission for the Administrative Licensing Items concerning Non-Banking Financial Institutions and the Interim Provisions on the Administration of the Specialized Subsidiaries of Finance Lease Companies*, specialised subsidiaries of finance lease companies may establish project companies overseas to engage in financial leasing businesses. The specialised subsidiaries shall comply with the laws and regulations of the place where the project company is located, and the relevant reporting provisions for establishment of a project company in domestic bonded areas by a finance lease company to engage in financial leasing business, including but not limited to the following:

Reporting matter	Reporting content/time requirements
Contract concluded	1. The finance lease company should report to the CBRC or its branches within 15 working days from execution of the lease contract by the project company; 2. The report should cover a feasibility study report for the project, the articles of association of the project company, information of the personnel responsible for the project, a legal opinion issued by a law firm on the financial leasing project undertaken by the project company or the relevant contract text, and other documents and materials required by the CBRC or its branches.

Reporting matter	Reporting content/time requirements
Financial leasing business	1. Finance lease companies should submit quarterly special reports to the CBRC and its branches on the relevant information on financial leasing business launched by the project company established; 2. The report should include information on project companies newly established, existing and closed during the reporting period; type and size of leased assets; financial status and business results; business environment and risk analysis; and operation management and risk control measures.
The completion of the performance of the lease contract by the project company or the occurrence of significant events	1. The finance lease company should report to the CBRC or its branches within 10 working days of the completion of performance of the lease contract by the project company or occurrence of a significant event; 2. The report should include equity transfer, asset sale, damage or loss of the subject matter and other major losses, and litigation.
The completion of the performance of the lease contract by the project company and completion of liquidation	1. The finance lease company should report to the CBRC within 15 working days upon completion of liquidation of the project company; 2. The report should include information on completion of liquidation.

Although such method does not require pre-approval from the CBIRC, as the project company is a special project subsidiary established for conducting the financial leasing business under a specific lease contract, normally, it can only conduct a specific financial leasing business. However, the required license and registration formalities in Macao for the establishment of a financial leasing specialised subsidiary or a project subsidiary for financial leasing are the same. Therefore, when setting up a financial leasing company in Macao, the finance lease company should consider setting up a financial leasing specialised subsidiary (a platform-type company that can carry out financial leasing business in a particular field) or a project subsidiary for financial leasing (a project company conducting a particular financial leasing business) according to its development needs and purposes.

- Post- reporting

  In accordance with the *Measures for the Administration of Finance Lease Companies*, an overseas project company established by a specialised subsidiary shall, after commencing financial leasing business, report to the local CBRC offices, and the local CBRC offices where the finance lease company is located on a quarterly basis.

(III) Registration requirements of Ministry of Finance (for finance lease companies with State-owned financial capital)

In accordance with the *Measures for the Administration of the Registration of Property Rights over State-owned Financial Capital (for Trial Implementation)*, for overseas subsidiaries established by finance lease companies with state-owned financial capital, the head office of the financial institutions to which such finance lease companies belong must register such subsidiaries with the competent financial authorities.

Conclusion

This article gives preliminary introduction to the establishment of financial leasing companies in Macao by Mainland leasing companies. Due to the differences in the shareholders' information, the nature of the company, the purpose of outbound investment and the development plan of the Mainland leasing company, the examination requirements of application materials of the AMCM and the approval/filing requirements of the relevant Mainland government departments for Mainland leasing companies seeking to set up financial leasing companies in Macao will also be different. Mainland leasing companies need to take adequate consideration of its own situation and needs in establishing a financial leasing company in Macao.

Hong Kong fund industry updates: Carried interest tax concession regime and the OFC and REIT Grant Scheme

Jingjing Jiang, Cindy Shek

Jingjing Jiang

Cindy Shek

Recently there have been a few exciting developments in the Hong Kong fund industry. This client alert provides an update on the enactment of the carried interest tax concession regime for private equity funds, as well as subsidies to be granted to eligible open-ended fund companies (**OFCs**) and real estate investment trusts (**REITs**).

I. Carried interest tax concession regime

On 7 May 2021, the *Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Ordinance* (**Ordinance**) came into operation, and introduced the much anticipated tax concession regime for carried interest distributed by eligible private equity funds operating in Hong Kong SAR (the **Carried Interest Tax Concession Regime**) to their fund sponsors.

Under the Carried Interest Tax Concession Regime, eligible carried interest will be taxed at 0% profits tax rate and all of the eligible carried interest would also be excluded from the employment income for the calculation of the investment professional's salaries tax.

The Carried Interest Tax Concession Regime, coupled with the introduction of the limited partnership fund regime which came into force on 31 August 2020, aim to attract more private equity funds to operate and be managed in Hong Kong, while leveraging the unique advantages that Hong Kong has to offer.

We list out in the table below a summary of the key requirements under the Carried Interest Tax Concession Regime:

Subject	Key requirements
Eligible carried interest	• A sum received by or accrued to a person by way of profit-related return subject to a hurdle rate which is a preferred rate of return on investments in the fund; and • The Ordinance does not specify the ratio of the hurdle rate, therefore the hurdle rate can be determined as 0%.
Tax rate for eligible carried interest	• "Eligible carried interest" will be taxed at a 0% profits tax rate; and • All of the eligible carried interest would also be excluded from the employment income for the calculation of the investment professional's salaries tax.
Qualified fund/carried interest payer	• The eligible carried interest should be distributed by a fund which fulfills the definition of "fund" under section 20AM of the Inland Revenue Ordinance (applies to private equity funds managed in Hong Kong or outside Hong Kong), and the fund must be certified by the Hong Kong Monetary Authority ("**HKMA**"); • Certified affiliated corporations or joint ventures who are providing investment management services in Hong Kong; and • ITVF Corporations.
Qualifying transactions	• The carried interest tax concession regime must occur from private equity transactions, specifically stocks, debentures, loan bonds, funds, bonds or notes issued by private companies.

Subject	Key requirements
Qualifying carried interest recipients	• Only persons providing investment management service to a HKMA certified investment fund in Hong Kong or arranging such services to be carried out in Hong Kong are considered qualifying carried interest recipients; • These recipients include SFC licensed corporations, unlicensed entities that provide investment management services to a “qualified investment fund” defined under the unified tax exemption for funds regime or the ITVF Corporation; and • Persons employed by the foregoing entities or their affiliated corporations or joint ventures providing investment management services in Hong Kong.
Substantial activities in Hong Kong	• Qualifying carried interest recipients must demonstrate they are undertaking core income generating activities in Hong Kong; • Having two or more full-time employees in Hong Kong who carry out the investment management services; and • The operating expenditure incurred in Hong Kong for the provision of the investment management services for each year of tax assessment shall be HK$2 million or more.

II. Subsidies available to eligible OFCs and REITs

(I) Introduction

The Securities and Futures Commission (SFC) announced on 10 May 2021 the implementation of the Hong Kong Government’s grant scheme to subsidise the setting up of OFCs and REITs in Hong Kong (Grant Scheme). The purpose of the Grant Scheme is to reinforce Hong Kong’s role as a leading capital raising venue and its status as an international asset and wealth management centre by encouraging a broader range of investment vehicles.

(II) Details of the Grant Scheme

1. Application period for OFC and REIT applicants

The Grant Scheme is valid for application for a period of three years, from 10 May 2021 to 9 May 2024. As the Government has allocated funding of HK$270 million to the Grant Scheme (as announced by the Financial Secretary in the 2021-22 Budget Speech), the Grant Scheme will operate on a first-come-first-served basis, meaning the application period may be curtailed when the initial funding is fully committed.

Although the Grant Scheme will operate on a first-come-first-served basis based on the submission time of the grant application, the SFC will only take up an application if the applicant has submitted all relevant documents that meet applicable requirements and has submitted the application within the relevant application deadline. Application documents may be returned by the SFC if they are not in good order.

2. Eligible applicants

- Investment managers of OFCs: An Investment manager of an OFC, who has successfully incorporated the OFC or re-domiciled the non-Hong Kong fund corporation in Hong Kong as an OFC on or after 10 May 2021, may apply for a grant under the Grant Scheme on behalf of the OFC.
- REIT managers: A REIT manager may apply for a grant under the Grant Scheme on behalf of a SFC-authorised REIT listed on the Stock Exchange of Hong Kong Limited (SEHK) on or after 10 May 2021 with a minimum market capitalisation of HK$1.5 billion (or equivalent) at the time of listing. For a REIT which is also listed outside Hong Kong, the minimum market capitalisation of its units listed on SEHK should be HK$1.5 billion (or equivalent) at the time of listing.

3. Grant amount

The grant amount will be equivalent to 70% of eligible expenses (see below for an explanation of eligible expenses) for each application, with the following conditions:

- OFC: Subject to a cap of HK$1 million per OFC and a maximum of three OFCs per investment manager.
- REIT: Subject to a cap of HK$8 million per REIT.

4. Eligible expenses

Eligible expenses must be expenses paid to Hong Kong-based service providers in relation to the incorporation of an

OFC, re-domiciliation of a non-Hong Kong fund corporation to Hong Kong as an OFC or listing of a REIT on SEHK. Examples of eligible expenses include:

OFC	REITS
• Fees charged by law firms or legal advisers for legal work in relation to the incorporation or 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. • Fees charged by auditors, accountants or tax advisors for accounting and/or tax services in relation to the incorporation or re-domiciliation of an OFC. • Fees charged by fund administrators, corporate service providers or company secretaries for incorporation or re-domiciliation services in relation to the set-up of an OFC, including work done for all filings necessary for the incorporation or re-domiciliation or registration of an OFC. • Fees charged by regulatory consultants for work done in relation to the incorporation or re-domiciliation of an OFC and the authorisation of an OFC with the SFC. • Listing agent fees in the case of listed OFCs.	• Underwriting commissions charged by underwriters for the listing of a REIT. • Fees charged by law firms or legal advisors for legal work in relation to the listing of a REIT, including (i) the drafting of legal documents and offering circular of the REIT and (ii) work done in relation to the authorisation of a REIT with the SFC. • Fees charged by auditors, accountants or tax advisors for accounting and/or tax services in relation to the listing of a REIT. • Fees charged by the valuer of a REIT to produce valuation report on properties for the listing of a REIT. • Expenses paid to marketing agencies or consultants for advertisement and marketing related services for the listing of a REIT, including roadshow expenses. • Listing agent fees.

The following are not considered eligible expenses:

- Statutory fees such as registration or application fees to the SFC and expenses incurred in relation to an application to the SFC for the licensing or registration of an investment manager.
- Costs incurred in the establishment of a sub-fund under a pre-existing umbrella OFC and listing fees to the SEHK.
- Audit fees paid to accounting firms in relation to the annual audit review.

5. Minimum operation condition

The Government reserves the right to claw back the grant if:

- the OFC commences winding-up or applies for termination of registration within two years from the date of its incorporation or re-domiciliation; or
- the REIT is delisted from SEHK or suspended from trading within two years of its listing date.

Whether a suspension of trading warrants a clawback of grant will be considered on a case-by-case basis. An example from the SFC's Frequently Asked Questions[1] is that a temporary trading suspension of a REIT due to pending announcements will not generally give rise to a clawback of grant. On the other hand, a grant awarded may be clawed back if a REIT has been suspended from trading on SEHK for a continuous period of 18 months within 2 years of its listing date.

6. Application process and deadline

An applicant must submit the Grant Scheme application form together with the required supporting documents to the SFC within three months from (as applicable):

- the date of the certificate of incorporation or re-domiciliation issued by the Companies Registry for private OFCs;
- the authorisation date for public OFCs (the public OFC may submit to the SFC a duly signed and completed "Confirmation of Intention to Apply for a Grant" as part of its initial product application submission); or
- the listing date of the REIT.

Conclusion

We believe the Grant Scheme provides much welcomed incentives for the asset and wealth management industry in Hong Kong. Along with the facilitative tax environment created by the Carried Interest Tax Concession Regime, we foresee market players which are exploring onshore options to view Hong Kong as an increasingly attractive place of domicile for funds.

[1] https://www.sfc.hk/-/media/files/PCIP/FAQ-PDFS/FAQ-on-OFC-and-REIT-Grant-Scheme__20210510.pdf

Introduction of the Hong Kong Limited Partnership Fund regime

Hayden Flinn, Jingjing Jiang, Guo Sun Lee, Cindy Shek, Minny Siu, Justin Cherrington

Hayden Flinn

Jingjing Jiang

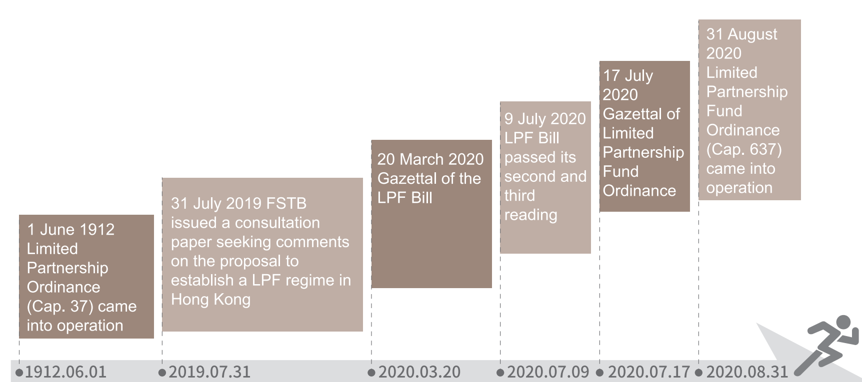
Guo Sun Lee

With the Legislative Council of Hong Kong SAR passing its second and third reading of the Limited Partnership Fund Bill ("**Bill**") on 9 July and gazettal of the Limited Partnership Fund Ordinance (Cap.637) ("**LPFO**") on 17 July, the long-awaited Hong Kong Limited Partnership Fund ("**LPF**") regime is finally set to sail on 31 August 2020.

In addition to forming an open-ended fund company ("**OFC**") or a unit trust, the introduction of the LPF regime now provides fund managers with the option of setting up funds structured as a limited partnership in Hong Kong SAR.

This article identifies the key issues fund managers and sponsors should consider in light of the new LPF regime.

I. What has changed since March 2020?



Legislative process of the LPF regime


Minny Siu


Cindy Shek


Justin Cherrington

The Bill was scrutinised by the Legal Services Division since its introduction in March. Whilst remaining largely intact, several amendments were introduced. In particular, section 24(2)(c) of the Bill requires a statement by the General Partner ("**GP**") in the annual return as to whether the LPF will remain in operation, or will carry on business as a fund 12 months after the anniversary of the latest annual return submitted to the Companies Registrar ("**Registrar**"). Amendments to section 89 of the Bill has also been introduced to define the burden and standard of proof in respect of a person for a specified offence under the LPFO.

II. The GP and the investment manager

The GP is required to appoint an investment manager to conduct day-to-day investment management functions.

Who can be an investment manager of a LPF?

- A Hong Kong incorporated company
- A registered non-Hong Kong company
- A Hong Kong resident that is at least 18 years old
- The General Partner of the LPF

(I) Must the GP and/or the investment manager be licensed?

If the GP has fully delegated the investment management activities to the investment manager, the GP may not need to be licensed. In turn, unlike the Hong Kong OFC, the GP does not necessarily need to appoint a Securities and Futures Commission ("**SFC**") licensed entity to act as the investment manager if the LPF will not be carrying on a business of regulated activities in Hong Kong.

The SFC clarified the licensing requirements applicable to private equity funds in early 2020[1]. In summary, if a person conducts regulated activities in Hong Kong, he would need to be licensed irrespective of his role in the LPF (the likely roles which may trigger a licensing requirement include the GP, the investment manager, the investment committee, the distributor or placement agent). Unless otherwise exempted, licensing requirements may be triggered when a person or entity deals in, advises on or manages a portfolio of assets (this may include private equity and venture capital investments) which fall within the definition of "securities" under the SFO.

A GP or an investment manager of a LPF which does not invest in "securities" (e.g. the LPF invests in shares in a Hong Kong private company, non-securities assets such as real estate or other commodities) may be able to remain unlicensed. It should be noted that although shares or debentures of a Hong Kong private company falls outside the definition of "securities" under the SFO, shares or debentures of private companies incorporated outside of Hong Kong would still be considered as "securities".

Although retaining unlicensed GP and/or the investment manager may mean the LPF is free from the SFC's direct supervision hence arguably lowering regulatory and compliance costs, certain market players including investors and various service providers may prefer to deal with licensed sponsors so as to comply with their internal approval process and provide additional regulatory comfort. Fund managers may wish to plan ahead and consider if they wish to set up a fund management business in Hong Kong, or partner with licensed entities.

[1] SFC's circular dated 7 January 2020 entitled *"Circular to private equity firms to be licensed"*, accessible at: https://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=20EC2

(II) Do I need to appoint a custodian?

The GP is not required to appoint a third party custodian to demonstrate proper custody of the LPF assets under the LPFO. However, to the extent that the GP or the investment manager is a Type 9 licensee, the requirements under the SFC's Fund Manager Code of Conduct will apply to the investment management activities in respect of the LPF. This includes a requirement for the GP or the investment manager (as applicable) to: (a) exercise due skill, care and diligence in the appointment of the custodian; or (b) if self-custody is adopted, the GP or the investment manager must adopt policies and enforce procedures to separate custodial functions from its investment management functions.

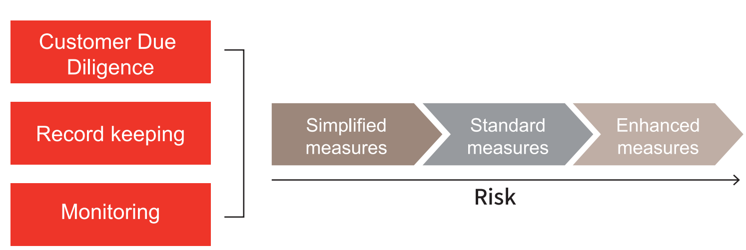
III. Responsible person of the LPF and its obligations

The LPFO requires a GP to appoint a responsible person ("**RP**") to conform with the Anti-Money Laundering ("**AML**") and Counter Terrorist Financing ("**CTF**") obligations of the LPF against each customer of the LPF (including the limited partners of the LPF) in accordance with Schedule 2 of the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap.615) ("**AMLO**").

The RP may be:	Regulated by:
Authorised institution (i.e. bank)	Hong Kong Monetary Authority (HKMA)
Licensed corporation	Hong Kong Securities and Futures Commission (SFC)
Legal professional	Hong Kong Law Society
Accounting professional	Hong Kong Institute of Certified Public Accountants (HKICPA)

The RP will remain ultimately responsible for the LPF's AML/CTF obligations under the LPFO, which is notably different from other jurisdictions including Singapore and the Cayman Islands where the ultimate responsibility of AML/CTF compliance rests with the GP (although the GP can outsource such functions to third party service providers).

Below shows an overview of the requirements under Schedule 2 of the AMLO:



Given the LPFO requires the RP to be an authorised institution, a licensed corporation, an accounting professional or a legal professional, such parties are already subject to the AMLO. Implementation of AML/CTF measures should therefore be relatively straightforward. For instance, a LPF managed by a Type 9 licensee should be able to leverage its existing AML/CTF policies and measures that are already in place when managing an offshore domiciled limited partnership fund.

As the global financial services sector is steering towards digitisation of their services and processes, the regulators have also caught up by updating the Hong Kong Monetary Authority AML Guidelines and SFC Guideline on Anti-Money Laundering and Counter-Terrorist Financing in late 2018, which provide guidance to authorised institutions and licensed entities on remote customer onboarding from the AML and ongoing compliance perspectives. Accordingly, LPFs may thereby onboard investors by utilising these remote measures.

IV. Registration and ongoing compliance

The LPF regime adopts an opt-in registration scheme which does not require SFC authorisation or approval unless the LPF is targeted to the retail public.

The LPF application pack is to be submitted by a Hong Kong law firm or a solicitor. Similar to a private company in Hong Kong, the LPF is required to file annual returns and notify the Registrar for change of particulars. Schedule 3 of the LPFO also prescribes fees for lodging a registration application, filing annual return and notification of change, which are all notably lower than the existing fees charged by our Cayman counterpart.

Hong Kong law firm / solicitor	• Submit application to the Registrar on behalf of the GP for the registration of a LPF
GP / Registered office provider	• File with the Registrar: (i) annual return; (ii) notification of changes to particulars of the LPF • Record keeping (including audited financial statements, register of the GP and LPs, AML/CTF records and LPF transaction records)

It is advisable for fund sponsors to start lining up their service providers, including the administrator or company secretarial providers, who may assist with these ongoing regulatory obligations.

V. Tax implications

As with any fund jurisdictions, tax treatment continues to play a vital role in fund structuring. With the recent publication of the interpretation and practice notes in respect of profits tax exemption for funds by the Inland Revenue Department (referred as DIPN 61), there is now further clarity as to the taxation of each fund entity (including the relevant LPFs and any special purpose entities), investor and the investment manager in terms of whether they qualify for the unified fund tax exemption ("**UFE**").

(I) Taxation implications for the LPF and special purpose entity

The UFE was contained in the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 which came into effect on 1 April 2019. The UFE provides a jurisdictionally neutral tax treatment for private funds in Hong Kong. In summary, private funds (including LPFs) will be exempted from profits tax in Hong Kong as long as they meet the definition of a "fund" and satisfy certain conditions. To qualify for the UFE, the relevant profits of the LPF must derive from "qualifying transactions" (including transactions in securities, futures contracts, shares in private companies and foreign currencies etc) that are carried out or arranged in Hong Kong by an authorised institution or licensed corporation or where the LPF is a qualified investment fund. This profit tax exemption, subject to certain conditions, also applies to special purpose entities held by the LPF.

Further, unlike Singapore which requires the GP to apply to the local monetary authority for tax exemption, the UFE does not impose pre-approval requirements. Rather it allows for self-assessment by the relevant entity to determine if the LPF satisfies the relevant conditions to be profit tax exempt.

The subscription, transfer or redemption of LPF interest will not attract Hong Kong stamp duty as it does not fall under the definition of "stock". However, stamp duty will apply where the LPF accepts capital contributions or distributes profits in kind which involve the transfer of dutiable assets (such as Hong Kong stock or immovable property).

(II) Taxation implications for the investment manager / investment advisor

Management fee received by a Hong Kong-based investment manager will generally be subject to profits tax of 16.5% without specific tax incentive. However, as Hong Kong adopts a territorial concept of taxation, only profits sourced in Hong Kong would be subject to Hong Kong taxation. Hence, if the core investment management activities are conducted outside of Hong Kong, an offshore claim on the relevant portion of the management fee income can be applied for to lower the profits tax. This may be relevant and favourable to investment managers with transnational presence.

(III) Carried interest remains unresolved

The Financial Secretary announced earlier this year in the Budget that the Hong Kong Government aims to provide more certainty on carried interest taxation which has yet been clarified. The industry is expecting attractive tax concession on carried interest to complement the LPF regime and completing the Hong Kong investment management ecosystem.

VI. Fund documentation

The LPFO affirms contractual freedom among partners of a LPF[2], which is on par with many other popular offshore fund jurisdictions. Accordingly, there should be no need for a complete overhaul of the existing fund documentation that fund sponsors and investors have been using for existing funds established in other jurisdictions.

There is no requirement for a LPF to have a private placement memorandum or an offering document, and the GP is not required to file the same with the Registrar or the SFC. This is contrary to the Cayman regime which, under the revised Private Funds Law, 2020, requires either a private placement memorandum, a summary of terms or marketing materials containing certain prescribed information to be filed with the Cayman Islands Monetary Authority.

Fund sponsors who are looking to conduct fundraising with the LPF structure may wish to start revisiting existing fund documents with their legal advisers to cater for jurisdiction-specific amendments.

VII. The way forward

The LPFO does not currently allow re-domiciliation of offshore funds to become an LPF in Hong Kong. We look forward to the Hong Kong Government introducing such mechanism as an enhancement to the LPF regime as we understand a lot of market players are exploring this possibility.

The LPF regime is undoubtedly introduced at an opportune time. With the recent changes to Cayman private funds regulations, ranging from more stringent reporting and filing obligations and economic substance requirements to changes in legislations, the initial attractiveness derived from tax benefits and reporting laxity has largely subsided. We also see a global trend where fund sponsors are preferring to align the substance of asset management activities with the fund domicile. In addition, Hong Kong's proximity to China Mainland and its membership in the Greater Bay Area forms a breeding ground for attractive investment opportunities in fast-growing industries ranging from technology, media and telecom, healthcare, biomedical to fintech companies.

The authors would like to thank Florence Lau and Boer Ma for their contributions to this article.

[2] Section 16(1) of the LPFO.

IRD practice note DIPN 61

Justin Cherrington, Jingjing Jiang, Sam Duncan

Justin Cherrington

Jingjing Jiang

I. Introduction

The Hong Kong Inland Revenue Department (**IRD**) released Departmental Interpretation and Practice Note (**DIPN**) 61 on 30 June 2020, with the aim of clarifying the scope and operation of the new unified tax treatment for investment funds in Hong Kong SAR which applies from 1 April 2019.

The new unified tax regime replaces the earlier profits tax exemptions that applied separately to offshore funds, offshore private equity (**PE**) funds and open-ended fund companies (**OFCs**). The changes were introduced by the Inland Revenue *(Profits Tax Exemption for Funds) (Amendment)* Ordinance 2019 (**2019 Ordinance**).

This guidance from the IRD is relevant for all funds operating in Hong Kong but particularly so for those funds that will embrace the Hong Kong Limited Partnership Fund regime. It was also timely given and echoed the announcements issued in early 2020 by the Financial Secretary regarding changes to the tax treatment of a genuine carried interest for Hong Kong-Limited Partnership Fund (**LPF**).

II. Summary of DIPN 61 and the unified fund regime

In summary, the 2019 Ordinance seeks to remove the ring-fencing features that previously benefited offshore funds by extending profits tax exemption to privately offered funds operating in Hong Kong, regardless of whether they are domiciled inside or outside of Hong Kong. From 1 April 2019, all funds (regardless of their structure, size, purpose or the location of their central management and control) will enjoy profits tax exemption, subject to meeting certain conditions.

DIPN 61 outlines the conditions for accessing the new unified funds exemption. Broadly speaking: (1) a "**qualifying fund**" will be exempted from profits tax on assessable profits arising from (2) "**qualifying transactions**" in certain classes of specified assets, incidental transactions and (if the fund is an OFC) transactions in assets of a class that is not specified, provided that (3) the transactions are carried out or arranged in Hong Kong by a "**specified person**", or the fund is otherwise a "**qualified investment fund**". These conditions are discussed below.

Further, where a fund is exempted, a "special purpose entity" (**SPE**) owned by the fund may be likewise exempted (to the extent of that ownership interest). DIPN 61 explains that this is intended to cater for funds with one or more tiers of SPEs to hold their investment in private companies in order to facilitate the subsequent disposal of such companies by transferring the ownership interests in SPEs.

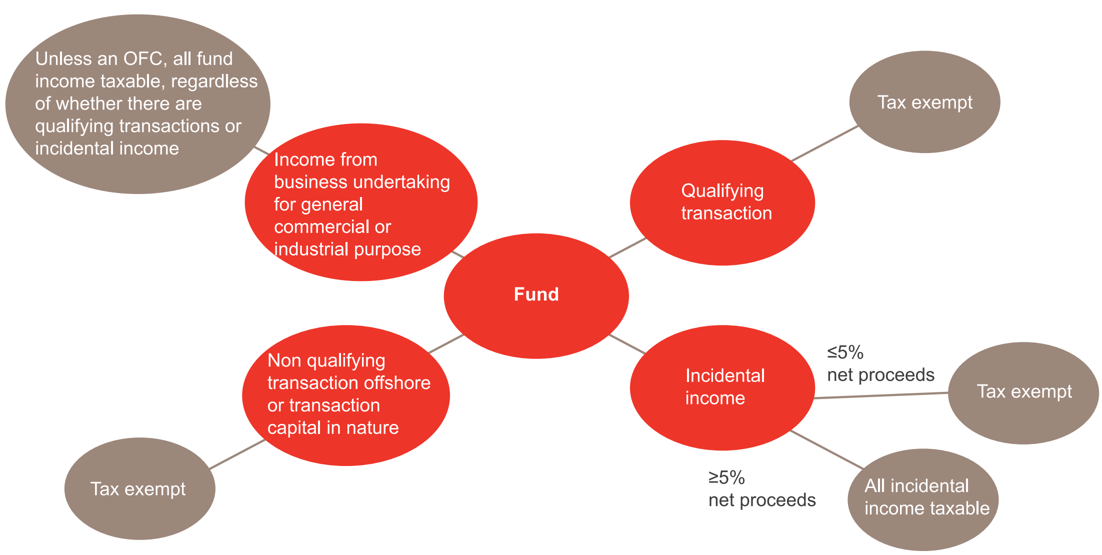
(I) Qualifying funds

In applying each of the criteria the IRD has adopted a holistic approach in terms of ascertaining whether a fund satisfies the requirements for the profits tax exemption.

- The profits tax exemption applies to entities that qualify as a "**fund**" for the whole of the year of assessment. A fund can take many different forms, including a mutual corporation, OFC, limited partnership or other trust-like arrangement. What these arrangements have in common is that they have the characteristics of pooled investment, similar to the definition of "collective investment scheme" under the Securities and Futures Ordinance (Cap. 571) (**SFO**).
- DIPN 61 provides the IRD's views on the meaning of the terms: "arrangement in respect of property" and "managed as a whole", as well as the "pooling", "control" and "purpose tests" that are relevant for determining whether an entity is a qualifying fund.
- Relevantly for many of our clients, DIPN 61 contains guidance and examples of when complex and multi-vehicle fund structures, including master-feeder structures and parallel fund, will be considered one or more "funds" for the purposes of the exemption.
- Single investor funds may satisfy the requirements for exemption where the investor is grouped/invested with other funds, such that the fund structure is seen as managed as a whole and satisfies the pooling requirements. Other than this possible exception, the guidance provides that, only under "very special circumstances" will the IRD accept that a fund with only one investor at a particular point in the income year is a qualifying fund (e.g. during the start-up period or winding-down period).

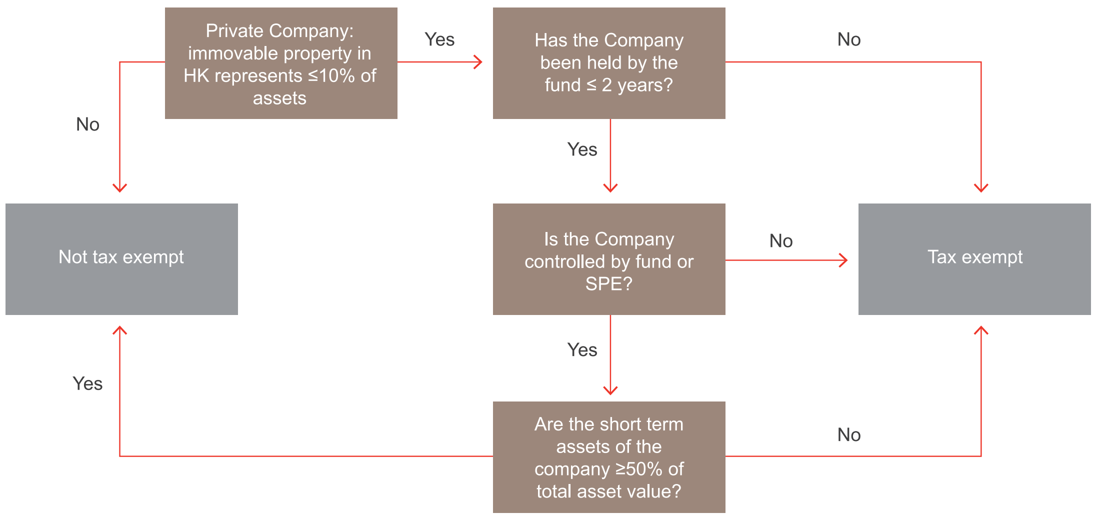
(II) Profits from qualifying investments

- For qualifying funds, no profits tax is payable on profits from "**qualifying transactions**"[1] and incidental transactions (up to a 5% threshold). DIPN 61 contains commentary on when a transaction is likely to be incidental – for example, the IRD considers that holding a debt interest to derive interest income is not a "qualifying transaction" in securities (because there are not two parties involved) but the receipt of interest on such a security is incidental and subject to the 5% threshold.



[1]Schedule 16 of the Inland Revenue Ordinance (Cap. 112) lists 11 classes of assets that are specified for qualifying transactions.

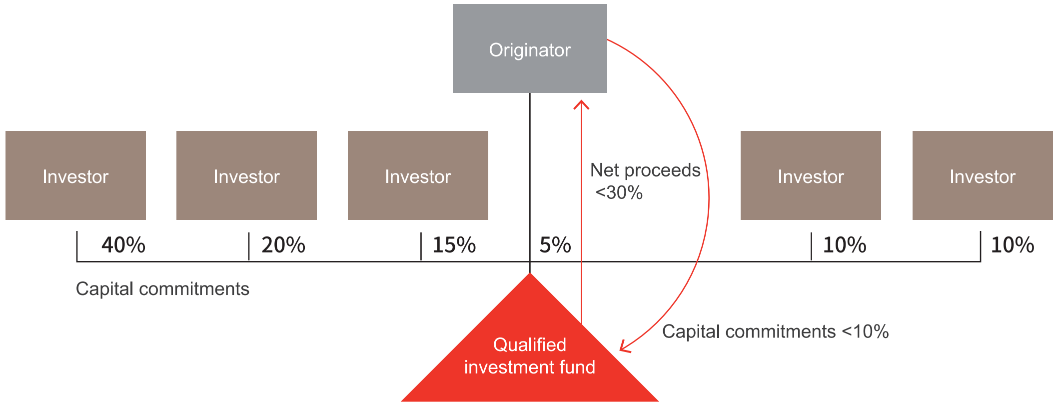
- Where the qualifying transactions involve interests issued by private companies, in order for the profits exemptions to apply, a fund will need to satisfy a number of additional conditions. These additional conditions are likely to be relevant to PE funds.



Source: Appendix 3 of DIPN 61 from the Inland Revenue Department Hong Kong

(III) Carried out or arranged by a specified person or "qualified investment fund"

- The qualifying transaction must be carried out or arranged in Hong Kong by a "**specified person**". This includes a corporation licensed under the SFO. DIPN 61 explains that this includes a situation where the investment manager of a fund (i.e. a specified person) arranges in Hong Kong to buy or sell stocks traded on the Tokyo Stock Exchange through an intermediary in Tokyo.
- If this condition is not satisfied, the exemption may still apply if the fund is a "**qualified investment fund**". Broadly, this includes a fund with over 4 external investors who together contribute over 90% of the aggregate capital commitments of the fund, provided that not more than 30% of the net proceeds of the fund can be distributed to the originator (i.e. investment manager) or its associates.



- These requirements seek to deny tax exemption for funds that are simply a vehicle of one single investor, or where profits are siphoned to one single investor who may be the fund manager.
- Additionally, the 30% distribution limit concerns the payment of performance fees or carried interest (in whatever form). In other words, the fund may pay a carried interest of up to 30% of net proceeds without impacting its exemption status. The IRD considers that this 30% limit is higher than the industry benchmark for performance fees or carried interests that is typically paid to investment managers (i.e. 20% of the fund's profits above a hurdle rate). This requirement may be of particular importance in respect of the future taxation of genuine carried interest for Hong Kong-based funds as the Government frames the profit tax exemption on such interests.
- Helpfully, DIPN 61 provides guidance on when it is appropriate to look through a series of intermediaries in a fund structure (e.g. feeder funds or parallel funds) when counting the number of investors.

III. Former fund regimes

While the 2019 Ordinance introduced a unified tax exemption for investment funds, the former regimes for offshore funds, offshore PE funds and OFCs are still applicable for years of assessment ended prior to 31 March 2019.

The IRD guidance published in DIPN 43 and 51 continues to be relevant in circumstances where the former regimes apply (i.e. pre-1 April 2019).

IV. Further observations

DIPN 61 also contains guidance on:

- the anti-round tripping provisions, which are designed to prevent abuse or roundtripping by resident persons to take advantage of the profits tax exemption;
- the tax residence of funds and SPEs;
- the reporting, compliance and due diligence requirements for privately offered funds under the Common Reporting Standard (CRS);
- the Hong Kong and United States Intergovernmental Agreement (IGA) for Foreign Account Tax Compliance Act (FATCA), which applies to certain privately offered funds and passive NFFEs (broadly, a non-US entity that is not a financial institution); and
- Hong Kong's transfer pricing regime – and in particular, areas of relevance for fund investment managers, such as ensuring that the management fee they charge is at arm's length and the fund maintains adequate transfer pricing documentation, as required.

SFC introduces enhancements to further promote the OFC regime

Hayden Flinn, Cindy Shek, Florence Lau

Hayden Flinn

Cindy Shek

On 2 September 2020, the Securities and Futures Commission of Hong Kong SAR (**SFC**) published the *Consultation Conclusions on Proposed Enhancements to the Open-ended Fund Companies (**OFC**) Regime and Further Consultation on Customer Due Diligence Requirements*[1] (**Consultation Conclusion**). The Consultation Conclusion summarised the feedback from the industry and the SFC's response in relation to its consultation paper[2] issued in late 2019 (**Consultation Paper**).

I. Overview

- The OFC regime was introduced in July 2018 to provide an option for Hong Kong domiciled funds to be structured in a corporate form[3].
- On 20 December 2019, the SFC issued the Consultation Paper under which it proposed relaxations and enhancements to the OFC regime in the following areas:
  - custodian eligibility requirements for private OFCs;
  - investment scope for private OFCs;
  - re-domiciliation of overseas corporate funds; and
  - significant controllers register requirements applicable to all OFCs.
- After months of deliberation, the Consultation Conclusion confirmed the following enhancements to private OFCs:
  - The custodian eligibility requirements would be expanded to include Type 1 licensed entities. A new Appendix A to the OFC Code[4] would be introduced and be applicable to custodians of private OFCs.

[1]https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=19CP4

[2]SFC, Consultation Paper on Proposed Enhancements to the Open-ended Fund Companies Regime, available at: https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/openFile?refNo=19CP4.

[3]An overview of the OFC regime is available at https://www.kwm.com/en/hk/knowledge/insights/open-ended-fund-companies-are-here-20180731

[4]Requirements for safekeeping of private OFC scheme property under 7.3(g) of the OFC Code.

- The investment scope of private OFCs would be expanded to allow investments in all asset classes.
- All investment restrictions on private OFCs would be removed. However, new provisions would be included in the OFC Code to require investment managers and custodians to have sufficient expertise and experience in managing and safekeeping asset classes in which OFC invests, with corresponding enhanced risk disclosure in the offering documents.
- Re-domiciliation of overseas corporate funds would be allowed as long as they satisfy the key requirements for the registration of an OFC, including the appointment of an investment manager, custodian and director who fulfill the relevant eligibility requirements.

- Apart from the introduction of re-domiciliation of overseas corporate funds which is expected to take effect on 1 November 2021, the abovementioned enhancements on OFCs have now taken effect in Hong Kong.
- On 23 December 2020, the SFC also concluded a further consultation on the client due diligence (CDD) requirements for OFCs.[5] It was proposed that an OFC will be required to appoint a responsible person to perform anti-money laundering and counter terrorist financing (AML/CTF) functions similar to the requirements on limited partnership funds under the Limited Partnership Fund Ordinance[6]. The SFC is seeking to work on the legislative amendments to give effect to such new requirements.

II. Details of the enhancements to the OFC regime

(I) Custodian eligibility requirements for private OFCs

Under the previous regime, custodians for both public and private OFCs were required to meet the same eligibility requirements as for custodians of SFC-authorised funds. In other words, OFC custodians must either be (i) a Hong Kong or overseas bank (or a trust company which is a subsidiary of a Hong Kong or overseas bank); or (ii) a trustee of a registered scheme under the *Mandatory Provident Fund Schemes Ordinance*.

Many industry players have called out for greater flexibility on custodian eligibility requirements, noting that it is common to have other local or overseas service providers, including prime brokers to hold assets for private funds. In addition, comparable jurisdictions such as Singapore allow broker-dealers to act as custodians for private variable capital companies if they hold the relevant licence.

Taking into account industry feedback, the SFC has confirmed that intermediaries licensed or registered for Type 1 (dealing in securities) regulated activities may act as custodians for private OFCs provided the following requirements are met:

Free from license condition	The licensed or registered intermediary's license or registration shall not be subject to the condition that it shall not hold client assets.
Minimum capital requirement	The intermediary has to meet the capital requirements of minimum paid-up share capital of HK$10 million and minimum liquid capital of not less than HK$3 million.
Private OFC shall be the client	The private OFC shall be the client of the intermediary in respect of its Type 1 regulated activity business.
Responsible/executive officer	The custodian is required to have at least one responsible officer/executive officer responsible for the overall management and supervision of the private OFC's custodial function.
Independence from investment manager	The intermediary must be independent of the investment manager.

[5] https://apps.sfc.hk/edistributionWeb/api/consultation/conclusion?lang=EN&refNo=20CP3

[6] For details on the Hong Kong Limited Partnership Fund regime, please refer to our earlier publication, available at: https://www.kwm.com/en/hk/knowledge/insights/hk-limited-partnership-regime-rolling-out-20200729.

Although the eligibility threshold for private OFC custodians has been lowered significantly, the proposed custodian should take note that the SFC requires the custodian to be compliant with all of SFC's regulations, codes and related guidance applicable to OFC custodians, including the Appendix A of the OFC Code[7] which further elaborates on the obligations of OFC custodians, including requirements regarding dealings with client money and client securities and the keeping of records.

(II) Investment scope

Previously, private OFCs must invest at least 90% of their gross asset value in securities and futures contracts and/or cash, bank deposits, certificates of deposit, foreign currencies and foreign exchange contracts (**SFO Assets**). Investments in other non-SFO Assets classes were subject to a 10% "de minimis" investment limit. These investment restrictions applicable to private OFCs have been removed altogether, so as to put private OFCs on a level playing field with other overseas corporate fund structures (including the Irish Collective Asset-management Vehicle in Ireland, the Open-ended Investment Company in the United Kingdom and the Variable Capital Company in Singapore), as well as the Limited Partnership Fund (LPF) in Hong Kong SAR.

The SFC has also introduced new provisions in the OFC Code to require that investment managers and custodians have sufficient expertise and experience in managing and safekeeping asset classes in which an OFC invests, including requiring enhanced risk disclosure in the fund offering documents in respect of different type and nature of assets.

(III) Re-domiciliation of overseas corporate funds

The previous OFC regime did not provide for OFC re-domiciliation. As such, corporate funds incorporated overseas could only "re-domicile" by way of other means including asset transfer or share swaps which would trigger associated tax obligations. By contrast, other jurisdictions have established statutory re-domiciliation mechanisms for both conventional companies and corporate funds, and ancillary tax legislation.

On 2 July 2021, the Securities and Futures (Amendment) Bill 2021 ("**Amendment Bill**") was gazetted to introduce a statutory re-domiciliation regime which allows offshore corporate funds to migrate to Hong Kong while maintaining their corporate identity, continuity and track record without having to establish a completely new legal entity. It is also confirmed that no stamp duty will arise as there will be no change in the legal personality of the corporate fund, and as such there will be no "transfer" of assets from one legal person to another when the fund migrates to Hong Kong using the OFC structure. The Amendment Bill is due to come into operation on 1 November 2021.[8]

The "onshorisation" of funds has become more popular these days, due to various factors including investor preferences, perceptions around use of traditional offshore centres, the enhanced requirements by overseas regulators on the transparency of offshore funds, and economic substance requirements being introduced by traditional offshore fund jurisdictions. The re-domiciliation of corporate funds will allow the OFC regime to be on par with other jurisdictions, and increase the competitiveness and attractiveness of Hong Kong as a fund domicile jurisdiction.

(IV) AML/CTF obligations of OFCs

There is currently no prescribed AML/CTF obligation imposed on OFCs, and the investment manager of each OFC is expected to carry out the relevant AML/CTF measures.

The SFC Consultation Paper proposed to require all retail and private OFCs to keep a register of significant controllers (SCR) similar to the requirement under the Companies Ordinance (Cap. 622 of Laws of Hong Kong SAR) for all other conventional companies, so as to enhance the transparency of corporate beneficial ownership of OFCs.

However, the SFC acknowledged the difficulties which would arise from requiring OFCs to keep a SCR given its open-ended nature. In particular, the investors in a public OFC are constantly changing due to the frequent subscription and redemption of shares feature of retail funds. Accordingly, the SFC proposed to require OFCs to appoint a responsible person (being an authorised institution, a licensed corporation, an accounting professional or a legal professional) to carry out AML/CTF functions as stipulated under Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615 of Laws of Hong Kong SAR), to further align with the LPF regime.

[7]The SFC's *Code on Open-ended Fund Companies* is available at: https://www.sfc.hk/web/EN/assets/components/codes/files-current/web/codes/code-on-open-ended-fund-companies/code-on-open-ended-fund-companies.pdf.

[8]For a more detailed discussion about process and effect of the re-domiciliation regime, please see our client alert on "*Moving your investment funds to Hong Kong – Hong Kong's fund re-domiciliation proposal*" at https://www.kwm.com/en/hk/knowledge/insights/moving-your-investment-funds-to-hk-hks-fund-re-domiciliation-proposal-20210309.

On 23 December 2020, the SFC concluded a further consultation on the CDD requirements for OFCs.The SFC agreed that the appointment of a responsible person should be made by the board of directors of an OFC, given that the board is legally responsible for all affairs of an OFC. The SFC is seeking to work on the legislative amendments in particular the Securities and Futures Ordinance (Cap. 571 of Laws of Hong Kong SAR) and other relevant legislations to give effect to such new requirements.

(V) Grant Scheme

On 10 May 2021, the SFC announced the implementation of the Hong Kong Government's grant scheme to subsidise the setting up of OFCs in Hong Kong. The Grant Scheme is valid for application for a period of three years (from 10 May 2021 to 9 May 2024), and will operate on a first-come-first-served basis.[9]

III. Implementation timeline

The SFC has proposed the following timeline for the proposed enhancements:

Proposed enhancement	Proposed effective date
Custodian eligibility requirement	Effective.
Expansion of investment scope and removal of investment restrictions	Effective.
Re-domiciliation of overseas corporate funds	Amendment Bill is expected to come into effect on 1 November 2021.
AML/CTF requirements	6-month transition period after passing the amendment bill to allow time for OFCs to prepare for implementation.

Conclusion

We welcome the SFC's enhancements to the OFC regime. We see this as an important step for the SFC to improve the OFC regime to further develop Hong Kong into a full service asset management centre.

[9]For a more detailed discussion about the grant scheme, please see our client alert on "*Hong Kong fund industry updates: Carried interest tax concession regime and the OFC and REIT Grant Scheme*" at https://www.kwm.com/en/hk/knowledge/insights/hk-fund-industry-updates-carried-interest-tax-concession-regime-and-the-ofc-and-reit-grant-scheme-20210514.

Is Hong Kong SAR ready for its own limited partnership fund regime?

Hayden Flinn, Guo Sun Lee, Jingjing Jiang, Cindy Shek, Justin Cherrington

Hayden Flinn

Guo Sun Lee

Jingjing Jiang

The Financial Services and the Treasury Bureau (**FSTB**) of Hong Kong SAR published a consultation paper on 31 July 2019 seeking comments on the proposal (**Proposal**) to establish a regime for limited partnership funds (**LPF**) in Hong Kong. King & Wood Mallesons submitted a detailed submission on the Proposal to the FSTB during the four-week industry consultation period and held a face to face meeting with the FSTB discussing our submissions. Finally, the Limited Partnership Fund Ordinance (Ordinance) came into operation on 31 August 2020 after the Bill (**Bill**) was gazetted on 20 March 2020 and introduced into the Legislative Council for its First Reading and Second Reading in due course.

The proposed LPF regime, together with the introduction of the open-ended fund company (**OFC**) regime in July 2018, and the expansion of mutual recognition of fund arrangements in recent years show the Hong Kong government's commitment to strengthen the city's position as an international hub for fund management activities and investment fund domiciliation.

This client alert outlines the key characteristics and requirements of the proposed LPF regime under the Ordinance and its major differences from the Proposal, followed by our take on the proposed LPF regime.

I. Driving forces for the introduction of the LPF regime

With 560 private equity and venture capital firms and around US$160 billion worth of asset under management in Hong Kong in 2019[1], Hong Kong is currently Asia's second-largest private equity (**PE**) hub. The increasing number of Mainland Chinese PE investors (encompassing state-owned enterprises, pension and insurance funds and domestic PE funds) who are constantly expanding their inbound and outbound investment activities bring tremendous potential for Hong Kong to develop its own PE market.

Unfortunately, the old fund regime in Hong Kong is not well-equipped for such development to take place. The unit trust structure and the OFC structure, the two fund forms offered under the old Hong Kong regime, are more popular amongst public funds and hedge funds since PE funds usually take the form of limited partnerships. Whilst the existing Limited Partnerships Ordinance (Cap. 37) (**LPO**) in Hong Kong allows the establishment of partnership, it has features which are not appealing for use in the PE fund context, for example its restrictive provisions with respect to capital contributions and distribution of profits, the lack of contractual flexibility of the partnership and the absence of a straightforward dissolution mechanism.

For these reasons, the PE industry has long been calling for the introduction of a new limited partnership regime that is catered for PE fund use.

[1] According to AVCJ's data and cited by Legislative Council in its Brief on the Bill dated 18 March 2020 and accessible at: https://www.legco.gov.hk/yr19-20/english/bills/brief/b202003201_brf.pdf.

Cindy Shek

Justin Cherrington

II. What makes Hong Kong an ideal place of domicile?

Recently, we have seen traditionally-popular PE fund domicile jurisdictions such as the Cayman Islands introduce reforms to their laws and regulations in light of global initiatives to combat cross-border tax avoidance, money-laundering and terrorist financing. In December 2018 and June 2019, the Cayman Islands instituted the *Cayman Islands International Tax Co-operation (Economic Substance) Law* (**Economic Substance Law**) as a response to global OECD BEPS standards regarding geographically mobile activities. The Economic Substance Law introduces certain reporting and economic substance requirements for "relevant" entities conducting "relevant activities", and these entities will be required to report to the Cayman Tax Information Authority in respect of some of their activities on an annual basis. This impacts most Cayman Islands incorporated managers who are now required to comply with economic substance requirements and subject to more stringent regulatory oversight. Furthermore, on 7 February 2020, the Private Funds Law, 2020 came into force in the Cayman Islands, which requires, among other things, certain closed-ended funds to be registered with and regulated by the Cayman Islands Monetary Authority.

These reforms pose uncertainties to the fund formation environment. The absence of clarity and market consensus around the economic and practical impact of these changes offers an opportunity for Hong Kong to become the next alternative jurisdiction for investment funds with the LPF regime.

Hong Kong's proximity to China Mainland and position as the financial centre in the Guangdong-Hong Kong-Macao **GBA** continues to offer Hong Kong the natural edge to stay competitive in the international market.

In addition, Hong Kong has been an organic part of the renminbi internationalisation drive, opening up channels for renminbi to benefit from its financial environment. To date, Hong Kong provides the broadest range of offshore renminbi products, and has been hosting the largest renminbi liquidity pool outside China Mainland. As Hong Kong continues to bridge the expansion of offshore renminbi activities and support the growing demand for renminbi reserves assets, we see increasing opportunities for investment funds to be domiciled in Hong Kong under the proposed LPF regime which would facilitate sponsors in managing renminbi assets portfolios through Hong Kong.

While IPOs have been a popular means of exit for many PE funds, Hong Kong continues to lead the world in IPO – offering yet another unique advantage for the proposed LPF regime.

The possibility of unifying an investment fund's domicile, operations, management team and exit channels in one single jurisdiction avoids the complexities and costs of appointing additional layers of service providers and dealing with multiple regulators, thus making Hong Kong an ideal place of domicile.

III. Proposed LPF regime at a glance

Broadly, the LPF is a "fund" that is registered by the Registrar of Companies (**RoC**) as an LPF. It comprises one general partner (**GP**) and at least one limited partner (**LP**) and is governed by its limited partnership agreement (**LPA**). Key entities of an LPF include the investment manager (**IM**), the auditor, the responsible person (**RP**), and if applicable, the authorised representative (**AR**). Custodians are not mandatory as long as there is proper custody of assets.[2]

The table below shows the key features of the LPF, the GP, the LP, and the key entities of the LPF:

[2] Unlike the unit trust regime and the OFC regime, there is no bright-line requirement that there must be a custodian. This is a favourable feature as a custodian is not necessarily required for some of the assets in which PE funds may invest (eg real estate and property).

Key features

<table>
<tr><th colspan="2">The LPF</th></tr>
<tr><th>Requirements</th><th>Characteristics</th></tr>
<tr><td>• must satisfy the definition of “fund” as set out in the Ordinance[3]
• must have one GP and at least one LP and be constituted by the LPA;
• must have a registered office in Hong Kong and a business registration certificate.</td><td>• has no separate legal personality;
• has the freedom to contract;
• has no minimum capital requirement or statutory investment restrictions.</td></tr>
<tr><th colspan="2">The GP</th></tr>
<tr><th>Requirements</th><th>Characteristics</th></tr>
<tr><td>• must be any of the following:
- a private company limited by shares incorporated in Hong Kong
- a registered non-Hong Kong company
- a limited partnership (whether it is registered under the LPO or a foreign jurisdiction with or without a separate legal personality)
- an LPF
- an individual who is at least 18 years old</td><td>• has unlimited liability for all debts and obligations of the LPF
• bears the ultimate responsibility for the management and control of the LPF
• has the duty to appoint an IM, an auditor, and an AR if the GP is an LPF or a non-Hong Kong limited partnership with no legal personality
• has the duty to ensure proper custody of assets</td></tr>
<tr><th colspan="2">The LP</th></tr>
<tr><th>Requirements</th><th>Characteristics</th></tr>
<tr><td>• can be any of the following:
- an individual
- a corporation
- a partnership
- an unincorporated body
- any other entity</td><td>• has the right to participate in the economic return of the LPF but has no day-to-day management rights or control over the assets
• its liability is limited to the agreed contribution it makes, unless the limited partner has participated in the day-to-day management of the LPF, subject to the non-exhaustive exemptions granted under the “safe harbour” provisions[4]</td></tr>
<tr><th colspan="2">The IM</th></tr>
<tr><td colspan="2">• must be appointed by the GP to carry out day-to-day investment management functions of the LPF[5];
• must be any of the following:
- a Hong Kong incorporated company
- a registered non-Hong Kong company
- a Hong Kong resident that is at least 18 years old
• can be the GP itself.</td></tr>
<tr><th colspan="2">The auditor</th></tr>
<tr><td colspan="2">• must be appointed by the GP to carry out annual audits of the financial statements of the LPF;
• must be independent of the GP, the IM and also the AR (if applicable) of the LPF.</td></tr>
<tr><th colspan="2">The RP</th></tr>
<tr><td colspan="2">• must be appointed by the GP to carry out the anti-money laundering and counter-terrorist financing (AML) measures set out in Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615) (AMLO)[6];
• must be any of the following:
- an authorised institution
- a corporation licensed by the Securities and Futures Commission (SFC)
- an accounting professional
- a legal professional</td></tr>
</table>

[3]Under section 3 of the Ordinance, a “fund” is defined, in brief, as an arrangement where (i) either the property is managed as a whole by or on behalf of the operating person of the arrangement, or the contributions of the participating persons and the profits or income from which payments are made to them are pooled; (ii) the participating persons do not have day-to-day control over the management of the property; and (iii) the purpose or effect of the arrangement is to enable the operating person and participating persons to receive profits, income, gains or other returns arising from the acquisition, holding, management or disposal of the property. For the complete definition and exceptions for “fund”, please see section 3 of the Ordinance, which is accessible at https://www.elegislation.gov.hk/hk/cap637?xpid=ID_1595838263726_001.

[4]Section 27 and Schedule 2 of the Ordinance.

[5]The initial proposed IM is deemed to be appointed as the IM of the LPF with effect from registration of the LPF, until otherwise replaced (section 20(3) of the Ordinance).

[6]The initial proposed RP is deemed to be appointed as the RP of the LPF with effect from registration of the LPF, until otherwise replaced (section 33(3) of the Ordinance).

The AR	
Requirements	Characteristics
• must be appointed by the GP to be responsible for the management and control of the LPF if the GP is an LPF or a non-Hong Kong limited partnership with no legal personality[7]; • must be any of the following: - a Hong Kong incorporated company - a registered non-Hong Kong company - a Hong Kong resident that is at least 18 years old	• is jointly and severally liable for all debts and obligations of the LPF with the GP; • shares the ultimate responsibility for the management and control of the LPF with the GP.

IV. Registration

To register a fund as an LPF, the proposed GP of the LPF must make an application to the RoC, which is required to be submitted on behalf of such GP **by a Hong Kong law firm or a solicitor**. A fixed fee of HK$3,034 is payable to the RoC in respect of the application and registration of an LPF, which is relatively low compared to the prescribed fee in the Cayman Islands.

A streamlined channel is also provided to qualifying structures registered under the LPO to migrate to the LPF regime upon the submission of an application similar to what is required for the registration of a new LPF.[8] Such migration would not result in any identity or continuity disruptions and would not trigger any profits tax and stamp duty implications.

Unlike the OFC structure, which is required to be registered and authorised by the SFC (if it is a public OFC), the LPF is only required to register with the RoC and **does not** need the authorisation of the SFC unless it is offered to retail investors (subject to applicable exemptions) and **is not subject** to any SFC-imposed investment restrictions, disclosure and operational requirements. However, if the GP or the IM of an LPF carries out regulated activities in Hong Kong as defined in the Securities and Futures Ordinance (Cap. 571) (**SFO**), appropriate licence(s) from the SFC must be obtained.

A certificate of registration of LPF will be issued by the RoC upon completion of registration and is conclusive evidence that the fund is registered as an LPF.

V. Key comparisons between the Proposal and the Ordinance

We identified below several major differences between the Proposal and the Ordinance.

(I) Clear definition of “fund”

An LPF must meet the definition of “fund”. Unlike the Proposal which makes reference to the definition of “fund” under section 20AM of the Inland Revenue Ordinance (Cap. 112) (**IRO**) and the definition of “collective investment scheme” under the SFO, the definition of “fund” is set out in full under the Bill (also the Ordinance). As noted in our submission to the FSTB, this is the preferred approach as it helps to avoid any unnecessary confusion.

Notably, though the definition of “fund” under the Ordinance[9] remains highly similar to the definition of “fund” under the IRO and the definition of “collective investment scheme” under the SFO, one of the exclusions applicable to those definitions has been left out of the definition under the Ordinance. The IRO definition and the SFO definition both excludes “an arrangement under which each of the participating persons [i.e. the investors] is a corporation in the same group of companies as the person operating the arrangements”.

It is not advisable to include such exclusion in the LPF context as PE funds are often initially set up with LPs that are affiliated to the GP (**GP Affiliated LPs**) for administrative and commercial reasons. Under the Ordinance, such exclusion has instead been replaced by our suggestion that the LPF be given a 24-month window to satisfy the requirement that not all the partners in the LPF are corporations in the same group of companies.[10] This ensures that the LPF has sufficient time to line up and admit non-GP Affiliated LPs.

[7]The initial proposed AR is deemed to be appointed as the AR of the LPF with effect from registration of the LPF, until otherwise replaced (section 23(4) & (5) of the Ordinance).

[8]Part 7 of the Ordinance.

[9]See Footnote 3.

[10]Sections 7(1)(i) and 7(2) of the Ordinance. The failure to satisfy such requirement may entitle the RoC to strike the name of an LPF off the LPF register. Other circumstances in which the RoC may be entitled to do so include where the LPF is not in operation or carrying on business as a fund after 24 months of its registration or where the LPF does not have an IM or RP (section 65(2) of the Ordinance).

(II) Relaxed eligibility criteria of the GP

Under the Proposal, a GP must be a Hong Kong incorporated private company limited by shares. In our submission to the FSTB, we explained that there is no comparable requirement in other jurisdictions and it is unduly restrictive as it denies the flexibility of allowing the GP to be set up in other commonly used legal forms (eg a foreign corporation or a limited partnership). The FSTB decided to remove this requirement from the Ordinance, as reflected in the table above.

(III) New requirement for an AR

We understand that a main reason for the original requirement that the GP be a Hong Kong limited private company is the concern that there will be difficulties in attributing liability to a GP that has no legal personality. As noted above, such requirement has been relaxed under the Ordinance and the GP can now be an LPF or a non-Hong Kong limited partnership with no legal personality. To alleviate the relevant concern, such GP will now be required to appoint an AR who will share with the GP the ultimate responsibility to manage the LPF and be jointly and severally liable for any liabilities of the LPF.

(IV) Relaxed eligibility criteria of the IM

Like the Proposal, the Ordinance mandates that the GP delegates all day-to-day investment management functions to an IM. Whilst we consider such requirement to be unnecessary and unattractive as the GP can take on such functions itself and it imposes additional restriction on the set up of an LPF, it is worth noting that the requirement has been significantly relaxed.

Under the Ordinance, the IM is no longer required to be an authorised institution, a SFC-licensed entity, an accounting professional or a legal professional. Interestingly, it is specified that the GP of an LPF can act as the IM. Practically, this may be unorthodox from a legal perspective since the GP will essentially be contracting with itself in respect of such appointment. However, it is not unusual for GP to take up the investment management functions in certain PE funds so it would be interesting to see how this is applied practically.

(V) New requirement for an RP

As indicated under the Proposal, the original eligibility criteria of the IM aims at ensuring that suitable persons are appointed to undertake the necessary AML measures. In light of the now relaxed IM eligibility criteria under the Ordinance, to ensure relevant AML standards are met, the GP of the LPF is now required to appoint an RP who will take over the role of conducting AML measures.

VI. Safe harbour provisions

As noted in the table above, LPs may risk losing their limited liability if they participate in the management of the LPF. Taking into account the market practice for LPs to have some degree of management involvement or decision-making power in the LPF, a non-exhaustive list of "safe harbour" activities has been introduced in the Ordinance to offer bright-line guidance as to what activities would not be regarded as management of the LPF.[11] This should be sufficiently wide to cover the standard range of management that LPs have in PE funds.

Examples of such activities include:

- acting as or appointing someone to act as an agent, officer or employee of the LPF;
- acting as or appointing someone to act as a director, shareholder, or officer of the GP;
- serving on or appointing someone to serve on a board or committee of the LPF or the GP;
- serving on or appointing someone to serve on a board or committee of portfolio companies;
- approving the GP or the IM to carry out certain actions relating to the business, prospects or transactions of the LPF; and
- taking part in certain decisions of the LPF including extension of fund term and change in investment scope.

VII. AML concerns vs investor confidentiality

In line with international and local AML efforts, the Ordinance requires the RP to carry out necessary AML measures and imposes certain record-keeping obligations on the GP or the IM of the LPF.[12] In short, it is required that records containing particulars relating to the partners, customers, transactions and controller of each partner of the LPF[13] (**AML records**) should be kept at the registered office of the LPF or such other place notified to the RoC.

Although the AML records are required to be made available to the GP and LPs of the LPF, regulators and law enforcement agencies, it is made clear under the Ordinance that they must not be made available for public inspection. The public, however, will be able to inspect

[11] Schedule 2 of the Ordinance.

[12] Sections 33 and 29 of the Ordinance.

[13] For definition of "controller", please refer to section 29(6) & (7) of the Ordinance. The definition is largely similar to the definition of "beneficial owner" under the AMLO.

the LPF register kept by the RoC, which will contain all documents registered with and the certificate issued by the RoC. Such documents may include annual return which is required to be filed in a specified form by the GP to the RoC, amongst other notifications relating to certain changes to the LPF.[14] It is unclear at this stage what information will be required to be provided in the annual return. However, it is worth noting that where any information is specified as being excluded from public inspection in the Ordinance (eg the AML records), it will not be made available to the public as part of the LPF register kept by the RoC. This shows the government's effort to ensure a reasonably high level of confidentiality is accorded to the LPs to ensure the attractiveness of the proposed regime.

VIII. Tax treatment

LPF will enjoy profits tax exemption as long as it meets the definition of "fund" under section 20AM of the IRO and subject to certain exemption conditions. Qualifying funds will be able to enjoy profits tax exemption on transactions in qualifying assets in Schedule 16C to the IRO and incidental transactions for any year of tax assessment.

The LPF will be treated as a separate entity from partners for tax purposes. The GP (or authorised representative, if applicable) of the LPF is responsible for lodging profits tax returns on behalf of the LPF. Both the GP (or authorised representative, if applicable) and the Manager will be responsible for ensuring the LPF complies with the requirements of the IRO.

On distribution of profits and assets by the LPF to the LPs, it is proposed that those proceeds, as well as redemption and transfer of LP interests, will not be subject to stamp duty as an interest in a LPF is not a "stock".

While qualified LPFs may enjoy profits tax exemption, Hong Kong-based managers or advisors arranging or conducting the specified transactions remain chargeable. The IRD has stressed in their practice notes that these local service providers should be adequately compensated for their services or remunerated on an arm's length basis[15].

However, it would appear that the Hong Kong Government will legislate to address the IRD view that the carried interest is typically a fee for services or a type of disguised management fee. The Financial Secretary Paul

[14]For example, changes in the particulars relating to the AR (section 23(6) of the Ordinance), change of GP or changes in the particulars relating to the GP (section 25(1)(a) & (b) of the Ordinance), changes in the address of the registered office of the LPF (section 25(1)(c) of the Ordinance), changes in the investment scope or principal place of business of the LPF (section 25(1)(d) of the Ordinance), change of IM or changes in the particulars relating to the IM (section 25(1)(e) of the Ordinance), and change of RP or changes in the particulars relating to the RP (section 25(1)(f) of the Ordinance).

[15]Paragraph 72 of PN51 provides that management and performance fees based on a cost-plus formula are not likely to have been determined on the arm's length basis, in particular when the investment managers or advisors performed significant functions and bore considerable risks in Hong Kong to generate the profits of the offshore funds.

Chan Mo-po said in his budget speech in February 2020:

> *With a view to attracting more private equity funds to domicile and operate in Hong Kong, we plan to provide tax concession for carried interest issued by private equity funds operating in Hong Kong subject to the fulfilment of certain conditions. We will consult the industry on the proposal, and the relevant arrangement will be applicable starting from 2020-21 upon completion of the legislative exercise.*

IX. Dissolution and liquidation mechanisms

Unlike the limited partnership regime under the LPO, the LPF regime offers a straightforward dissolution mechanism. One important feature is that an LPF may be dissolved in accordance with the LPA. This offers the flexibility much needed in the PE fund context as unlike public funds or hedge funds, PE funds often have specific investment targets and cycles and hence a limited term.

Apart from dissolution in accordance with the LPA, an LPF can also be dissolved with or without a court order in certain default situations.[16] In respect of dissolution without a court order, an LPF can be dissolved where certain default events occur in relation to the GP or the AR (if applicable) of the LPF and that the GP or the AR is not replaced within 30 days after the date of the occurrence of such default events. These events include where the GP or the AR is bankrupt, dissolved, dead, wound up, or ceases to be the GP or the AR of the LPF (as the case may be).

In respect of dissolution with a court order, a partner or a creditor of an LPF may apply to the court for the LPF to be dissolved if, for example, a partner wilfully or persistently commits a breach of the LPA, the business of the LPF can only be carried on at a loss, or it is just and equitable that the LPF be dissolved. Further, an LPF may be wound up by the court as an unregistered company in accordance with the Companies (Winding UP and Miscellaneous Provisions) Ordinance (Cap. 32). [17]

X. The future vehicle of choice?

The proposed LPF regime provides a practical alternative for the domiciliation of PE funds and potentially more flexibility for fund managers to meet market demand. The limited partnership is a familiar investment vehicle for fund managers across different jurisdictions. With the Chinese government's initiative of developing the GBA[18], we see the potential for the LPF regime to be embraced by fund managers in the region seeking to raise funds from Mainland Chinese investors or to raise funds to invest in China.

Given the change of the regulatory landscape in traditional offshore jurisdictions like the Cayman Islands, this proposed LPF regime also enables Hong Kong to grasp the opportunity of the shift of fund structures and activities from offshore to onshore.

Additionally, Hong Kong's relatively extensive network of double tax agreements, as compared with other PE fund domicile jurisdictions (such as the Cayman Islands), may prove beneficial for LPFs and investors and their relevant underlying overseas investments.

The authors would like to thank Florence Lau, Boer Ma, Cheryl Ho and Hazel He for their contributions to this article.

---

[16] Sections 70(2) and 71 of the Ordinance.

[17] Part 6, Division 2 of the Ordinance.

[18] The "Outline Development Plan for the Guangdong-Hong Kong-Macau Greater Bay Area" was announced in February 2019, under which one of the key focus areas is to develop the Greater Bay Area into an international financial hub, including developing Guangzhou into a private equity "trading market".

Practical guides on orphan SPV repackaging transactions for Hong Kong SAR and China Mainland clients

Richard Mazzochi, Minny Siu, Angus Sip, Ryan Iskandar

Minny Siu

Richard Mazzochi

Angus Sip

Introduction

We observe growing interest from Chinese financial institutions in the use of orphan special purpose vehicles ("SPVs") in repackaging structures for financing deals. Chinese clients do not just include traditional sell-side clients like investment banks and authorised institutions, but also securities houses and many buy-side clients such as fund managers and asset managers.

The key advantages in the use of repackaging structures include their off-balance sheet treatment, and reduced credit risks to the arranger's corporate group.

This article provides an introduction to the background, basic features and commercial uses of repackaging transactions, and answers to some of our clients' frequently asked questions.

I. How long have repackaging structures been around?

Repackaging structures are not a recent invention. The earliest repackaging transaction is thought to have been conceived as early as the 1980s in the UK. Since then there has been explosive growth in the scale and variety of repackaging transactions across multiple asset classes, including bond-linked, equity-linked, credit-linked, commodity-linked and other structures linked to bespoke products.

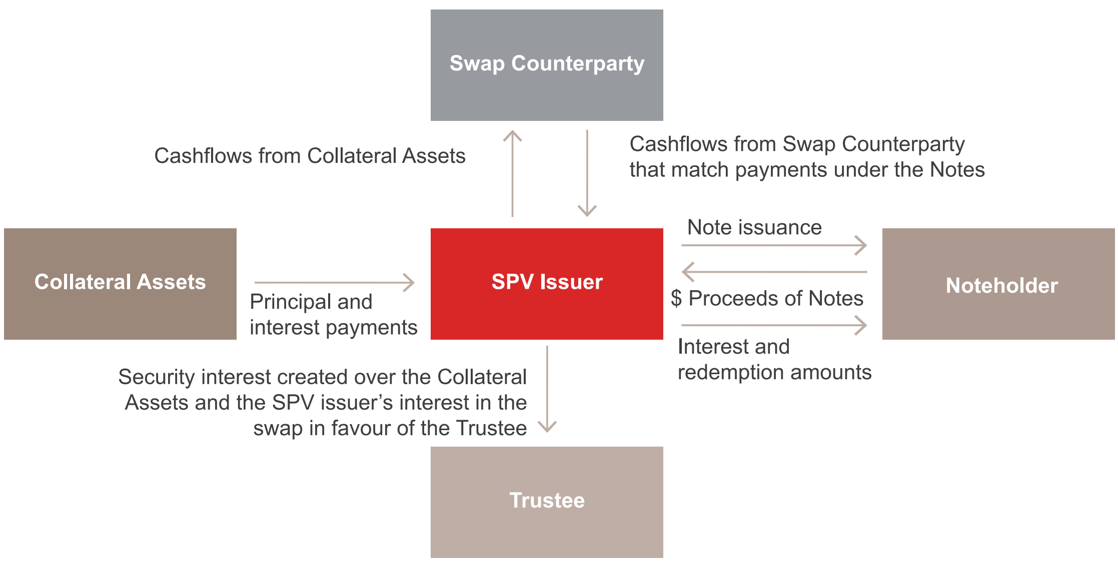
The following key features of repackaging transactions are all well-established in global markets:

- orphan nature of the SPV;
- insolvency remoteness and ring-fencing through limited recourse and non-petition;
- security over the underlying collateral assets;
- use of derivatives to manage cashflows discrepancies between the note level and the collateral asset pool level; and
- use of pre-enforcement liquidation by a disposal agent and trustee enforcement.

The volume and complexity of repackaging transactions fell after the global financial crisis in 2008, but have resumed in recent years. There have been various initiatives in recent years to develop multi-dealer repackaging programmes in Europe and the US, where multiple financial institutions accede to a common programme to offer products on more standardised terms.

The use of repackaging transactions is relatively novel to China Mainland clients. Instead of using the repackaging structure in traditional methods such as large volume "flow" transactions that are linked to safe and liquid assets, Chinese financial institutions have successfully and creatively leveraged repackaging structures to fit their own unique business and capital needs.

II. What is the basic structure of a repackaging transaction?



Traditionally, many of the simpler repackaging transactions are structured with the following features:

- An orphan SPV issuer issues notes ("**Notes**") and uses the issuance proceeds to purchase underlying assets, such as a portfolio of bonds ("**Collateral Assets**").
- In repackaging transactions arranged by Chinese financial institutions, these structures are often "pass-through", under which the cashflows under the Notes will match the cashflows under the Collateral Assets precisely without the need for a swap in managing cashflow discrepancies.
- If it is necessary to modify the cashflows under the Collateral Assets for any reason (e.g. changing the interest rate or currency), the SPV issuer enters into a swap transaction with the Swap Counterparty (usually the arranger or one of its affiliates), under which the SPV issuer pays to the Swap Counterparty cashflows it receives from the Collateral Assets, and the Swap Counterparty pays to the SPV issuer cashflows which match payments under the Notes.
- The SPV issuer grants security over the Collateral Assets it holds as well as all of its rights, title and interest under the swap transaction (if any) and other related transaction documents in favour of the Trustee.
- The Trustee holds the benefit of the security on trust for the secured creditors, which include the Noteholders and the Swap Counterparty.

To increase cost-efficiency, arrangers will typically arrange for note programmes to be established by the SPV issuers. The programme documentation will set out the framework for the basic structure above, which allow the SPV to enter into repackaging transactions using shorter form issuance documentation. Such programmes are commonly known as "repackaging programmes".

III. What is an orphan SPV?

A fundamental feature of repackaging structures is the use of an insolvency remote "orphan" SPV as the issuer. The SPV is typically a company established in a tax neutral or tax favourable jurisdiction (such as the Cayman Islands or Ireland), and is independently owned and controlled by independent directors.

When establishing a repackaging programme, a professional corporate services provider is usually appointed to assist with incorporating and managing the SPV. The professional corporate services provider's core business activities include holding the shares of the SPV on trust for a charitable purpose, as well as providing independent directors for the SPV. The SPV and the professional corporate services provider will enter into an administration agreement appointing the professional corporate services provider as the administrator of the SPV and setting out the scope of its services. Any fees, costs and expenses payable to the administrator will usually be borne by the arranger.

At KWM, we have strong relationships with the most well-established corporate services providers that have a long track record in incorporating and managing orphan SPVs. While fraud risk cannot be completely eliminated, appointing a reputable corporate services provider will help to minimise this risk. Arrangers and investors can also take comfort that the Collateral Assets for any series of Notes is secured in favour of the Trustee, who holds the security on trust for the secured creditors. The orphan SPV and its directors are usually subject to restrictions from dealing with Collateral Assets under the repackaging programme documents.

Such arrangements ensure that the SPV will not be regarded as a subsidiary of the arranger or the originator, or indeed of any corporate group. It will be for all intents and purposes an "orphan" with no affiliates.

IV. What are the pros and cons of repackaging transactions?

A common question that many Chinese clients ask is whether they should set up a repackaging programme, or a more traditional structured notes programme with a corporate group entity as the issuer. Some of the pros and cons of setting up a repackaging programme are set out below.

(I) Pros

- Off-balance sheet treatment in respect of Collateral Assets – Perhaps the most important advantage that a repackaging structure gives is off-balance sheet treatment in respect of the Collateral Assets. The SPV is an "orphan" that is not an affiliate or subsidiary of the arranger group. This means that any Collateral Assets that the SPV purchases for any repackaging transaction will not form part of the balance sheet of the arranger group, including any assets that the SPV purchases from the arranger group. When the arranger group sells assets to the SPV, this accelerates cash receipts on the sale of the assets while removing the assets from the balance sheet of the arranger group. In doing so the debt-to-equity ratio of the arranger group is reduced, and the financial ratios are improved so as to enable it to borrow more on-balance sheet.
- Off-balance sheet treatment in respect of Notes – For similar reasons as described above, any Notes issued by the orphan SPV will not form part of the balance sheet of the arranger group. This has a number of advantages – for example, that the arranger group will not need to hold capital under the Financial Resources Rules ("FRR") for notes issued by the orphan SPV issuer. In addition, for Chinese financial institutions, Notes issued by the orphan SPV should not constitute foreign debt of the Chinese financial institutions and therefore should not require NDRC filings.

  Although there have been instances where issuances by a corporate group issuer under a structured notes programme have achieved off-balance sheet treatment, this often requires discussions with accountants and specific structuring features (such as holding and granting security over the reference assets). Using a repackaging programme is arguably a more established and reliable method of achieving this outcome.
- Reduced credit risk to the arranger group – Another important advantage of repackaging transactions is reduced credit risk to the arranger group. Investors in structured notes issued by a corporate group issuer are exposed to the credit risk of both the arranger group (via the issuer) and reference assets that underlie the structured notes. However, in a repackaging transaction, investors are only exposed to the credit risk of the Collateral Assets. The SPV issuer is not part of the arranger group and is structured to be "insolvency remote".
- Tackle investment restrictions – Repackaging structures may also help tackle investment restrictions imposed on the investors. Financial institutions or funds may be subject to investment restrictions, such as restrictions from making loans or investments in equity or fund products. Often they are not restricted from investing in fixed income products. Repackaging notes issued by an orphan SPV are often regarded as fixed income products falling within their investment scope.
- Others – Other key benefits of using repackaging transactions include obtaining a favourable tax treatment and avoiding conflicts of interest with an independent board in place at the SPV level.

(II) Cons

- Costs – The main drawback of establishing a repackaging programme is cost. As it is a more complex structure than a traditional structured notes programme, there are more parties and documents involved, which will involve a substantially higher establishment and on-going maintenance cost. The list of the key parties and documents involved in a repackaging programme are described below.
- Time – It also generally takes longer to establish the repackaging programme than a traditional structured notes programme. A typical timeline for establishing a repackaging programme is described below.

We observe a trend amongst Chinese Mainland financial institutions in Hong Kong SAR to maintain both a repackaging programme and a traditional structured notes programme, which provides the greatest flexibility to meet client and business demands.

V. How to achieve "insolvency remoteness" in repackaging transactions?

An SPV is structurally independent of the arranger group, and will not be affected by the insolvency of the arranger group.

Apart from the SPV corporate ownership independence, the programme documents will also adopt contractual "insolvency remoteness". Common contractual provisions include:

- Restrictions on the SPV against engaging in any business (other than the issuance of notes under the repackaging programme), the disposal of assets, declaration of dividends, owning of any subsidiary or incurring of liabilities except for those contemplated by the repackaging transactions.
- "Limited recourse" language – i.e. noteholders and other secured creditors in respect of a repackaging transaction only have recourse to Collateral Assets which are subject to security for that transaction.
- "Non-petition" language – i.e. noteholders and other secured creditors agree not to take any legal proceedings or file any winding-up petition against the SPV.

VI. How to achieve "ring-fencing" in repackaging transactions?

It is typical for arrangers to establish repackaging programmes such that a single SPV can enter into multiple series of repackaging transactions. It is important that each series of repackaging transaction is "ring-fenced" from all other series, such that the collateral assets held by the SPV for a particular series are only available to the noteholders and other secured creditors for that series, and not to any other creditor of the SPV.

This is achieved by:

- "Limited recourse" language – i.e. noteholders and other secured creditors for a particular series will only have recourse to Collateral Assets which are subject to security for that series only, and not to the Collateral Assets for any other series.
- Security – i.e. security over Collateral Assets for a particular series is created in favour of the trustee, which holds it on trust for the noteholders and other secured creditors for that series only.

It is also important that the SPV is "insolvency remote" (as discussed in Section V above) from a ring-fencing perspective, as these ring-fencing mechanisms may not always survive in an insolvency scenario.

VII. How are repackaging transactions operated in practice?

As discussed in Section III above, arrangers typically appoint professional corporate services providers when establishing repackaging programmes, who appoint independent directors for the SPV. The directors will be involved in signing transaction documents and holding board meetings, but will not be typically involved in running the transactions. This means that other parties will be responsible for all structural and operational aspects of repackaging transactions, including making all determination and decisions and taking actions.

We list out some of the most common roles in a typical repackaging transaction:

Arrangers	• Managing and overseeing the setting up of programme and structuring each note issuance
Dealer	• Initial purchaser of notes for on-sale to investors • Usually a Type 1 licensed entity
Calculation Agent	• Making certain calculations and determinations in connection with the Notes
Originator	• The arranger (or one of its affiliates) usually holds (or acts as the dealer in respect of) the Collateral Assets that are sold to the SPV • The originator can also be a buy-side client of the arranger which holds the underlying asset and is looking to accelerate cash receipts and remove assets from its balance sheet
Disposal Agent	• Pre-enforcement liquidation of the Collateral Assets before redemption
Swap Counterparty	• Taking on certain risks in a repackaging, e.g. interest rate and currency mismatches between the receivables and the Notes, or providing leverage on the return of the Notes

Arrangers will usually also appoint a professional trustee and agency services provider to perform the following roles:

Account Bank	• Maintaining an account into which proceeds of the underlying assets are deposited
Custodian	• Safekeeping of the underlying assets (usually for securities cleared through external clearing systems)
Paying Agent	• Making payments to the noteholders as they fall due
Note Trustee / Security Agent	• Acting on behalf of the noteholders as an intermediary between the noteholders and the issuer, representing the noteholders' interests throughout the life of the notes • Also holding the benefit of the security on behalf of the investors and other parties whose interests are secured
Settlement Agent	• Assisting with the initial settlement of the Notes • Usually be appointed if the arranger does not have an account with clearing systems

A key consideration for arrangers is that, while they will necessarily be heavily involved in structuring and running repackaging transactions, there are certain limits in order to retain off-balance sheet accounting treatment. For example, arrangers should not have any control over the orphan SPV's board of directors. The directors need to be genuinely independent directors that act in the best interests of the orphan SPV.

Voting rights in respect of the Collateral Assets should be held solely by the orphan SPV but not the arranger. As security interest over the Collateral Assets is created in favour of the trustee, the SPV usually covenants not to exercise voting rights unless it receives a direction from the noteholders by way of extraordinary resolution.

VIII. What documents are required to establish a repackaging programme?

Arrangers will need to appoint a local counsel to incorporate the SPV in their jurisdiction of choice (e.g. for a Cayman SPV, Cayman counsel is required). Many such local counsel have a professional corporate services provider arm, and it is common to appoint both of them together.

Local counsel will typically prepare the following documents:

SPV incorporation documents	• To incorporate the SPV
Declaration of Trust	• For the share trustee to declare a charitable trust over the shares of the SPV
Administration Agreement	• To appoint the professional corporate services provider as the administrator of the SPV • Arranger usually also signs up to bear the fees, costs and expenses on behalf of the SPV

As your arranger and trustee counsel, we will prepare the following programme documents:

Offering Circular	• Disclosure document for the repackaging programme • Will contain risk factors, terms and conditions, selling restrictions and any other disclosure that may be required
Principal Trust Deed	• Appoints the trustee and sets up the framework for creating the notes and security for any series
Agency Agreement	• Appoints the agents of the SPV as listed in Section VII above
Dealer Agreement	• Agreement to sell notes to the Dealer for distribution to investors
Swap Schedule	• Form of Schedule to an ISDA Master Agreement between the Swap Counterparty and SPV • Sets up the framework for confirmations to be entered into for any issuance • Not always necessary to be drafted at programme establishment

IX. What licences may be required for repackaging transactions?

The following licences may be relevant to repackaging transactions under the Securities and Futures Ordinance (Cap. 571) (SFO):

Type 1 (Dealing in securities)	• Repackaging notes are typically sold to professional investors • Type 1 licence always required when selling to corporate or individual professional investors • The Dealer must be a Type 1 licensed entity for the SPV to rely on an exemption under the SFO
Type 3 (Leveraged foreign exchange trading)	• Potentially relevant if an FX swap is required
Type 8 (Securities margin financing)	• Needs to be considered for leveraged transactions
Type 9 (Asset management)	• This may be relevant in "managed" repackaging transactions, where notes issuance proceeds are deposited with an investment or asset manager • Not required for most repackaging transactions
Type 11 (Dealing in or advising on OTC derivative products)	• When it comes into force, the arranger group entity that acts as the swap counterparty will need to be Type 11 licensed

There are many other regulatory considerations that may be relevant to repackaging transactions, including but not limited to:

- suitability requirements when marketing to investors;
- arrangers' liability for market misconduct and misrepresentation;
- SFC Code of Conduct requirements for complex products and derivative products; and
- regulations in relation to OTC derivatives, including reporting, margining, clearing and potential licensing issues.

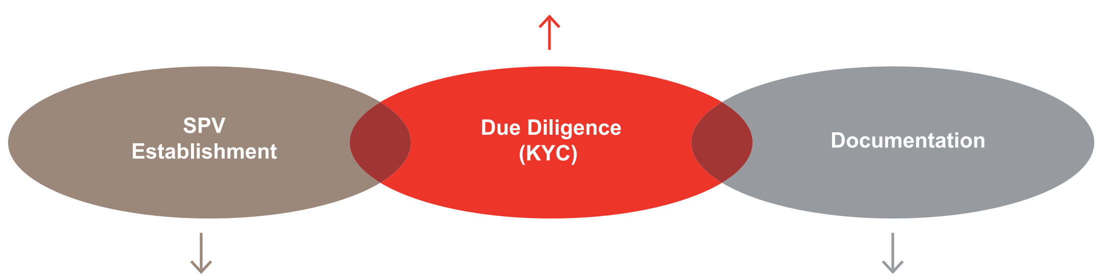
This is a big topic which needs to be considered on a case-by-case basis for each transaction. We are happy to discuss further with any client on potential regulatory considerations relating to any repackaging transaction.

X. What is a typical timeline for establishing a repackaging programme?

Depending on the corporate approval process of the arranger institution (which may range from one month to up to six months or more), the setup of a repackaging programme itself can be completed within six to ten weeks. Timeline for a note drawdown under the programme varies from case to case depending on the complexity and novelty of the structure.

The programme establishment process is summarised in the chart below.

- KYC will be conducted by the note trustee / agent.
- Time for KYC completion for new SPV can be three weeks or more. KYC needs to be completed before programme establishment.



- The SPV establishment process is straightforward and will be handled by an offshore counsel in a suitable offshore jurisdiction. It usually takes up to a week to establish a SPV.
- A legal identifier code (LEI) is now mandatory for programme establishment. This is usually obtained within 48 hours of SPV establishment.

- Draft Offering Circular will be provided to clearing systems for comments and allocation of programme number.
- Turnaround time for ICSDs is at least ten business days.
- Other programme level documentation include: Principal Trust Deed, Agency Agreement, Dealer Agreement.

Interpretation of *the Supreme People's Court's Opinion on Taking Forward a Pilot Measure in relation to the Recognition of and Assistance to Insolvency Proceedings in the Hong Kong Special Administrative Region*

Hao Zhaohui, Shen Yuhan


Hao Zhaohui

On 14 May 2021, the Supreme People's Court (SPC) and the Hong Kong Special Administrative Region (HKSAR) government signed *the Record of Meeting on Mutual Recognition of and Assistance to Bankruptcy (Insolvency) Proceedings between the Courts of the Mainland and the Hong Kong Special Administrative Region* (the "Record of Meeting"). In order to further refine the cooperative framework for insolvency matters in both places, the SPC has issued *the Supreme People's Court's Opinion on Taking Forward a Pilot Measure in relation to the Recognition of and Assistance to Insolvency Proceedings in the Hong Kong Special Administrative Region* (the "Pilot Opinion"), which provides innovative guidelines for insolvency cases cross border of Mainland and HKSAR, the scope and legal effect of mutual recognition, and the cooperate method of both judicial. Starting from the background of the Pilot Opinion, we, as a law firm specializing in debt restructuring in the China Mainland and Hong Kong SAR, analyse the innovative highlights of the Pilot Opinion and look ahead at the prospect of cooperation on cross-border insolvency developments.

I. Background of the Pilot Opinion

Under the *Basic Law of the Hong Kong Special Administrative Region of the People's Republic of China*, Hong Kong may render judicial assistance through consultation with judicial organs in other parts of the country. In terms of mutual recognition and enforcement of judgments and arbitral awards, eight arrangements for judicial assistance in civil and commercial matters have been signed between the Mainland and Hong Kong, but bankruptcy matters had been excluded from the judicial assistance scope before. Article 5 of *the Enterprise Bankruptcy Law of the People's Republic of China* (the "Enterprise Bankruptcy Law") contains principled provisions on cross-border bankruptcy, but there is no systematic judicial document in this area. The promulgation of the Pilot Opinion is an expanded exploration of judicial assistance in the bankruptcy sector. It is undoubtedly an inspiration for cross-border insolvency practice, preservation of estate, involvement in derivative litigation and arbitration, and foreign creditors' participation in insolvency proceedings.

Simultaneously, cross-border trade and investment have raised actual demands for collaboration in cross-border insolvency practice. Statistics show that in 2018, Hong Kong set up about 40,000 enterprises in the Mainland and the Mainland's non-financial direct investment in Hong Kong were more than USD 70 billion. Frequency investment activities will inevitably be accompanied by the withdrawal of some enterprises. Therefore, the demand for mutual assistance in debt restructuring judicial proceedings is no longer a matter in theory. Prior to the signing of the Record of Meeting, bankruptcy practitioners in both places were "struggling" in individual cases and were unable to find the golden rule. With the signing of the Record of Meeting, the Pilot Opinion was issued timely to boost the confidence of cross-border investors, offer stable expectations for parties involved in cross-border transactions, and provide a fair model for dealing with cross-border bankruptcy cases.

II. Interpretation of innovation points of the Pilot Opinion

The Pilot Opinion contains innovative provisions regarding the model, the scope of applicable cases, the legal effect, the application materials to be submitted by Hong Kong liquidators and the termination of assistance. This article analyses the innovative provisions based on the specific provisions of the Pilot Opinion as follows:

(I) Scope of the pilot

Articles 1 and 5 of the Pilot Opinion provide for the applicable territorial scope and competent court, which designates Shanghai Municipality, Xiamen Municipality in Fujian Province and Shenzhen Municipality in Guangdong Province as pilot areas in the Mainland. The intermediate people's courts of the three pilot cities may recognize and assist with the Hong Kong insolvency proceedings in accordance with the Pilot Opinion. Shanghai, Shenzhen and Xiamen were chosen for the reason that they are the top three cities that accommodate most places of business, representative offices or assets of debtors in the Hong Kong insolvency proceedings, and that there are many Hong Kong-invested enterprises in the three regions. In 2019 and 2020, the Shanghai Third Intermediate People's Court and the Shenzhen Intermediate People's Court respectively obtained bankruptcy assistance from the High Court of the Hong Kong Special Administrative Region (the "High Court"), which have gained experience on a case-by-case basis.

Hong Kong courts, in accordance with common law principles, recognize and assist the insolvency proceedings in the Mainland not limited to the insolvency proceedings conducted by people's courts in the aforesaid pilot areas. In fact, in the previous bankruptcy liquidation cases of CEFC Shanghai International Group Limited ("CEFC") and Shenzhen Everich Supply Chain Co., Ltd. (Everich), Hong Kong courts recognized the position and power of Mainland administrators in Hong Kong, on the grounds that the insolvency proceedings of the two places were highly compatible, and that they did not harm the interests of creditors. Therefore, with the precedents and later regulations, it would be more convenient for Mainland administrators to apply for the judicial recognition and assistance of bankruptcy cases to the Hong Kong courts.

(II) Types of applicable cases

Articles 2 to 4 of the Pilot Opinion set out the applicable types of cases. Firstly, the Pilot Opinion applies to 1) similar collective debt liquidation procedures in the two places, including bankruptcy proceedings (bankruptcy liquidation, reorganization and settlement proceedings) in the Mainland, under which the debtor must satisfy the bankruptcy requirements under Article 2 of the Enterprise Bankruptcy Law; and 2) compulsory winding up, creditors' voluntary winding up and scheme of arrangement approved by court of Hong Kong in accordance with section 673 of the *Companies Ordinance* of the HKSAR. Secondly, the so-called "Centre of main interests" principle, which means the Pilot Opinion applies to Hong Kong insolvency proceedings where the HKSAR has been the centre of main interests of the debtor continuously for at least 6 months. And "Centre of main interests" generally means the place of incorporation of the debtor. At the same time, the people's court shall take into account other factors including the place of principal office, the principal place of business, the place of principal assets etc. of the debtor.

(III) Application materials

Articles 5 to 8 of the Pilot Opinion stipulate what materials Hong Kong liquidators shall submit and what information shall be specified in their application when they apply to mainland courts for recognition of and assistance to Hong Kong insolvency proceedings. Article 8 stipulates that the people's court shall make a notification and announcement within five days from the date of receiving the application for recognition and assistance, and that interested parties shall have the right to put forward objections in writing.

(IV) Legal effect

Articles 9 to 15 of the Pilot Opinion describe the legal effect of the Mainland's recognition of and assistance to the Hong Kong insolvency proceedings. Generally speaking, mailing an application for recognition and assistance in enforcement by a Hong Kong administrator to a People's Court in the Mainland has almost the same effect of the insolvency proceedings in the Mainland under the Enterprise Bankruptcy Law. On one hand, after the people's court recognizes the Hong Kong insolvency proceedings, individual repayment will be deemed invalid. On the other hand, any civil action or arbitration involving the debtor that has started but has not yet been concluded shall be suspended; however, such action or arbitration can proceed after the Hong Kong administrator takes over the debtor's property. Additionally, the measures for preserving the property of the debtor by the courts of the Mainland shall be lifted and the procedure for execution shall be suspended. The Hong Kong liquidator shall not perform his duties beyond the scope provided by the Enterprise Bankruptcy Law and the law of the HKSAR. In other words, the Hong Kong liquidator is not allowed to enjoy any preferential treatment that goes beyond the extent permitted by applicable laws in bankruptcy proceedings in the Mainland on the ground that it complies with Hong Kong laws. Especially when the Hong Kong liquidator performs any duty that involves waiver of property rights, creation of security on property, loan, transfer of property out of the Mainland and other acts for disposing of the property that has a major impact on the creditors' interest, it requires separate approval by the people's court. The Pilot Opinion also innovatively proposes the "two-administrator model", which means that for a case where the people's court recognizes the Hong Kong insolvency proceedings, it may, upon an application by the Hong Kong liquidator or a creditor, designate a Mainland administrator, whose duties and affairs shall be dealt with in accordance with the Enterprise Bankruptcy Law, instead of laws of the HKSAR.

(V) Termination of proceedings

Articles 17 to 18 of the Pilot Opinion stipulate that under what circumstances that a people's court may modify or terminate any recognition or assistance. Such circumstances include: the centre of main interests of the debtor is not situated in the HKSAR or it has been situated in the HKSAR for less than six months continuously; Article 2 of the Enterprise Bankruptcy Law of the People's Republic of China is not satisfied; Mainland creditors are unfairly treated; there is fraud; there is any other circumstance where the people's court considers that recognition or assistance shall not be rendered and the people's court shall refuse to recognise or assist the Hong Kong Insolvency Proceedings if it considers that such recognition or assistance violates the basic principles of the law of the Mainland or offend public order or good morals.

(VI) Ways of paying off creditor's rights

According to Article 20 of the Pilot Opinion, if a people's court recognizes and assists the Hong Kong insolvency proceedings, the bankruptcy property of the debtor in the Mainland shall first satisfy preferential claims under the law of the Mainland. The remainder of the property is to be distributed in accordance with the Hong Kong Insolvency Proceedings provided that creditors in the same class are treated equally. It is intended to maintain the principle of complying with the substantive provisions of the laws and regulations of the Mainland. Where a creditor's claims have the priority to be paid substantively based on security interests, priority of construction proceeds and other provisions in accordance with the laws and regulations of the Mainland, the creditor continues to enjoy its rights based on the nature of the security interests or construction proceeds. Such rights are derived from the substantive provisions of the laws of the Mainland, and therefore will not be affected by the bankruptcy proceedings outside the territory. In addition, the balance of insolvency estate shall be distributed and liquidated in accordance with the Hong Kong insolvency proceedings based on the principle of equal liquidation.

III. Significance of the Pilot Opinion to bankruptcy practitioners in the Mainland and Hong Kong

(I) Response to judicial practice exploration

Prior to the promulgation of the Pilot Opinion, there had been precedents of mutual recognition of Insolvency proceedings between the Mainland and the HKSAR in practice. The typical cases were bankruptcy liquidation of CEFC and Everich.

In the CEFC bankruptcy liquidation, CEFC's administrator applied to the High Court for recognition of Insolvency proceedings in the Mainland. Upon examination of the relevant evidence, Justice Jonathan Harris of the High Court held that since the domestic insolvency proceedings are collective liquidation (or reorganization) proceedings involving all creditors and the insolvency proceedings are opened by the company's in its place of incorporation (Mainland China), given the compatibility between the Enterprise Bankruptcy Law and the Hong Kong bankruptcy law, the insolvency proceedings in the Mainland may cover the debtor's assets, liabilities and affairs in Hong Kong. Meanwhile, Justice Harris specifically pointed out in the decision that, without the special permission of the High Court, any person other than the administrators shall not file any lawsuit relating to CEFC, as long as CEFC is still under the insolvency and liquidation proceedings in the Mainland[1].

In the Everich bankruptcy liquidation case, the Hong Kong court also held that the insolvency proceedings initiated in the Mainland were the whole insolvency proceedings for the disposal and takeover of the debtor (i.e. the Collective Insolvency Proceedings, the identification standard of which was to determine whether the insolvency proceedings were made for the interests of all creditors), and the insolvency proceedings were initiated in the place of incorporation of the debtor. Therefore, the Hong Kong court granted Everich's administrators various administrative duties as well as rights, including but not limited to receiving the information of the company, investigating the property of the company, preventing the property disposal of the debtor, taking over the assets and accounts of the debtor, and filing a lawsuit in the name of the debtor. The effectiveness of Mainland administrators' actions in Hong Kong was recognized[2].

(II) Opportunities and challenges for future cooperation on cross-border insolvency

It should be noted that Article 14 of the Pilot Opinion sets forth restrictive provisions for the Hong Kong administrator on the waiver of property rights, creation of security on property, loan, transfer of property out of the Mainland and other acts for disposing of the property that has a major impact on the creditors' interest. This article maintains certain equivalence with the aforesaid case provisions of Hong Kong courts recognizing insolvency proceedings in the Mainland. However, Article 15 of the Pilot Opinion provides an innovative model for the Mainland administrator and Hong Kong liquidator to assist with the bankruptcy of the debtor in the Mainland, i.e. the people's court may, upon an application by the Hong Kong liquidator or a creditor, designates a Mainland administrator to take charge of the insolvency affairs of the debtor in the Mainland, which imposes a higher requirement on practitioners' familiarity with the laws of both places, as well as on cross-border asset disposal and participation in litigation.

IV. Prospects for cooperation between the two places on insolvency matters

In summary, the Pilot Opinion provides clear guidelines for the transition of mutual recognition and assistance, and for the mutual assistance of bankruptcy administrators in insolvency proceedings in both the Mainland and Hong Kong. It is undoubtedly a significant achievement of judicial assistance in the bankruptcy sector between the Mainland and the HKSAR. For the bankruptcy practitioners in the Mainland and the HKSAR, we believe that as economic exchanges between the two places deepen, the Pilot Opinion will certainly apply to more cases and provide more extensive and clear guidance for the future assistance in cross-boundary insolvency, which will in turn improve the business environment.

[1]HCMP 2295/2019, by the High Court of the Hong Kong Special Administration Region Court of First Instance.

[2]HCMP 708/2020, IN THE HIGH COURT OF THE HONG KONG SPECIAL ADMINISTRATIVE REGION COURT OF FIRST INSTANCE.

Applying for enforcement of Mainland awards in Hong Kong SAR under the *Arbitration Ordinance* 2021

Qi Yuan, Han Weizhe, Wang Shuai

Qi Yuan

Introduction

The *Arbitration (Amendment) Ordinance 2021* of the Hong Kong Special Administrative Region of China ("**Hong Kong**") (the "**Arbitration Ordinance**") took effect on 19 May 2021, further promoting the implementation of the *Supplemental Arrangement Concerning Mutual Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region* (Fa Shi [2020] No. 13] (the "**Supplemental Arrangement**") in Hong Kong. This article will focus on the major changes in the Arbitration Ordinance, briefly review the basic procedures for enforcing Mainland awards[1] in Hong Kong SAR, and address several practical concerns often enquired by Mainland parties.

I. Major changes in the Arbitration Ordinance

On 17 February 2021, the Department of Justice of Hong Kong issued a press release proposing amendments to the then-current Arbitration Ordinance to fully implement the Supplemental Arrangement[2]. The Legislative Council of Hong Kong considered and passed the amendments in the following month[3]. There are two major changes: firstly, it removes the restrictions on the enforcement of Mainland awards under Section 93, allowing parties to enforce their awards both with Mainland courts and the High Court of Hong Kong ("**Hong Kong court**") at the same time; secondly, it repeals the list of "recognised" Mainland arbitral authorities[4] published under Section 97.

These changes provide a new solution to the enforcement of Mainland awards. We will likely see more parties to seek enforcement of the Mainland awards in favour of them in Hong Kong SAR when they meet challenges in China Mainland.

II. Overview of the Mainland awards enforced in Hong Kong

From 2000 to 2009, 94.22% of Mainland awards were successfully enforced in Hong Kong. The Hong Kong court received eighty four applications to enforce Mainland awards. All applications were granted with the leave to enforce. Eighteen respondents seek to set aside the order and only five of them were approved[5].

From 2009 to 2017, 96.58% of Mainland awards were successfully enforced in Hong Kong. During this time, the number of applications reached to 249, of which 85, or 34.13% were from the Mainland, ranking the first place. In other words, 9 Mainland awards on average filed for enforcement in Hong Kong each year. Especially in 2017, 17 Mainland awards were filed for enforcement in Hong Kong[6]. In this eight years, 11 applications were made to set aside the order and the only 3 were granted.

[1]Under the Arbitration Ordinance, Mainland award means an arbitral award made in accordance with the Arbitration Law of the People's Republic of China.

[2]https://www.doj.gov.hk/sc/community_engagement/press/20210217_pr1.html, last accessed on 1 May 2021.

[3]https://www.legco.gov.hk/yr20-21/chinese/ord/2021ord001-c.pdf, last accessed on 1 May 2021.

[4]https://www.gld.gov.hk/egazette/pdf/20162051/cgn201620517226.pdf, last accessed on 2 May 2021.

[5]Paragraph 100 of the Report of the Bills Committee on Arbitration Bill of the Legislative Council of Hong Kong issued for the House Committee meeting on 22 October 2010, cited by Zhou Lixin, Xiao Zhenran and Li Shilie in "Enforcement of Mainland Awards in Hong Kong (I)", footnote 17. https://www.hkba.org/node/13884, last accessed on 2 May 2021.

[6]https://www.hkiac.org/about-us/statistics/enforcement-awards, last accessed on 1 May 2021.

According to these publicly available data, we believe that the Mainland awards are very likely to be enforced in Hong Kong. This record also demonstrates that the close cooperation in trade and capital between the Mainland and Hong Kong has given rise to a series of civil and commercial disputes, and that many of the parties ordered to pay compensation in Mainland awards may have properties available for enforcement in Hong Kong. Therefore, Hong Kong is an unignorable option to enforce awards for Chinese parties to international arbitration and cross-border disputes.

III. Basic procedures for applying for enforcement of Mainland awards

A party applying for enforcement of an award in Hong Kong should first submit an application to the Court of First Instance of the Hong Kong court (the "**Court**") in accordance with Section 84 of the Arbitration Ordinance[7]. Then the Court may grant a leave to "enter judgment" in terms of the application.

Once the court has granted the leave, the award becomes enforceable as if it were a judgment of the Hong Kong court. If the Court dismisses the application, the applicant may also, with leave, appeal to the Hong Kong court against the Court's decision.

According to the Rules of the High Court[8], after a "leave" is granted, the court will serve an "order granting the leave" on the party subject to enforcement ("debtor") and require the debtor to perform the award. The debtor may raise objection within 14 days or a period specified by the court upon receipt of the order. During this "objection period", the award cannot be actually enforced.

IV. Legal issues to be considered in applying for enforcement of Mainland awards

(I) Property investigation prior to the initiation of enforcement proceedings

Different from the enforcement requirements in the Mainland, an applicant applying for enforcement in Hong Kong should provide information of the properties pending enforcement. The Hong Kong court are not obliged to and will not take the initiative to investigate about the debtor's property for the applicant.

In view of this, it is practically necessary for the applicant to investigate the debtor's property available for enforcement before making a formal application. In addition, property investigations prior to enforcement proceedings in the two jurisdictions are also different. The property investigation in Hong Kong may cover the following:

- Basic information. Obtaining from the registration authority the debtor's registration information, including but not limited to company's name, address, company secretary, and shareholders;
- Property. Using a third party institution database to search whether the debtor has ever held any property or conducted any transactions in Hong Kong to trace the debtor's assets;
- Litigations. Using a third party database to search whether debtor is involved in any litigation in Hong Kong[9] and to trace the debtor's assets;
- Winding up. This is to enquire with government authority whether the debtor has ever been or is now in the winding up proceedings, or has been declared liquidated. If the debtor is undergoing the winding up proceedings, then the applicant may make claims against the liquidator for repayment of the relevant debts; and
- Shareholding. To our knowledge, shareholders of listed companies in Hong Kong who hold more than 5% of shares are required to disclose their equity. Except for this, there is no way to directly and fully trace the debtor's equity investments in Hong Kong.
- In addition, the applicant may engage legitimate private investigation firms in Hong Kong to conduct a more in-depth investigation on the debtor's assets.

(II) Limitation on applications for enforcement of Mainland awards in Hong Kong

The *Arrangement Concerning Mutual Enforcement of Arbitral Awards between the Mainland and the Hong Kong Special Administrative Region* (Fa Shi [2000] No. 3) (the "**Arrangement**") provides: "Only when the result of the enforcement of the award by the court of one place is insufficient to satisfy the liabilities may the applicant apply to the court of another place for enforcement of the outstanding liabilities."

Subject to such requirement, many parties will give priority to the enforcement of arbitral awards in the Mainland, taking into account such factors as the cost of enforcement. If the enforcement proceedings in the

[7](1) Subject to section 26(2), an award, whether made in or outside Hong Kong, in arbitral proceedings by an arbitral tribunal is enforceable in the same manner as a judgment of the Court that has the same effect, but only with the leave of the Court. (2) If leave is granted under subsection (1), the Court may enter judgment in terms of the award. (3)The leave of the Court is required for any appeal from a decision of the Court to grant or refuse leave to enforce an award under subsection (1).

[8]Order 73, rule 10(6) of the Rules of the High Court: Within 14 days after service of the order made under paragraph (4) or, if the order made under paragraph (4) is to be served out of the jurisdiction, within such other period as the Court may fix, the debtor may apply to set aside that order, and the settlement agreement, award, order, direction or emergency relief shall not be enforced until after the expiration of that period or, if the debtor applies within that period to set aside the order made under paragraph (4), until after the application is finally disposed of.

[9]Including: Hong Kong Court of Final Appeal, High Court, District Court, Small Claims Tribunal, Labour Tribunal, and Lands Tribunal.

Mainland are ineffective or pending, the enforcement proceedings in Hong Kong may not commence in a timely manner, which may have a significant impact on the interests of the successful parties.

The guiding case *CL v. SCG [2019] HKCFI 398*[10], jointly issued by the Supreme People's Court and the Department of Justice of Hong Kong, affirms the general provision on the time limit for applying for enforcement of a Mainland award in Hong Kong: The limitation period for application for enforcement of an award shall commence on the date when the debtor "fails to make payment within a reasonable time of the publication of the Award and demand being made".

In addition, under Section 4.1.c of the Hong Kong Limitation Ordinance, the limitation period for enforcement application is six years. Not the same as in the Mainland, there is no provision for suspension or interruption of such period.

Before the 2021 amendment, it is important for the applicant to be aware of these differences and coordinate the enforcement procedures in the Mainland and Hong Kong. After the amendment, it is recommended that the successful party should apply for enforcement in both the Mainland and Hong Kong at the same time against the debtor as soon as possible.

(III) Documents required to be submitted in connection with applications for enforcement of Mainland awards in Hong Kong

In accordance with Section 85 of the Arbitration Ordinance[11], and Order 73, Rule 10 of the Rules of the High Court, the documents required to be submitted for enforcement of Mainland awards in Hong Kong include: (1) an affidavit; (2) the duly authenticated original award or a duly certified copy of it; (3) the original arbitration agreement or a duly certified copy of it; and (4) an authenticated translation if the award is not in Chinese or English.

It is worth noting that as an application for enforcement of an award is generally made ex *parte* by a party, the party making the application assumes a duty of full and frank disclosure of all relevant information in support of the application. In *Grant Thornton International Ltd v JBPB & Co [2013] HKEC 477*, the court held that the applicant should disclose facts and evidential material relevant to the success of the application, including whether there is any proceeding to set aside the arbitral award. Inaccurate disclosure or material omissions may be fatal to the application.

Additionally, as the Arbitration Ordinance allows for simultaneous applications for enforcement of awards in both the Mainland and Hong Kong, the problem of double enforcement still exists. The Supplemental Arrangement provides for a system to share information between the two jurisdictions, i.e. "The courts of the two places shall, at the request of the court of the other place, provide information on its status of the enforcement of the arbitral award. The total amount to be recovered from enforcing the arbitral award in the courts of the two places shall not exceed the amount determined in the arbitral award." In the future, applicants are encouraged to disclose the enforcement of the award in the Mainland, in particular the amount recovered, and apply for enforcement in Hong Kong only in respect of the amount not yet recovered, in order to improve the efficiency of the application review and the possibility of the leave being granted.

(IV) The relationship between the Mainland's proceedings to set aside arbitral awards and Hong Kong's enforcement proceedings

In accordance with *UNCITRAL Secretariat Guide on the Convention on the Recognition and Enforcement of Foreign Arbitral Awards* (New York, 1958), the Convention on the Recognition and Enforcement of Foreign Arbitral Awards "does not apply to setting aside proceedings" and "a respondent's cross-motion to set aside the award was governed by domestic law on arbitration." Similarly, the Arrangement and the Supplemental Arrangement (collectively, the "Arrangements"), which deal with inter-regional judicial matters in China, do not deal with the setting aside of arbitral awards.

The Mainland award is made under the *Arbitration Law of the People's Republic of China* (the "Arbitration Law"). Pursuant to Article 58 of the Arbitration Law, the application for setting aside a Mainland award shall be made to the intermediate people's court at the place where the arbitration institution resides. According to Section 95(2)(f) of the Arbitration Ordinance, a Hong Kong court may refuse to enforce a Mainland award if the award has been set aside by a court of competent jurisdiction in the Mainland.

If the debtor applies for setting aside the Mainland award in the Mainland at the same time as the applicant applies

[10] https://www.chinacourt.org/article/detail/2020/11/id/5627700.shtml, last accessed on 2 May 2021.

[11] (a) the duly authenticated original award or a duly certified copy of it;

(b) the original arbitration agreement or a duly certified copy of it; and

(c) if the award or agreement is not in either or both of the official languages, a translation of it in either official language certified by an official or sworn translator or by a diplomatic or consular agent.

for enforcement of such award in Hong Kong, how will the enforcement proceedings in Hong Kong proceed before the Mainland court makes a ruling on the setting aside case? Does it have to be suspended? Neither the Arbitration Ordinance nor the Arrangements explicitly address this issue. It is noteworthy that under Sections 89 and 98D of the Arbitration Ordinance, if the party concerned applies for setting aside or suspending a Convention award[12] or a Macao award[13], the Hong Kong court "may, if it thinks fit, adjourn the proceedings for the enforcement of the award" and "may, on the application of the party seeking to enforce the award, order the person against whom the enforcement is invoked to give security." There is, however, no similar statutory provision in respect of Mainland awards.

In the precedents such as *La Dolce Vita Fine Dining Co Ltd v. Zhang Lan and Others [2020] HKCFI 622*, however, the Hong Kong court, in response to an application by the respondents for a stay of proceedings in relation to the enforcement of a Mainland award (where the place of arbitration was Beijing), rendered an order as follows: "The Summons be adjourned for a period of 3 months from the handing down of this Decision, on condition that the 1st, 2nd and 3rd Respondents give security by payment into court (or by provision of such other security as is acceptable to the Applicants) of 40% of the total sum of the Awards, and costs of the Summons on indemnity basis."

In view of this, we understand that if a debtor applies for a stay of enforcement proceedings on the ground that the Mainland court has not yet made a ruling on the setting aside case, the Hong Kong court will also have the discretion to decide whether to stay the proceedings and whether to require the debtor to provide security depending on the actual circumstances of the case. Such practice is notably different from that in the Mainland where the enforcement court should order the stay of enforcement of a Mainland award if an application for setting aside such award is made by the debtor and accepted by a court.

(V) Property preservation or similar measures in enforcing Mainland awards

Under Article 6 of the *Arrangement Concerning Mutual Assistance in Court-ordered Interim Measures in Aid of Arbitral Proceedings by the Courts of the Mainland and of the Hong Kong Special Administrative Region*, before the arbitral award is made, a party to arbitral proceedings administered by a Mainland arbitral institution may, pursuant to the Arbitration Ordinance and the High Court Ordinance, apply to the High Court for interim measure. In Hong Kong, interim measure includes injunction and other interim measure for the purpose of maintaining or restoring the status quo pending determination of the dispute; taking action that would prevent, or refraining from taking action that is likely to cause, current or imminent harm or prejudice to the arbitral proceedings; preserving assets; or preserving evidence that may be relevant and material to the resolution of the dispute.

Therefore, where a Mainland award is potentially enforced in Hong Kong, the applicant should first consider to apply to a Hong Kong court for interim measures at the time of initiating arbitration in order to prevent the counterparty from transferring, concealing or selling its property.

If the applicant has not applied to the Hong Kong court for interim measures against the debtor before the award is made, it may still do so before or after the application for enforcement of the arbitral award is accepted in accordance with Article 4 of the Supplemental Arrangement.

(VI) Enforcement measures in enforcing Mainland awards

In addition to injunction and other interim measures, the applicant may, depending on the type of assets of the debtor, seek charging order, asset sale order, third party debt order, or to have the responsible person to be examined by the court under Order 48 of the Rules of the High Court to disclose assets of the debtor. The applicant may even file a winding up petition to compel the debtor to go bankrupt and subsequently seek repayment of its debt from the debtor's estate.

The victory in arbitration is an important step for obtaining legal relief, but it is not the end of the story. Where a debtor refuses to perform a binding award, the ultimate satisfaction of the claim still depends on the progress of the court's enforcement proceedings. Parties who have obtained a favourable Mainland award and need to apply for enforcement of such award in Hong Kong should figure out a best solution for the enforcement by fully considering the specific circumstances of the case, the assets of the debtor, as well as the procedure, time and financial costs of the various enforcement measures.

[12]Under the Arbitration Ordinance, Convention award means an arbitral award made in a State or the territory of a State, other than China or any part of China, which is a party to the New York Convention.

[13]Under the Arbitration Ordinance, Macao award means an arbitral award made in Macao in accordance with the arbitration law of Macao.

Another major breakthrough: Mutual assistance in cross-border insolvency between China Mainland and Hong Kong SAR

Barbara Chiu, Nichole Hou, Tony Gu

Barbara Chiu

Nichole Hou

Introduction

The recent decision by the Hong Kong court in *Re Ando Credit Ltd* [2020] HKCFI 2775 marks its first appointment of provisional liquidators[1] over a Hong Kong company with the express purpose of allowing the liquidators to seek recognition in China Mainland.

This represents a major breakthrough in judicial cooperation over cross-border winding up[2], demonstrating China Mainland and Hong Kong's key efforts in facilitating mutual assistance for winding up matters. We understand that the Mainland and Hong Kong have begun to discuss a bilateral mechanism to recognise and assist companies in winding up matters, and we look forward to seeing the arrangement in operation as soon as possible.

I. Background

The winding up of Hong Kong companies is governed by the *Companies (Winding Up and Miscellaneous Provisions) Ordinance* (Cap. 32) and is generally divided into voluntary winding up and compulsory winding up. This article focuses on compulsory winding up – if a company is unable to pay its debts, its creditors may petition the court for an order of compulsory winding up and the appointment of a liquidator. One of the liquidator's major duties is to investigate the assets of the company in liquidation, recover such assets, and repay debts to the creditors based on the *pari passu* principle.

In theory, a winding up order issued by Hong Kong courts covers worldwide assets. In other words, all assets of the company in liquidation, regardless of the location, are subject to the winding up laws of Hong Kong. However, in practice, the actual execution of a Hong Kong winding up order in other jurisdictions requires judicial recognition from that particular jurisdiction.

Although Article 5 of the *Enterprise Bankruptcy Law of the People's Republic of China*[3] allows PRC courts, without contravening fundamental principles and relevant practices of the PRC laws, to recognise and enforce judgements of foreign courts, we understand that the provision does not apply to winding up orders issued by Hong Kong courts. A letter from the Supreme People's Court of the PRC in 2011[4] explicitly stated that there is no legal

---

[1] Known as "bankruptcy administrator" or "liquidation group" in China Mainland.

[2] Known as "enterprise bankruptcy" in China Mainland.

[3] Article 5 of the *Enterprise Bankruptcy Law of the People's Republic of China*: "Where any legally effective judgment or ruling made by a foreign court involves any debtor's assets within the territory of the People's Republic of China and if the debtor applies with or requests the people's court to confirm or enforce it, the people's court shall, according to the relevant international treaties that China has concluded or acceded to or according to the principles of reciprocity, conduct an examination thereon and, when believing that it does not violate the basic principles of the laws of the People's Republic of China, does not damage the sovereignty, safety or social public interests of the state, does not damage the legitimate rights and interests of the creditor within the territory of the People's Republic of China, grant confirmation and permission for enforcement." (English translation)

[4] "The Supreme People's Court's Reply Letter Regarding Norstar Automobile Industrial Holding Limited's Request for Application for Recognition of An Order of the Courts of the Hong Kong Special Administrative Region" (《最高人民法院关于北泰汽车工业控股有限公司申请认可香港特别行政区法院命令案的请示的复函》) [2011] Civ 4 Others No. 19.

basis for the PRC courts to recognise winding up orders of Hong Kong courts, and the *Arrangement on Reciprocal Recognition of Judgments in Civil and Commercial Matters*[5] is similarly not applicable.

Given the absence of a mechanism for recognising the Hong Kong's winding up process in China Mainland, liquidators appointed by Hong Kong courts often face difficulty when investigating and recovering assets in China Mainland. In order to resolve problems resulting from this, Hong Kong courts have indicated in different cases that there is an urgent need to establish a statutory cross-border insolvency mechanism[6]. Recent cases[7] have also reflected Hong Kong courts' desire actively to facilitate cooperation in cross-border insolvency.

II. The judgment of *Re Ando*

In Re Ando Credit Ltd, the applicant made an ex *parte* application to the court to appoint a provisional liquidator for a Hong Kong company Ando Credit Limited (安道信貸有限公司) ("Ando"). The application was made with the express purpose of seeking recognition in China Mainland, with a view to facilitating the Hong Kong liquidator to recover the very substantial receivables believed to be owed to Ando by its debtors in China Mainland.

The Companies Judge acknowledged the possibility of recognition of Hong Kong appointed liquidators under the PRC Enterprise Bankruptcy Law, citing the article "Exploration into the practice of cross-border bankruptcy between Mainland and Hong Kong" (《内地与香港跨境破产的实践探索》). That article reflected the increasingly open attitude towards the recognition and assistance with China Mainland insolvency proceedings by the Hong Kong courts and also the likelihood of PRC courts providing assistance based on the principle of reciprocity. The court noted that in the near future, an agreement may be entered into between the Hong Kong SAR Government and the PRC Supreme People's Court which will provide a clear statutory basis for such mutual recognition.

The court granted the application and specifically ordered the inclusion of an express provision permitting the provisional liquidators to make an application for recognition to the Shenzhen Bankruptcy Court, subject to the Hong Kong court's approval of the various stages of the application.

III. Insights from *Re Ando*

The Re Ando decision showcased another significant step in promoting judicial cooperation regarding cross-border insolvency. Given the unprecedented nature of the case, it remains to be seen whether and how the appointment of the provisional liquidators is to be recognised by the Shenzhen Bankruptcy Court, and the degree of scrutiny by the Hong Kong courts during the various stages. In any event, the decision should be welcomed by creditors and insolvency practitioners, especially in light of the growing number of cross-border financial arrangements with debtors based in China Mainland.

In line with the trend, the Legislative Council Panel on Administration of Justice and Legal Services in Hong Kong issued a policy paper in June 2020 proposing a possible framework for co-operation between Hong Kong SAR and China Mainland on recognition of and assistance in corporate insolvency matters. It is hoped that any such a formal framework would simplify the mutual judicial recognition of insolvency proceedings and afford better protection of the assets of the debtor company as well as the interests of the creditors.

---

[5]The full name is "Arrangement on Reciprocal Recognition and Enforcement of Judgments in Civil and Commercial Matters by the Courts of the Mainland and of the Hong Kong Special Administrative Region" (《内地与香港特别行政区法院相互认可和执行当事人协议管辖的民商事案件判决的安排》).

[6]*Re Cw Advanced Technologies Ltd* [2018] 3 HKLRD 552, para 35, "*From the perspective of Hong Kong policy-makers, this case underscores again the urgent need to enact a statutory cross-border insolvency regime*" and *Re Da Yu Financial Holdings Limited (in liquidation)* [2019] HKCFI 2531, paras 46 and 53.

[7]Since the beginning of 2020, the High Court of Hong Kong have begun to recognize China Mainland liquidators, and cases include the CEFC case (*Re CEFC Shanghai International Group Ltd* [2020] 1 HKLRD 67) and the Everich case *(Re The Liquidator of Shenzhen Everich Supply Chain Co, Ltd* [2020] HKCFI 965).

Chinese domestic enterprises' path to REIT offerings and listings in Hong Kong SAR

Sun Haotian, Chen Hua, Wang Letao, Jessica Zhou, Yang Xiaoquan, Qiu Liang, Li Nan, Wen Jiaolin


Sun Haotian


Chen Hua


Wang Letao


Jessica Zhou


Yang Xiaoquan


Qiu Liang

On 17 May 2021, SF Real Estate Investment Trust ("SF REIT") was successfully listed on the Stock Exchange of Hong Kong Limited (HKEx), making itself the first listed logistics real estate investment trust (REIT) in Hong Kong Special Administrative Region ("Hong Kong"). It points out a new possible option for the Chinese domestic enterprises seeking financing offshore. Yuexiu REIT became the first Hong Kong-listed REIT with underlying properties located in China in 2005. CMC REIT and SF REIT have also got listed in Hong Kong in recent years. In addition to Singapore, Hong Kong has become another major market for public offerings of REITs by the domestic enterprises. This article provides an all-round introduction to the offering of REITs in Hong Kong by Chinese domestic enterprises from such perspectives as the background of offshore REIT offering, the transaction structure and listing procedures of REITs in Hong Kong, the red-chip restructuring for REIT offerings and compliance.

I. Overview of Offshore offering of REITs by Chinese enterprises

After explosive growth, China's real estate market has gradually entered a stage of high existing housing stock. It is particularly urgent to make good use of existing assets and realise the exit of heavy assets. REITs originated in the U.S. in 1960, and have grown rapidly in developed regions such as Australia, Hong Kong, and Singapore, as well as some emerging markets. As they are publicly offered, REITs are characterized by strong liquidity, high investor recognition, and non-reflection on the balance sheet. In order to make good use of existing assets and ease financial pressure, more and more Chinese domestic enterprises choose to issue REITs in Hong Kong or Singapore where there are mature rules and investors with a good understanding of assets from China Mainland.

(I) REIT listings on HKEx[1]

To date, REITs with Chinese properties listed on HKEx are as follows:

Name	Date of listing	Property type	Property portfolio
Yuexiu REIT (00405.HK)	21 December 2005	Complex, office building, shopping mall	City Development Plaza, Fortune Plaza, Victory Plaza, and White Horse Building
Hui Xian REIT (087001.HK)	Friday, 29 April 2011	Complex, hotel	Oriental Plaza
Spring REIT (01426.HK)	5 December 2013	Office building	China Central Place Tower 1 and Tower 2
CMC REIT (1503.HK)	10 December 2019	Complex and office building	New Times Plaza, Cyberport Building, Technology Building, Technology Building 2, and Garden City Shopping Centre
SF REIT (2191.HK)	17 May 2021	Industrial and logistics	Asia Logistics Hub - SF Centre, FTI Park in Guicheng, Foshan, and FTI Park in Wuhu

(II) REIT listings on SGX[2]

To date, REITs with Chinese properties listed on SGX are as follows:

Name	Date of listing	Property type	Property portfolio
Mapletree Logistics Trust (M44U.SG)	28 July 2005	Industrial and logistics	Mapletree Northwest Logistics Park (Phase 1), Mapletree Northwest Logistics Park (Phase 2), Mapletree Waigaoqiao Bonded Logistics Park, Mapletree Yangshan Bonded Logistics Park, Mapletree Ouluo Logistics Park, Mapletree American Industrial Park, Mapletree Hangzhou Logistics Park, Mapletree Jiaxing Logistics Park, Mapletree Zhenjiang Logistics Park, Mapletree (Wuxi) Logistics Park, Mapletree Wuxi New District Logistics Park, Mapletree Changshu Logistics Park, Mapletree Nanchang Logistics Park, Mapletree Tianjin Logistics Park, Mapletree Wuhan Logistics Park, Mapletree Fengdong (Xi'an) Industrial Park, Mapletree Xi'an Distribution Centre, Mapletree Changsha Logistics Park Phase 1, and Mapletree Zhengzhou International Logistics Park
Starhill Global REIT (P40U.SG)	20 September 2005	Shopping mall	Renhe Spring Zongbei Property
Ascott Residence Trust (HMN.SG)	31 March 2006	Serviced residences	Somerset Xuhui Shanghai, Ascott Guangzhou, Citadines Xinghai Suzhou, Citadines Zhuankou Wuhan, Somerset Grand Central Dalian, Somerset Heping Shenyang, and Somerset Olympic Tower Tianjin
CapitaLand China Trust (AU8U.SG)	8 December 2006	Shopping mall	CapitaMall Xizhimen, CapitaMall Wangjing, CapitaMall Grand Canyon, CapitaMall Shuangjing, CapitaMall Qibao, Rock Square, CapitaMall Xinnan, CapitaMall Saihan, CapitaMall Erqi, CapitaMall Minzhongleyuan, CapitaMall Wuhu
Mapletree Greater China Commercial Trust (RW0U.SG)	7 March 2013	Office building	Gateway Plaza and Sandhill Plaza
OUE Commercial REIT (TS0U.SG)	27 January 2014	Complex	Lippo Plaza

[1]According to data on cn-abs.com, as of 17 May 2021, 15 REITs from the China have been listed in Hong Kong. Since RREEF China Commercial Trust and New Century REIT have been delisted, there are now 13 REITs available for trading.

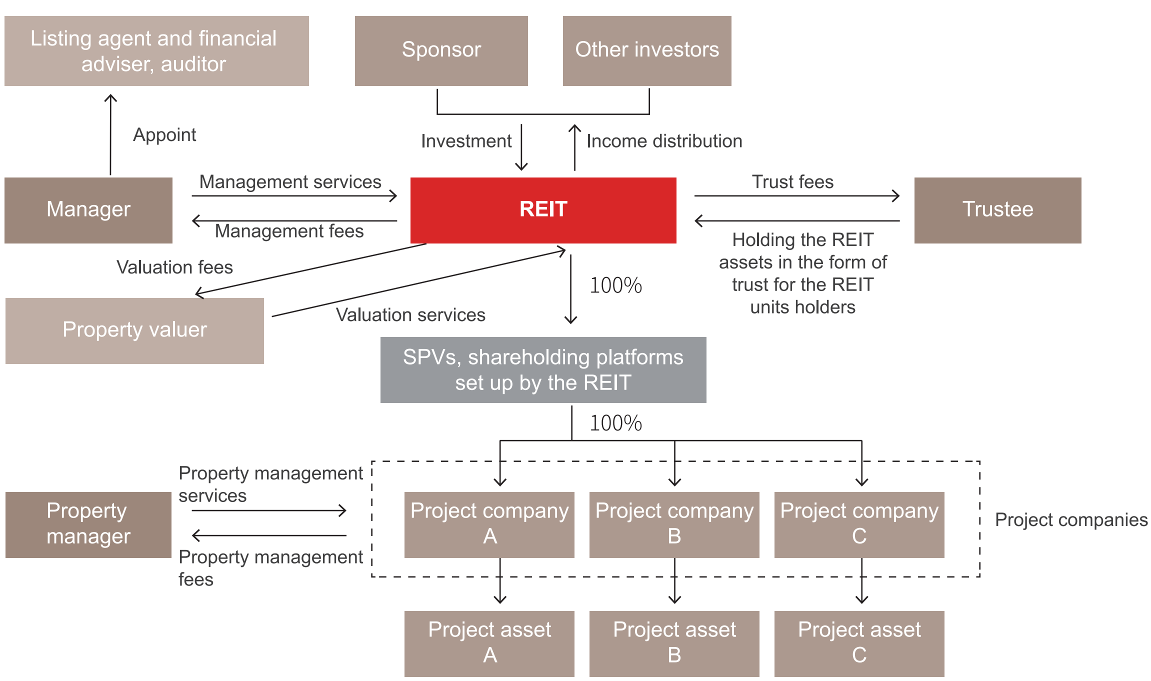
[2]According to the Singapore Stock Exchange (SGX), as of 14 May 2021, a total of 47 REITs from the China were available for trading on Singapore Stock Exchange.

Name	Date of listing	Property type	Property portfolio
BHG Retail REIT (BMGU.SG)	11 December 2015	Shopping mall	BHG Beijing Wanliu, BHG Chengdu Konggang, BHG Dalian Jinsanjiao, BHG Hefei Mengchenglu, and BHG Xining Huayuan
EC World REIT (BWCU.SG)	28 July 2016	Industrial and logistics	Chongxian Port Investment, Chongxian Port Logistics, Fu Heng Warehouse, Fu Zhuo Industrial, Hengde Logistics, the Stage 1 Properties of Bei Gang Logistics, and Wuhan Meiluote
EC World REIT (BWCU.SG)	20 January 2017	Industrial and logistics	Shiqi Metro Mall, Xiaolan Metro Mall, Ocean Metro Mall, Dasin E-Colour, Shunde Metro Mall, and Tanbei Metro Mall
Sasseur REIT (CRPU.SG)	28 March 2018	Shopping mall	Sasseur (Chongqing Liangjiang) Outlets, Sasseur (Chongqing Bishan) Outlets, Sasseur (Hefei) Outlets, and Sasseur (Kunming) Outlets

II. Transaction structures and key processes of REITs in Hong Kong

(I) Transaction structures

The main transaction structures of REITs in Hong Kong are as follows:



(II) Key processes

1. Key listing rules

On 4 December 2020, the Securities and Futures Commission of Hong Kong ("SFC") released the revised *Code on Real Estate Investment Trusts* ("Code"). Comparing with the 2014 Code, the main highlights of this revision include: 1) REITs are allowed, subject to relevant conditions, to invest in minority-owned properties, 2) their investment in a property development projects may exceed 10% of the gross asset value, and 3) their maximum borrowing limit is increased from 45% to 50% of the total gross asset value. The main provisions of the latest Code are as follows:

Main rules	Main contents
Characteristics	1. Dedicated investments in real estate that generates recurrent rental income; 2. Active trading of real estate is restricted; 3. The greater proportion of income shall be derived from rentals of real estate; 4. A significant portion of income is distributed to holders in the form of regular dividends; 5. A maximum borrowing limit is defined; and 6. Connected party transactions are subject to holders' approval.
Open market requirements	At least 25% of the total issued and outstanding units must at all times be held by the public.
Institution requirements	1. Must be in the form of trust; 2. Must have a trustee acceptable to the SFC, and the trustee and the manager shall be independent of each other; 3. Must have a manager acceptable to the SFC, and the manager must appoint a listing agent, a financial adviser, and an auditor; 4. Must appoint an independent property valuer who shall value the relevant REITs on a yearly basis.
Investment limitations	The scheme shall primarily invest in real estate. 1. The real estate shall generally be income-generating (at least 75% of the gross asset value of the scheme shall be invested in real estate that generates recurrent rental income at all times); 2. The scheme may acquire uncompleted units in a building which is unoccupied and non-income producing or in the course of substantial development, redevelopment or refurbishment (but the aggregate contract value of such real estate together with the Property Development Costs shall not exceed 25% of the gross asset value of the scheme at any time); 3. The offering document shall clearly disclose if the scheme intends to acquire further properties during the first 12 months from listing.
	The scheme may invest in the following financial instruments: 1. Securities listed on HKEx or other internationally recognised stock exchanges; 2. Unlisted debt securities; 3. Government and other public securities; and 4. Local or offshore property funds; Provided that: investment in any of the above financial instruments may not exceed 10% of the gross asset value of the scheme.
	The aggregate investments in such Minority-owned Properties shall not exceed 10% of the gross asset value of the scheme ("10% Cap").
	The aggregate investments in Non-qualified Minority-owned Properties, Property Development, Relevant Investments and other ancillary investments of the scheme shall not exceed 25% of the gross asset value of the scheme at any time. Investments in Qualified Minority-owned Properties are not included into such aggregate investments.
	Holding period limitations The scheme shall hold each property within the scheme (other than a Non-qualified Minority-owned Property) for a period of at least two years.
	Limitations on borrowing 1. Aggregate borrowings shall not at any time exceed 50% of the total gross asset value of the scheme; 2. The scheme may pledge its assets to secure such borrowings.
	If a REIT is named after a particular type of real estate, the REIT shall invest at least 70% of its non-cash assets in such type of real estate.
Highlights	It is the management company's responsibility to conduct all proper and thorough due diligence on all relevant aspects of any property investment. Relevant aspects would include matters such as: 1. The ownership and title of the property; 2. Necessary government approvals and town planning requirements; 3. Restrictions on property usage and foreign ownership; 4. Safety requirements; 5. Land premium requirements;

Main rules	Main contents
Highlights	6. Existence of encumbrances on the property; 7. Compliance with zoning and building requirements; 8. Current and prospective leases and material agreements; 9. Outgoings required in maintaining and operating the property; and 10. The scope and value of the insurance in place.
Holding period	Unless the scheme has clearly communicated to its holders the rationale for disposal prior to this minimum holding period and its holders have given their consent to such sale by way of a special resolution at a general meeting.
Dividend policy	The scheme shall distribute to unit holders as dividends each year an amount not less than 90% of its audited annual net income after tax.

2. Listing application procedures

Hong Kong REITs are mainly regulated by the SFC. All REITs proposed to be listed on the Hong Kong securities market must first be approved by the SFC, and then apply for listing in accordance with the requirements of HKEx. In addition, an REIT seeking for listing is governed by the Code and the relevant provisions of Listing rules issued by HKEx.

The application for listing of REITs in Hong Kong is divided into two stages. In the first stage, after an issuer files the listing application (A1) with the SFC, the SFC will make several rounds of enquiries for the issuer to respond. If no further enquiries are made, the SFC will issue approval-in-principle ("AIP") to the issuer. In the second stage, after the issuer obtains the AIP from the SFC, it shall file the listing application (A2) with HKEx and upload the post-hearing information packs on HKEx's website. The AIP will be issued until HKEx has confirmed that it has no further comments. After the completion of the public offering and pricing, a REIT was officially approved by the SFC and HKEx for its listing on the exchange.

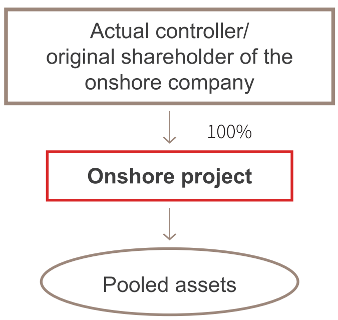
Unlike an IPO application, REITs are required to apply for REIT manager and responsible officer licenses in their listing applications. After the establishment of a REIT management company, if at least one responsible officer of the management company is required to pass one of the recognised industry qualification examinations, the issuer may apply to the SFC for a Type 9 license or a responsible officer license. The issuer's application for REIT manager and responsible officer licenses may be conditionally approved by the SFC when it obtains the AIP from the SFC for its REIT listing, and when it obtains the AIP from HKEx, the SFC will issue a formal approval and the REIT manager and responsible officer licenses.

III. Offshore listing and restructuring of REITs

Offshore listing and restructuring of REITs is essentially the same as the restructuring required for a Chinese enterprise to issue and list shares on an offshore stock exchange through a Red-chip structure ("Offshore IPO and Restructuring"). It requires a new offshore issuer and a new shareholding structure, allowing onshore assets to be injected into the offshore structure and achieve the consolidation of financial statements at the offshore issuer level. Therefore, the offshore listing restructuring of REITs is also a red-chip restructuring.

(I) Overall structure of REITs red-chip restructuring

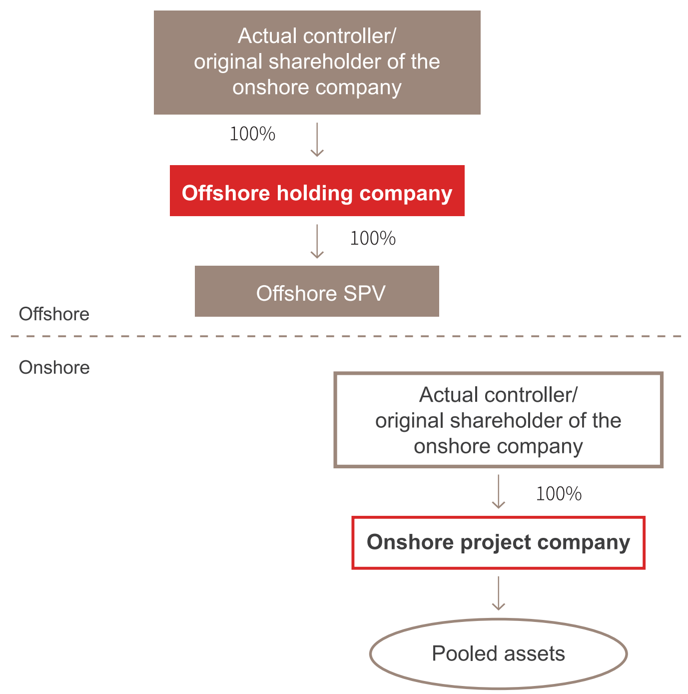
The shareholding structure of a project company before red-chip restructuring is roughly as follows:



According to red-chip restructuring practices, a general shareholding structure of “actual controller/original shareholder of an onshore company - offshore holding company - offshore SPV - onshore company” will be formed after the red-chip restructuring. The main steps are as follows:

1. Building an offshore red-chip shareholding structure

After the restructuring kicks off, a red-chip shareholding structure will first be established overseas by the actual controller/original shareholder of the onshore company. As an offshore shareholding platform, a shell company may be set up in the Cayman Islands, the British Virgin Islands (BVI) or Hong Kong based on its structure design and actual needs, such as tax avoidance, confidentiality and convenience of future offshore shareholding operations. A general offshore red-chip structure is as follows:



Circular No. 37 or ODI formalities?

There are some relevant offshore investment formalities involved in the process that the Chinese actual controller/original shareholder of the onshore company sets up an offshore structure and finally holds shares in the offshore holding company.

Currently, onshore natural persons are only allowed to make overseas investment by way of round-trip investment via offshore SPVs in the onshore company in which they originally held equity interests. They are required to go through the foreign exchange registration formalities for their overseas investment in accordance with the Circular *of the SAFE on Foreign Exchange Administration of Outbound Direct Investments and Financing and Round-Trip Investments by Domestic Residents via Special Purpose Vehicles* (“Circular No. 37”). The Chinese domestic enterprises and institutions, however, are required to go through the required formalities for their overseas direct investment (ODI), which generally include the approval or filing formalities with the authorities of commerce, development and reform, and foreign exchange administration. Therefore, if the actual controller or the original shareholder of the onshore company holds equity interests in the first tier offshore company in the name of an onshore natural person, they are required to go through the registration formalities in accordance with Circular No. 37; if they hold in the name of a Mainland enterprise or institution, they are required to go through the ODI formalities. As there is generally more than one tier of offshore companies in the offshore structure of red-chip restructuring, the Chinese domestic enterprises or institutions shall go through ODI offshore reinvestment formalities for their indirect investment in the second or even lower tier offshore companies according to relevant laws and regulations or capital inflow and outflow requirements.

ODI formalities are complex, time-consuming and subject to the principle of authenticity review. Therefore, for non-professional financial investment institutions whose controlling natural person shareholders can be traced after equity look-through review, it is suggested that they complete their ODI under REIT restructuring by going through the foreign exchange registration formalities according to Circular No. 37. For ODI by A-share listed companies, SASAC holding companies and other entities, because it is difficult to trace their natural person shareholders, they generally complete their ODI under REIT restructuring by going through the ODI formalities. It should be noted that under Circular No. 37, domestic natural person shareholders cannot actually make capital contributions in cash to offshore companies. Therefore, in the absence of debt financing, shareholders pay a relatively low cash consideration for shares in offshore holding companies under Circular No. 37. Those (such as financial investors) who acquire shares in onshore companies based on their valuation or other higher consideration may be exposed to the risk of tax base erosion. As a result, they would better think twice.

2. Outbound transfer of onshore assets

While building the offshore red-chip shareholding structure, there are also onshore restructuring actions such as spin-off of non-proposed listed assets and incorporation of proposed listed assets. Once completed, onshore and offshore equity interests will be connected by the way that the company at the lowest tier in the offshore structure[3] acquires the equity of an onshore project company ("Outbound Transfer of Onshore Assets"). Outbound Transfer of Onshore Assets is a key step in red-chip restructuring. It is advisable to avoid any changes in the equity structure of the offshore holding company after the Outbound Transfer of Onshore Assets, so as to prevent additional tax burden arising from indirect transfer of onshore assets in accordance with the *Announcement on Several Issues Concerning the Enterprise Income Tax on Indirect Transfer of Assets by Non-Resident Enterprises* ("Announcement No. 7").

Follow the two-step or sell-then-buy approach?

Outbound Transfer of Onshore Assets also involves another key regulation concerning red-chip restructuring, the *Provisions on the Merger and Acquisition of Domestic Enterprises by Offshore Investors* ("Document No. 10").

To avoid the application of the related party acquisition examination[4] under Document No. 10, a commonly used solution[5] is to "introduce unrelated offshore investors to onshore companies and change onshore companies into foreign invested enterprises, thus making the requirement that the target company under Document No. 10 shall be an onshore company not applicable". Since the REITs listings in Hong Kong and Singapore do not require actual controllers to remain unchanged for a certain period of time, red-chip restructuring of REITs has one more option than that of offshore IPOs. There are two ways to introduce unrelated offshore investors in REITs restructuring: (1) the two-step approach, i.e. introducing an unrelated offshore investor holding a small proportion of equity (e.g. 5%) to an onshore company to make it a China-foreign joint venture ("JV"), which will be then acquired by a subsidiary of the actual controller; and (2) the sell-then-buy approach, i.e. selling the 100% stake of the onshore company to an unrelated offshore investor to make the company a wholly foreign-owned enterprise ("WFOE"), which will be then acquired by a subsidiary of the actual controller.[6]

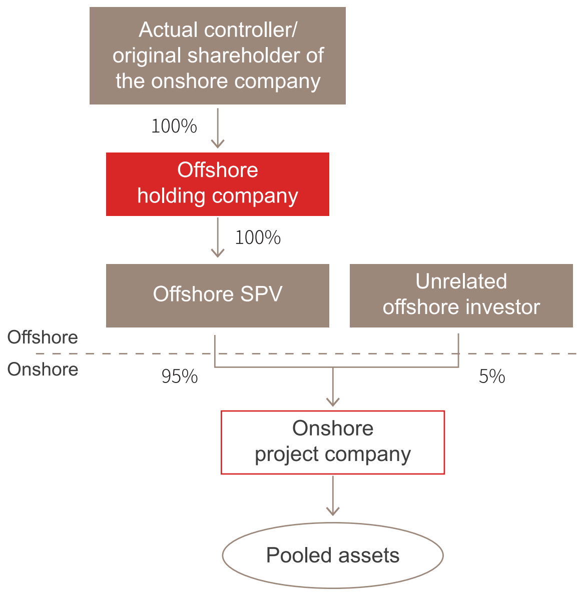
According to Document No. 10, offshore investors shall acquire the equity of an onshore company at its appraised value. In the two-step approach, an unrelated offshore investor only acquires a small proportion of the equity of an onshore company, which does not need too much fund, and the onshore company is still under the control of the actual controller. Thus, the acquisition by a subsidiary of the actual controller is acquisition under the common control, which may leave more room for tax planning. In the sell-then-buy approach, however, an unrelated offshore investor is required to buy 100% of the equity in the onshore company at one time, which needs more working capital to complete the acquisition. Moreover, as such acquisition is completed based on the company's valuation, the acquisition consideration is higher, and the original equity premium is higher, which may also bring greater tax costs. Meanwhile, as the M&A by the offshore investor is a transfer of control by a third party, the space for tax planning is relatively small compared with the transfer under the common control. Nevertheless, from listing cases of REITs, the sell-then-buy approach is the mainstream choice for listing REITs offshore, especially in Singapore. Therefore, if you choose to list REITs in Singapore, judging from regulators' common practice, it is safer to choose the sell-then-buy approach, and it is more appropriate to choose the two-step approach if you take economic efficiency into consideration.

[3]Subject to the characteristics of industries suitable for issuing REITs, the restricted industries for foreign investment are generally not involved, nor does it apply to Outbound Connect of Onshore Assets through VIE agreements.

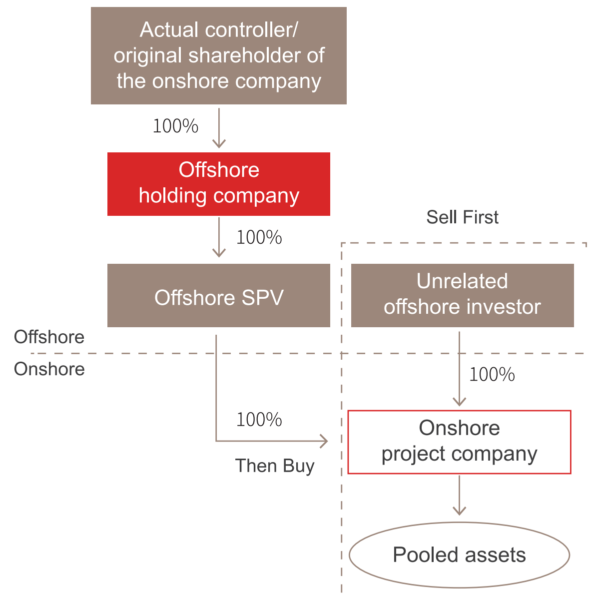
[4]According to Article 11 of Document No. 10, the merger and acquisition of an affiliated onshore company by an onshore company, enterprise or natural person in the name of an offshore company legally established or controlled by such onshore company, enterprise or natural person ("Affiliated M&A") shall be subject to approval by the MOFCOM. In practice, the MOFCOM approval for Affiliated M&A can hardly be obtained.

[5]This is only applicable to cases where the actual controller is a Chinese national. If the actual controller is a foreign national who does not habitually reside in China, there is usually no need to follow the two-step or the sell-then-buy approach, or go through foreign exchange registration formalities under Circular No. 37.

[6]Red-chip listing generally requires that the actual controller of a company to be listed remain unchanged for one year. The sell-then-buy approach, however, will result in the change of the actual controller of the company to be listed, so red-chip listing usually does not take this approach.

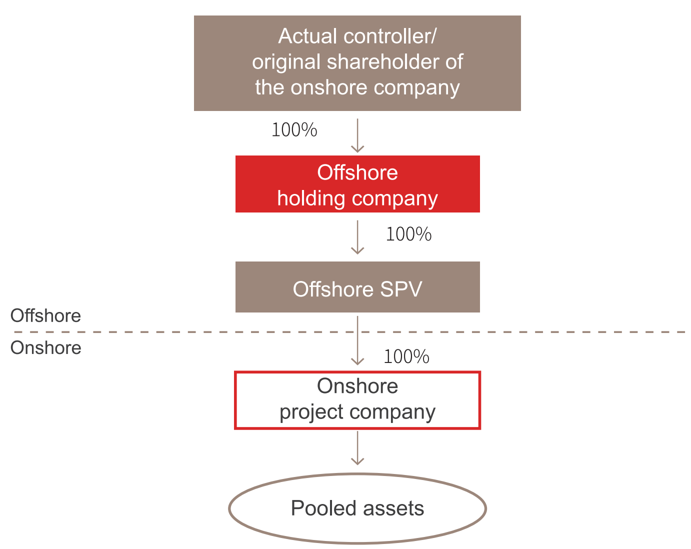


The two-step approach



The sell-then-buy approach

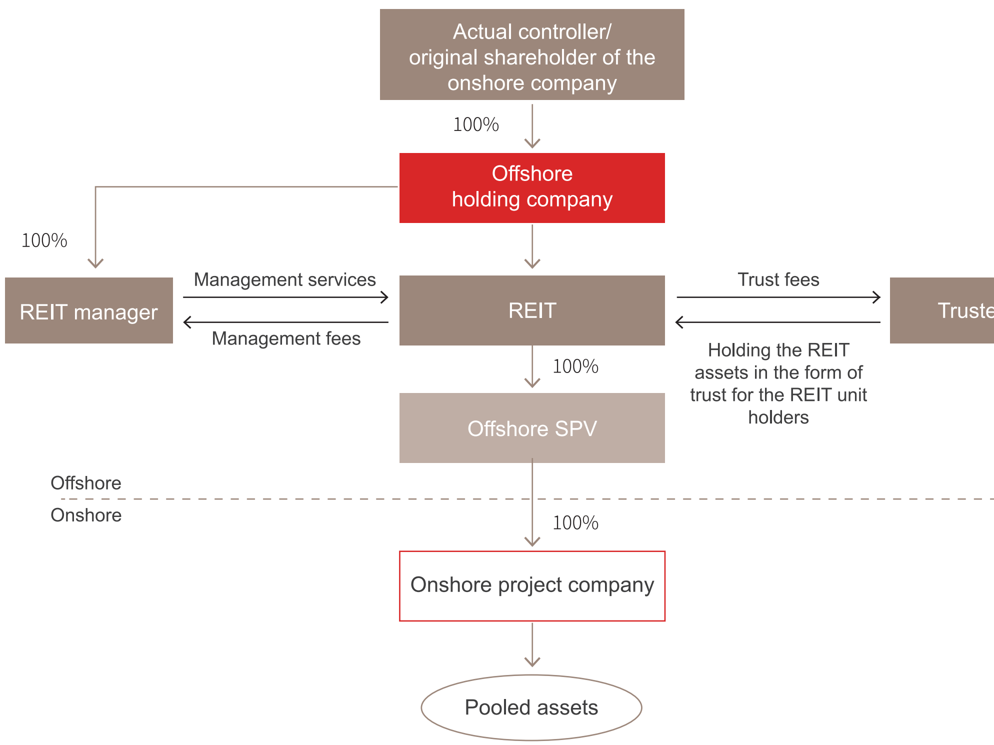
If you take the two-step approach, i.e., after an unrelated offshore investor acquires shares of an onshore project company, you may have the unrelated offshore investor exit the listing structure by directly acquiring its equity in the onshore project company via an offshore SPV; or the offshore holding company may achieve the 100% control of the onshore project company by offshore share swap or changing the unrelated offshore investor into a shareholder of the offshore holding company. In the end, the two-step or sell-then-buy restructuring lead to the following structure:



3. Trust structure building

The important factor that differentiates offshore listing and restructuring of REITs from Offshore IPO and Restructuring is that the former, based on the feature of REITs as a financial product, requires that a trust structure be established between the offshore holding company and the project company holding the property, appoint a REIT manager, and incorporate the project company into the REIT. After the trust structure is set up, the offshore holding company becomes the unitholder of the REIT. There are two common ways to build a trust structure: setting up a trust before the Outbound

Transfer of Onshore Assets; and setting up a trust by means of transfer after the Outbound Transfer of Onshore Assets. The former approach may avoid the application of Announcement No. 7 that requires EIT filing for indirect transfer of onshore assets, while the latter facilitates the injection of assets into the REIT when there is a greater possibility of successful listing and pricing, which is conducive to keeping safe these pooled assets. The trust, when built, will lead to the following structure:



(II) Other key issues under the law

1. Big Red-chip Approval?

It is generally accepted in practice that a big red-chip structure refers to a to-be-listed-offshore entity whose actual controller or controlling shareholder is a Chinese organisation in accordance with the *Notice of the State Council on Further Strengthening the Administration of Issuance and Listing of Shares Overseas* (the "**Red-chip Guidelines**"). If, however, the shares of the Chinese organisation are ultimately owned by a natural person, a structure will generally be erected offshore by the person in the restructuring to avoid the Big Red-chip Approval. For this reason, those who usually have to adopt a big red-chip structure are mainly Chinese companies, generally SOEs and listed companies, whose actual controller or controlling shareholder is not a natural person.

Approval of the China Securities Regulatory Commission (CSRC) and/or the relevant provincial people's government or the competent authorities under the State Council is required for an overseas listing under the big red-chip structure (the "**Big Red-chip Approval**") pursuant to the Red-chip Guidelines and the listing practices. In practice, except for large SOEs, it is difficult to obtain the Big Red-chip Approval.

The Red-chip Guidelines, however, leave a small space for the offering of REITs with a big red-chip structure: The Red-chip Guidelines are worded in such a way that the Guidelines only apply to the issuance of "shares" but not "trust units". For the existing REITs with a big red-chip structure in the Singapore and Hong Kong markets, no disclosures on Big Red-chip Approval are made in their offering documents. Therefore, REITs with a big red-chip structure are generally not considered to be subject to the Big Red-chip Approval if foreign counsel confirms that the trust units offered by the REITs are not "shares" under local listing rules.

2. How to pay the consideration for Outbound Transfer of Onshore Assets?

Onshore project companies in the REIT listings are all asset-heavy enterprises holding properties, which have a high net asset value. Both the Outbound Transfer of Onshore Assets and the injection of assets into REITs require a high consideration. If a share swap is impossible, it is a big challenge to pay the consideration in cash for the acquisition of the shares in the onshore project company. In typical offshore IPO restructuring, it is customary to pay the consideration prior to the submission of the listing application or prior to the listing. Quite differently, REITs may use the proceeds from the listing to pay the consideration for the Outbound Transfer of Onshore Assets. This arrangement relieves the pressure on the cash flow in the restructuring. Before submitting the application for the REIT listing, the issuer is required to take the following actions to effectuate the transfer of shares and shareholders' rights to the subsidiary of the offshore holding company: (i) procure that the subsidiary of the offshore holding company and the shareholders of the onshore project company have entered into a share transfer agreement; and (ii) complete the formalities for change with the competent administration for industry and commerce. The issuer, however, is not required to actually pay the consideration. After the REIT listing, the issuer may use part of the proceeds to pay the consideration, which will be disclosed in the application documents and the offering circular.

Before the offering of SF REIT, SF Holding Co., Ltd. was required to spin off its assets and subsidiaries (the "Spin-Off Assets") and inject the Spin-Off Assets into SF REIT. Pursuant to the Share Purchase Agreement, the buyer completed the closing by providing promissory notes to the seller first and must honour such promissory notes within five days after the offering. Banks were invited to form a syndicate to extend loans to the SF REIT subsidiaries to acquire the Spin-Off Assets. After the offering, SF REIT honoured the promissory notes with the proceeds and the loans from the syndicate.

Notably, however, if domestic assets are acquired by a foreign investor, Article 16 of Document No. 10 should apply. In another word, the consideration for the transfer of shares should generally be paid within three months of the date of issuance of the business license of the foreign-invested enterprise.

(III) Tax planning

As the project company in the REIT listing holds properties and is an asset heavy company, the transfer of shares and assets involved in the incorporation of proposed listed assets, the spin-off of non-proposed listed assets and the Outbound Transfer of Onshore Assets in the restructuring may incur heavy taxes. Therefore, tax planning is more important in the red-chip REITs restructuring than in the general offshore IPO restructuring.

A brief overview of common tax planning approaches in red-chip REITs restructuring is as below:

<table>
<tr><th colspan="2">Approach</th><th>Main content</th><th>Purposes of tax planning</th></tr>
<tr><td colspan="2">Provision for dividends</td><td>Increasing distributable profit and withholding for dividends to shareholders.</td><td rowspan="2">Reducing the net assets of the domestic company, and thus reducing share transfer consideration and share transfer premium in the case of an Outbound Transfer of Onshore Assets, and further reducing income taxes.</td></tr>
<tr><td colspan="2">Capital reduction</td><td>Reducing the capital of the onshore project company. Subject to a 45-day announcement period, it is time-consuming.</td></tr>
<tr><td rowspan="2">Forward spin-off
(i.e. transfer of pooled assets to a new entity)</td><td>Separation: The newly established entity after the separation holds the pooled assets</td><td rowspan="4">If the onshore project company holds both operating properties (pooled assets) and non-operating properties (non-pooled assets), it is required to spin off the assets, business, liabilities and personnel unrelated to the pooled assets of the REITs.
When the non-pooled assets are spun off, there are two types of spin-off: forward and reverse. Apart from the general transfer of assets, separation and asset contribution have some room for tax planning and can reduce the drain on the company's cash flow.</td><td rowspan="4">There is room for special tax restructuring, but only if no change occurs in 12 months in the shareholders of the newly spin-off company/new project company holding the pooled assets.
If, in order to meet the above requirement, it may be impossible to inject assets prior to the REIT listing. In this case, the sponsor will be required to undertake to contribute the assets immediately after the expiry of the 12-month lock-up period and to make up for the cash flows during the period when the properties are not pooled.</td></tr>
<tr><td>Asset contribution: The pooled assets are used to establish a new project company</td></tr>
<tr><td rowspan="2">Reverse spin-off
(i.e. retention of the pooled assets in the old entity)</td><td>The newly established entity after the separation holds the non-pooled assets</td></tr>
<tr><td>Asset contribution: The non-pooled assets are used to establish a new company</td></tr>
</table>

Approach	Main content	Purposes of tax planning
Share swap	In the case of an acquisition of an onshore project company by an SPV established under an offshore holding company, a share swap may be considered in addition to a cash acquisition. The SPV further establishes an onshore SPV ("Cash Company") which holds the cash assets equivalent to the valuation of the onshore project company. Subsequently, the SPV will acquire the onshore project company at a consideration of 100% of the equity interest in the Cash Company held by the SPV. In another word, the equity interest in the Cash Company held by the SPV is swapped with that in the onshore project company held by the original shareholders.	Reducing corporate income tax costs for the Outbound Transfer of Onshore Assets.
Establishment of a partnership in the middle	A domestic partnership is established indirectly by an offshore holding company to acquire the onshore project company.	The partnership may be exempt from corporate income tax. It may be set up in a location with a friendly tax environment, such as Hainan province and Nansha District, Guangzhou.
Setting Foreign debt	The onshore project company can borrow from its foreign shareholder, to set up foreign debt. On one hand, The interest expenses incurred by the company can be deducted before tax if the ratio of its debt investment to its equity investment from its affiliates does not exceed the prescribed threshold. On the other hand, for the onshore project company, in addition to dividends, debt and interest payment will allow outbound movement of funds and reduce taxes associated with dividends.	A certain ratio of equity to debt will be established in the onshore project company. The increased percentage of debt capital (debt financing) and the decreased percentage of equity capital (equity financing) will increase pre-tax deductions and distribution to the foreign shareholder in addition to the dividends, thus reducing the taxes.

The above are the main considerations related to tax planning. Please seek advice on relevant analysis and conclusion from accountants or professional tax advisors in the REIT listing.

IV. Key compliance points for offshore REIT listings

Like IPOs, the REIT listings in Hong Kong is also subject to a compliance test by the securities regulator. The due diligence and solution of compliance issues will decide whether the related assets can be listed and will have an impact on the valuation.

(I) General key points of legal due diligence of REIT assets

Logistics properties and commercial properties, including malls, office buildings and hotels, are currently the main properties in offshore REIT listings. The legal due diligence of these underlying assets and the project company particularly focuses on the following:

No.	Items	Special key points	Legal due diligence approach	Solutions
1	Planned vs actual use of the land	• The planned use of the land may be inconsistent with its actual use. • In accordance with Article 81 of the *Land Administration Law*, anyone who does not use state-owned land in accordance with the approved use shall be ordered to surrender the land and be fined by the competent authority of natural resources of the people's government at or above the county level.	Reviewing the use of land or buildings as stated in the state-owned land use certificate, contract for the grant of the right to use state-owned construction land, construction land permit, construction project planning permit and other relevant certificates.	• The company undertakes to fully compensate the REITs/project company for any losses suffered by the REITs due to the inconsistency between the planned use and actual use of the project. • To confirm the compliance of not using the land for the planned use of the project, a certificate of compliance shall be obtained from or an interview shall be conducted with the competent authority.
2	Investment intensity, land use and planning indexes	The project investment contract or any other agreements between the project company and the local government usually stipulate the investment intensity and tax contribution, etc. It is necessary to review whether the project investment amount and tax comply with the investment contract. Otherwise, there is the risk of breach of contract.	Reviewing the project investment contract and other agreements between the project company and the local government and referring to the project construction application documents.	If the project company is likely to be held liable for breach of contract for its failure to comply with the project investment contract, it may enter into a supplementary waiver agreement with the government to alter the original agreement or the government may waive the project company from liability for breach of contract.
3	Compliance of project operation modes	• The commercial real estate projects are mainly operated by the developers in three modes: self-holding; lease and sale; and leaseback after sale. • Investigating the compliance of different operation modes.	• Self-holding: Reviewing the compliance of the lease contracts and other agreements between the developer and tenants. • Lease and sale / leaseback after sale: Reviewing the construction of the project, the renewal of the contract after the expiration of the lease term, etc.	• Self-holding: Signing a new supplementary agreement or amending the contract to eliminate the non-compliance of the lease contracts or any adverse effect on the future benefit arrangement of the REITs. • Lease and sale / leaseback after sale: Rectifying the possible non-compliance in the project construction and obtaining the compliance certificate from the competent authority or interviewing with the competent authority on compliance.
4	Compliance of projects under construction or completed	• For projects under construction or completed, examining whether the approvals for EIA, planning, and inspection and acceptance after completion, and the title certificates have been obtained. • If any building is constructed without approval, the project company may be imposed administrative penalties such as demolition of such building and a fine.	By a physical visit, verifying whether the area and other information of the building are consistent with the EIA record or registration form, construction planning permit, completion and acceptance document and title certificate.	• Retaining the illegal building, but closing down its operation and terminating the relevant leases; and having an engineering consultant assess and confirm that the retention of the illegal part will not have any negative effect on the overall safety of the building. • Interviewing with local competent authority to confirm that the retention of the illegal part will not have any negative effect on the grant of the title certificate or future operation of the project, and that no penalty will be imposed. • Communicating with the SFC in advance to confirm that the retention of the illegal part will not have any material adverse effect on the REIT listing.

No.	Items	Special key points	Legal due diligence approach	Solutions
5	Restrictions on property imposed by mortgage and other restrictive agreements or arrangements	REITs are required to hold "good marketable legal and beneficial title" in the pooled assets in accordance with the Code. It is necessary to consider whether there are any restrictions on the property that may affect the above advice.	• Examining and retrieving the real estate registration information or the other rights stated in the real estate title certificate; and examining the guarantee contracts performed by the project company. • Reviewing shop leases, advertising space leases and other contracts to verify whether there are rights arrangements such as right of first refusal and early termination clauses that conflict with future transaction arrangements.	• Property mortgaged after the effectiveness of the Civil Code may be transferred in principle unless as prohibited by the mortgage contract or the related real estate register. Property mortgaged before the effectiveness of the Civil Code may not be transferred without the consent of the mortgagee. Therefore, most of the mortgages or other security created on the pooled property before the effectiveness of the Civil Code will be released or replaced before the REIT listing. • The existing clauses on the underlying assets in conflict with any future transaction arrangement should be modified or released by a supplementary agreement or otherwise in advance.
6	Transfer restrictions	The investment agreement, land grant contract and other documents of the project or local regulations may contain restrictions on the transfer of the land use right (especially industrial land) of the project (including transfer of assets, change of equity in the project company, change of control of the project company).	Searching local regulations, making enquiries with the project company and reviewing the investment agreement, land grant contract and other documents with government authorities.	A written consent to the transfer must be obtained from the party that restricts the transfer if there is any restriction on the transfer in the investment agreement, land grant document or local regulations.
7	Property lease registration and filing	In accordance with the law, upon conclusion of a property lease contract, the parties to the lease shall complete the property lease registration and filing formalities with the real estate administrative authority at the location of the leased property.	Checking the lease registration and filing certificate of the project; making further enquiries with the local real estate administrative authority to confirm whether the project properties require mandatory lease registration and filing.	• The project company completes the lease registration and filing formalities as soon as possible. • The company undertakes that it will fully compensate the REITs / project company for any losses suffered by the REITs as a result of any historical lease registration and filing issues.
8	Transfer of employees of the project company	In the REIT listing, the project company as the owner of the pooled properties should keep its tile clear and its legal relationship simple and may manage its real estate assets through the REIT manager.	Examining the existing employment contracts and employees of the project company to distinguish between key employees who will be retained with the project company and other support staff.	Terminating the employment contracts signed by project company with those other than the key employees to the extent possible and transferring such employment contracts to other light-asset companies in the group.

No.	Items	Special key points	Legal due diligence approach	Solutions
9	Review of special industry qualifications	In accordance with Item 36 of the *Decision of the State Council on Establishing Administrative License for Administrative Approval Items Really Necessary to Be Retained* (2016), the hotel industry requires special industry license issued by the public security authority of the local people's government at or above the county level. Therefore, the special industry license is also required for commercial properties such as hotels.	Reviewing the credentials provided by the company	• Those who carry out business without appropriate qualification certificate should apply for and obtain such certificate. • An interview should be conducted with and a certificate of compliance should be obtained from the competent authority in the case of carrying out business without a qualification certificate.

From the above key due diligence points, it can be seen that the due diligence of real estate assets and the project company in the REIT listing is more detailed and stringent than the due diligence of an overseas IPO of a general real estate developer. The former exercise focuses more on clear property ownership, compliance of the use of the buildings and the stability of the lease relationship. In addition, the former due diligence should also focus on common legal issues for general real estate developers, including idle land, late commencement and completion of construction, construction before approval, inspection and acceptance of civil air defence and fire protection works, and failure to pay social security contributions and housing funds in full.

(II) Special key points for A-share companies

If an A-share listed company intends to issue a REIT outside China, based on the characteristics of the REIT product, when assets are injected into the REIT from a subsidiary of the A-share company, such assets will no longer be recognised in the consolidated financial statements of the A-share company. Therefore, such transaction involves internal approval and disclosure of information relating to the sale of assets of the A-share listed company.

As required by the CSRC's *Administrative Measures for Information Disclosure of Listed Companies* as amended in 2021 and the applicable listing rules of the relevant stock exchange, when the amount of the asset sale reaches the threshold that requires approval by the board of directors or the shareholders' meeting, the A-share listed company shall comply with the approval procedures and make the required information disclosure in a timely manner. If the asset sale constitutes a major asset restructuring, the listed company shall also comply with the required approval and disclosure procedures in accordance with the Administrative Measures for the Restructuring of Major Assets of Listed Companies and other applicable regulations.

Thanks to intern Xiao Bin for his contribution to this article.

* For the purpose of this article only, China means the China Mainland only and excludes the Hong Kong Special Administrative Region, the Macao Special Administrative Region and the Taiwan region. Any reference to Hong Kong or the Hong Kong Special Administrative Region should be construed as the Hong Kong Special Administrative Region of the People's Republic of China.

HKEx publishes consultation conclusion and guidance to amend the Listing Rules on the listing of debt securities offered to professional investors

Hao Zhou, Richard Mazzochi, Minny Siu, Michael Lu, Song Yue, Jason Kuo

Hao Zhou

Richard Mazzochi

Minny Siu

Michael Lu

Jason Kuo

On 21 August 2020, The Stock Exchange of Hong Kong (the "HKEx") published amendments to the rules governing the listing of debt securities to professional investors to more closely align the rules with current market practice and to enhance the debt listing regime. The changes are made to Chapter 37 of the Main Board Listing Rules (the "Listing Rules"), which had last been updated in 2011, and are the result of a public consultation process culminating in the 21 August 2020 document titled Consultation Conclusions and Guidance[1]. The document summarises the rule changes and simultaneously promulgates a guidance letter[2] (the "Guidance Letter") on disclosure that primarily addresses disclosure considerations for debt instruments with special features.[3] Market participants and legal practitioners, including King & Wood Mallesons, provided commentary during the consultation process.

The most significant changes in our view are (1) the tightening of the rules applicable to listing eligibility for regional and local state-owned enterprises; (2) the amendment of the definition of "Professional Investor", obviating the need for a professional investor waiver; (3) the requirement to publish the listing documents on the website of the HKEx; and (4) the addition of new continuous reporting requirements relating to defaults and insolvency.

The amendments, which became effective on 1 November 2020, include the following key changes:

- Eliminate the need to apply for a professional investor waiver by amending the definition of "Professional Investor" to include high net worth individuals and other professional investors.
- Increase the minimum net assets requirement for issuers (other than State corporations) from HK$100 million to HK$1 billion.
- Narrow the definition of "State corporation" so as to exclude regional and local State-owned enterprises.
- Establish a minimum issuance size of HK$100 million (with an exception for tap issuances).
- Require issuers to publish listing documents (e.g., offering circulars, pricing supplements, among others) on the HKEx website on the listing date.
- Require disclosure of the intended investor market in the Hong Kong SAR (e.g., Professional Investors only) on the cover of the listing document.
- Establish new continuing obligation rules to require issuers and guarantors to disclose events of default, insolvency proceedings and winding-up applications and to make quarterly announcements following any suspension of trading.

Further details are set forth below.

[1] Available at https://en-rules.hkex.com.hk/sites/default/files/net_file_store/new_rulebooks/u/p/Update_129_Attachment.pdf.

[2] Guidance on Disclosures in Listing Documents and Continuing Obligations under Chapter 37 – Debt Issues to Professional Investors Only. See https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Other-Resources/Debt-Securities/20200821.pdf.

[3] Special features refer to the non-exhaustive list of special features of certain debt securities that render such debt securities complex. Such securities include perpetual or subordinated debt securities, or those with variable or deferred interest payment terms, extendable maturity dates, or those which are convertible or exchangeable or have contingent write down or loss absorption features, or those with multiple credit support providers and structures. See https://www.sfc.hk/web/EN/rules-and-standards/suitability-requirement/non-complex-and-complex-products/.

I. Applicants' and securities' qualifications for listing

The new rules include higher standards for listing. These higher standards are intended to ensure that only issuers with financial capacity and proven track records of supporting debt issuances of significant amounts will be eligible and to bring the quality of listings in line with other popular debt listing venues including the Singapore, Luxembourg and Ireland exchanges.

- Under the amended Rule 37.04, applicants no longer need to provide documents evidencing valid incorporation or establishment. Instead, applicants may provide written confirmation of valid incorporation and establishment, thus simplifying the application process.
- Under the amended Rule 37.05, issuers are now required to have minimum net assets of HK$1 billion, an increase from the previous HK$100 million.
- Under the amended Rule 37.09A, the minimum issuance size is set at HK$100 million, with the exception of tap issuances.
- Perhaps most notably, the definition of "State corporation" has been amended so as to exclude regional and local authorities. The effect of this change will be to force unlisted companies controlled by regional or local authorities to fulfil the listing eligibility requirements of net assets of at least HK$1 billion and issue size of at least HK$100 million rather than qualifying for the State corporation exemption from those minimums. Issuers who do not meet those standards will need to rely on a guarantor that does meet those criteria, thus potentially forcing many local SOEs who might otherwise have used keepwell structures to select a guarantee structure, or, failing that, seeking listings in other exchanges.

II. Application procedures

Application procedures have been simplified and, in some cases, more closely aligned with the practice in other exchanges.

- The repeal of Rules 37.35(e) – (i) and introduction of Rules 37.35 (k) – (m) modifies the application procedures in relation to the change from the provision of evidentiary documents to written confirmations set forth in the amended Rule 37.04.
- New Rule 37.39A requires issuers to publish listing documents on the HKEx website on the listing date, which is similar to requirements of other stock exchanges, such as the Singapore Stock Exchange.
- The definition of "Professional Investor" is revised to include high net worth and other professional investors prescribed by rules made under Section 397 of the *Securities and Futures Ordinance* (Cap. 571), thus eliminating the need to apply for a professional investor waiver.

III. Listing document

Although under the new rules the listing document must now be published, the overall "light-touch" approach to disclosure standards in Chapter 37 has not changed. Similar to other leading debt-listing exchanges, the HKEx only requires that a listing document contain certain disclaimers and "the information that the investors an issuer is offering the securities to would customarily expect it to contain". It need not comply with the detailed requirements contained in Appendix 1, part C[4] (which applies to retail securities).

However, for instruments that fall within the HKEx's definition of products with special features (which follows the SFC's definition of complex products), the Guidance Letter provides detailed considerations specific to certain products, which include:

- perpetual or subordinated debt securities;
- those with variable or deferred interest payment terms, extendable maturity dates;
- those which are convertible or exchangeable;
- those with contingent write down or loss absorption features; or
- those with multiple credit support providers and structures.

This guidance is likely to lead to additional language being added to the listing document, perhaps in a new paragraph in the Notice to Investors section or within a risk factor.

Specific amendments to the rules governing the listing document include the following:

- Under new Rule 37.39A, an issuer must publish on the HKEx's website the listing document (e.g., offering circular, offering memorandum, pricing supplement), in English or Chinese, on the listing date. This change brings the HKEx in line with its main competitor exchanges in Singapore, Luxembourg and Ireland which have historically required the publication of the listing document, although the allowance to publish the document only in Chinese is unique and differentiates the HKEx from its competitors.
- Under new Rule 37.31A, the front cover of listing documents must explicitly disclose that the intended

[4]Appendix 1, part C, available at https://www.hkex.com.hk/-/media/HKEX-Market/Listing/Rules-and-Guidance/Listing-Rules-Contingency/Main-Board-Listing-Rules/Appendices/appendix_1C.pdf?la=en

investor market in Hong Kong is professional investors only. This disclosure alerts retail investors in Hong Kong that they are not the intended class of investors. The HKEx has in practice been requiring such a statement when reviewing disclosure documents, but it is now expressly stated in the rules.

IV. Continuing obligations

Another major change to the rules is the addition of new requirements to assert increased oversight over, and expand the continuing disclosure obligations of, issuers and guarantors.

- New Rule 37.46A expands on the existing Rule 37.47(b) that requires the issuer, after consultation with the HKEx, to announce information necessary to avoid a false market in its listed debt securities. The new rule establishes an enquiry regime whereby the Issuer must make an announcement if requested by the HKEx. The Issuer may make an announcement that it does not believe a false market exists only if (i) the directors have completed an enquiry; (ii) all inside information has been disclosed; and (iii) the HKEx requests such an announcement.
- New Rule 37.47D imposes an obligation on issuers to publish quarterly announcements in the event that trading in their listed debt securities has been suspended.
- New Rule 37.47E requires issuers to announce as soon as reasonably possible information in relation to (i) a default on its listed debt securities; (ii) any appointment of a receiver or manager in respect of the business or any part of the business of the issuer or the property of the issuer; (iii) the presentation of any winding-up petition or order or the equivalent against or in respect of the issuer; or (iv) the passing of any resolution by the issuer that it be wound up by way of members' or creditors' voluntary winding-up, or equivalent action. Although previously issuers may have been obligated to provide such disclosure under Rule 37.47A, which requires an announcement of "any information" which may have a material effect on an issuer's ability to meet the obligations of its listed securities, the new rules make it an explicit requirement to disclose these default, insolvency and winding-up events. Of note, because the HKEx defines "listed debt securities" as securities listed on the HKEx, the first prong requiring announcement of any default on "its listed debt securities" may be interpreted to mean that an issuer must announce defaults across multiple stock codes if it has multiple listed debt securities, but it would not automatically be required to announce defaults of securities listed on other exchanges (although such default may still be a material event that should be announced pursuant to Rule 37.47A).

Conclusion

The amendments to the rules governing the listing of debt securities to professional investors will accomplish four overlapping objectives:

(i) more closely align the rules with current market practice;

(ii) streamline the listing application process;

(iii) enhance eligibility requirements; and

(iv) enhance the reporting obligations of issuers and guarantors.

The authors would like to thank Paul Marks, Anlei Zuo and Edward Ku for their contributions to this article.

One of the drivers for seeking secondary listing in Hong Kong SAR - exemption from the Hong Kong Listing Rules

Sam Huang

Sam Huang

Introduction

The U.S. further tightened its regulation against Chinese companies seeking to be listed in the U.S. in 2020. On 21 April 2020, the U.S. Securities and Exchange Commission ("SEC") and the Public Company Accounting Oversight Board ("PCAOB") issued a joint statement warning investors to beware of financial risks of Chinese companies. On 20 May 2020, the Senate passed the Holding Foreign Companies Accountable Act, providing that a Chinese company will be barred from listing on a U.S. stock exchange or continuing to trade in securities if the company does not allow the PCAOB to review its audit records.

Due to the high cost and uncertainty of the timing of privatisation and delisting from a U.S. stock exchange, Chinese companies already listed overseas ("Overseas-Listed Chinese Companies") tend to seek a secondary listing in the Hong Kong Special Administrative Region of China instead. For instance, the secondary listings of Alibaba in 2019 and JD.com and NetEase in 2020 in Hong Kong SAR provide a valuable reference for other Chinese companies. The return of such companies to the Hong Kong stock market will help boost its trading volume and consolidate Hong Kong's leading position in the global equity financing market. In addition, with the upgrading of the Shanghai-Hong Kong Stock Connect and Shenzhen-Hong Kong Stock Connect mechanisms and the inclusion of new economy companies in the Hang Seng Index, more mainland capitals will flow southward to gradually improve the valuation of the Chinese companies in the Hong Kong market.

Prior to 15 December 2017, U.S. listed Chinese companies applying for a second listing in Hong Kong SAR were viewed as Grandfathered Greater China Issuers. Such Chinese Companies are automatically exempted from some of the requirements of *the Rules Governing the Listing of Securities on the Stock Exchange of Hong Kong Limited* ("Hong Kong Listing Rules"). For instance, an Overseas-listed Chinese Company may submit a prospectus to the Stock Exchange of Hong Kong Limited ("HKEX") in confidence, whereas a normal listing applicant is required to disclose the A1 form (listing application form) on the HKEX's website at an early stage.

Such issuers of China concepts stocks ("Chinese Issuers") may also apply for additional exemptions under the Hong Kong Listing Rules. For example, an applicant may apply to retain the existing VIE and weighted voting right (WVR) structures, and may also apply to be exempted from various requirements of the Hong Kong Listing Rules relating to internal organization, corporate governance, ways of listing, trading and restricted transfer of shares, connected transactions, annual report disclosure, appointment of auditors and compliance advisors, share option schemes, among others.

If an Overseas-listed Chinese Company is exempted from the above listed requirements, it will take a shorter time for the company to complete its secondary listing smoothly. The three aforesaid Overseas-listed Chinese Companies completed their listings in Hong Kong SAR in approximately three to five months. Additionally, exemptions from the Hong Kong Listing Rules or the *Codes on Takeovers and Mergers and Share Buy-backs* (the "Takeovers Code") would simplify the approval procedures for refinancing and M&A of Overseas-listed Chinese Companies after their return to the Hong Kong market.

This article will introduce the exemptions granted by the HKEX and the Securities and Futures Commission ("SFC"), and discuss what can be taken as the possible reasons for Overseas-listed Chinese Companies to apply for exemptions.

I. Not viewed as a public company in Hong Kong SAR

The Corporate Finance Division of the SFC is responsible for the implementation of the Takeovers Code. Anyone who contravenes the Takeovers Code may be subject to private reprimand, public censure, disciplinary action or suspension of licence or revocation of registration by the SFC. In accordance with paragraph4.1 of the Takeovers Code, the Takeovers Code applies to takeovers, mergers and share buy-backs affecting public companies in Hong Kong SAR, and companies with a primary listing of their equity securities in Hong Kong SAR. If an Overseas-listed Chinese Company meeting the requirements of Rule 19C.01 of the Hong Kong Listing Rules seeks a secondary listing on the HKEX, it will not be viewed as a Hong Kong public company under paragraph 4.2 of the Takeovers Code.

If an Overseas-listed Chinese Company is granted an exemption by the SFC, it will not be required to comply with the Takeovers Code for mergers or acquisitions following a secondary listing in Hong Kong SAR, which will significantly reduce the approval time and cost required for such transactions and lower the uncertainty of transactions.

II. Simplified obligations for equity disclosure

Pursuant to Part XV of the Securities and Futures Ordinance ("SFO"), the HKEX's Practice Note 5 and paragraphs 41(4) and 45 of Part A of Appendix 1 to the Hong Kong Listing Rules, listed issuers are required to disclose the interests of shareholders and directors in the prospectus.

The Chinese Issuers are advised to apply for an exemption from the above disclosure obligations. Subject to the U.S. Securities Exchange Act, any person (including directors and officers) of any U.S. listed Chinese company who acquires more than 5% of the equity or voting rights is required to file a beneficial owner report with the SEC. Such person is also required to notify the SEC promptly of any material changes to previously reported data (including the acquisition or disposition of more than 1% of the equity or voting rights). In view of the above fact, such Chinese company may explain to the SFC that additional disclosure under the SFO will result in double reporting by insiders. This will not only bring excessive burden and additional costs, but also be of little significance to the protection of Hong Kong investors.

III. Protection of shareholders' interests

In accordance with Rule 19.30(1)(b) of the Hong Kong Listing Rules, an Overseas-listed Chinese Company seeking a secondary listing in Hong Kong SAR is required to provide at least the equivalent level of protection for shareholders' interests as that provided in the Hong Kong market. In addition, Rule 19C.06 of the Hong Kong Listing Rules provides that Appendix 3 and Appendix 13 of these rules do not apply to a Chinese Issuer if the issuer is a Grandfathered Greater China Issuer and can prove that it has met the eight shareholder protection requirements set out in Rule 19C.07. This means that HKEX may exempt such issuers from the said Rule 19.30(1)(b).

IV. Protecting minority shareholders' rights to convene and propose at general meetings

In accordance with Rule 19C.07(7) of the Hong Kong Listing Rules, minority shareholders of a listed company have the right to convene and propose at an extraordinary general meeting ("the right to request a meeting"). On a one vote per share basis, the minimum proportion of shareholders required for the convening of such a meeting may not be greater than 10% of the voting rights of the issuer's share capital.

Many Hong Kong listed companies have controlling shareholders who, together with the persons acting in concert, are entitled to exercise more than 30% of the voting rights at general meetings. This makes the controlling shareholders the de facto decision-makers of the company, thereby rendering the right to request a meeting meaningless. A Chinese Issuer without a controlling shareholder and having a more decentralized shareholder structure will in fact provide a higher level of protection for minority shareholders. In addition, as the majority of Overseas-listed Chinese Companies are entities incorporated in the Cayman Islands and are viewed as foreign private issuers, minority shareholders have the right to bring individual actions or derivative actions directly against the company. Given that minority shareholders enjoy adequate indirect protection under the U.S. federal securities laws, Chinese Issuers are advised to apply to the HKEX for an exemption from strict compliance with the said Rule 19C.07(7).

V. Financial information on the targets of investments and acquisitions following disclosure of track records

Rules 4.04(2) and 4.04(4)(a) of the Hong Kong Listing Rules provide that for subsidiaries acquired, or proposed to be acquired after the latest audited financial statements, the issuer shall also provide the results and balance sheets of those subsidiaries for each of the three years preceding the publication of the prospectus.

There will be a large number of invested companies involved if an Overseas-listed Chinese Company made a significant number of equity investments in its day-to-day operations prior to the listing. If such invested companies do not have historical financial data prepared in accordance with IFRS requirements, it will take a lot of time and resources to fully understand the management accounting policies of the target companies in order to prepare such financial documents. Thus, it will place a heavy burden on both the Overseas-listed Chinese Company and the invested companies.

A Chinese Issuer may apply for an exemption from the above requirements on the following grounds:

(i) As an Overseas-listed Chinese Company does not exercise control over invested companies, nor does it have seats in the Board or interfere in the day-to-day operations of these invested companies, it (as a minority shareholder) will not be in the position to compel the invested companies to prepare, and disclose in their prospectuses, the audited financial statements.

(ii) Disclosure of all equity investments is not required by U.S. securities laws.

(iii) Disclosure may be detrimental to the relationship between the Chinese Issuer and the invested companies and to their commercial interests; and as the invested companies are not public companies, disclosure of financial information may impair commercial sensitivity and place them at a disadvantageous position in competition.

(iv) The 5% threshold of the percentage of equity investment in the listed issuer's assets, profits, revenue, consideration and share capital (Rule 14.07 of Hong Kong Listing Rules) determines whether such investment and the disclosure are material to investors.

(v) Whether it is possible to provide alternative information on outbound investment in accordance with Chapter 14 of the Hong Kong Listing Rules, such as a description of the main business, amount of investment and a statement indicating that no core connected person of a company is the controlling shareholder of any invested company. (To ensure confidentiality, the name of the specific invested company may be represented by letters or numbers.)

VI. Non-disclosure of directors' residential addresses

In accordance with paragraph 33(3) of Part A of Appendix 1 to the Hong Kong Listing Rules, the information about the five natural persons who received the highest remuneration for the year shall be disclosed in the prospectus. In addition, paragraphs 6 and 45 of Schedule 3 to the *Companies (Winding Up and Miscellaneous Provisions) Ordinance* ("Winding Up and Miscellaneous Provisions") respectively provide that the residential addresses of directors shall be disclosed in the prospectus, and such addresses refer to the directors' usual residential address.

As many directors of Overseas-listed Chinese Companies are well-known figures both at home and abroad, disclosure of their addresses may expose them and their families to unnecessary disturbance and public attention. Given the increasingly stringent regulation over Overseas-listed Chinese Companies in the U.S., their directors are subject to malicious allegations or abusive lawsuits from time to time. Therefore, it will effectively reduce the harassment against directors if Chinese Issuers may apply to not disclose the addresses of such directors in the prospectus.

VII. Non-disclosure of the options of subsidiaries or connected entities in the consolidated financial statement

Paragraph 27 of Part A of Appendix 1 to the Hong Kong Listing Rules requires listed issuers to disclose in their prospectus particulars of options of subsidiaries or connected entities in the consolidated financial statement, including the consideration for which the options have been or will be granted, the exercise price and exercise period of the options, and the name and address of the grantee. Additionally, paragraph 10 of Part I of Schedule 3 to the Winding Up and Miscellaneous Provisions requires listed issuers to disclose information on the number and type of options, the period during which the options may be exercised, the price to be paid for the shares or debentures subscribed under the options, and the consideration paid or to be paid.

Most Overseas-listed Chinese Companies will develop an equity incentive plan, and disclose such plan in Form 20-F (annual report of a non-U.S. company) filed with the SEC. The disclosure in Form 20-F will also be consistent with that set out in the "Directors, Officers and Employees - Compensation - Equity Incentive Plan" section of the prospectus of Overseas-listed Chinese Companies seeking secondary listings in Hong Kong SAR. As Rule 19C.11 of the Hong Kong Listing Rules provides that Chapter 17 of the Hong Kong Listing Rules does not apply to exempt Chinese Issuers, such issuers are not required to disclose their equity incentive plans. In addition, details of options are not required to be disclosed in the Form 20-F filed with the SEC. As such, it will impose a considerable burden on Chinese Issuers if they are required to comply strictly with the Hong Kong disclosure requirements on options. As noted in the second point above, Chinese Issuers may apply to the SFC for an exemption from Part XV of the SFO in relation to disclosure of shareholders' interests. Chinese Issuers are also advised to apply for an exemption from the strict compliance with the disclosure requirements in relation to options.

VIII. No printed prospectus required

Chinese Issuers may apply for an exemption from the strict compliance with the requirement of providing printed copies of the prospectus under Rules 12.04(3), 12.07 and 12.11 of the Hong Kong Listing Rules. For the part of publicly offered shares selling to Hong Kong investors, an all-electronic application process is adopted and printed copies of its prospectus are not made available to the Hong Kong public.

IX. Exemption from providing company information to shareholders

Rule 2.07A of the Hong Kong Listing Rules provides that a listed company should, in principle, send printed copies of company information to holders of securities. Such information may be provided by the listed company via email, provided that the listed company has received prior express written confirmation from each holder of its securities or it has been approved at a general meeting.

This requirement often imposes a greater administrative burden and cost on Overseas-listed Chinese Companies. Such companies allocate a relatively small percentage of shares for subscription in Hong Kong SAR during their secondary listing, with more than 90% of their shares going to professional, institutional and other investors in the rest of the world. It is likely that there are over tens of thousands of holders of the ADSs of the Chinese companies worldwide and therefore it is not feasible to send printed copies of all company information to all securities holders.

Also, such companies are required to file a variety of company information with the SEC, which are posted on the SEC's Edgar. Regular reports set out in Form 20-F and Form 6-K are generally available on the investor relations pages of these companies.

X. No need to publish a monthly statement

Under Rule 13.25B of the Hong Kong Listing Rules, listed companies are required to publish monthly statements disclosing changes in the company's equity securities, debt securities and other securitisation instruments during the monthly reporting period.

If Overseas-listed Chinese Companies have been exempted from Part XV of the SFO in relation to disclosure of shareholders' interests (see the second point above on "Simplified obligations for equity disclosure") in the secondary listing in Hong Kong SAR, they may apply for an exemption from Rule 13.25B at the same time, and will only be required to provide the SEC with quarterly earnings and disclose the information on share repurchases in Form 20-F.

XI. Non-disclosure of the offer price in the prospectus

Paragraph 15(2)(c) of Part A of Appendix 1 to the Hong Kong Listing Rules provides that the offer price of the securities must be disclosed in the prospectus. It is recommended that Chinese Issuers apply to the HKEX for an exemption from this requirement. In lieu of the offer price, only the highest public offer price will be disclosed in the prospectus.

As the securities offered in a secondary listing in Hong Kong SAR are fully fungible with the ADSs, the public offer price may be determined by reference to, for example, the closing price of the ADSs on the pricing date or on the last trading day prior to that date. Given the fact that Chinese Issuers could not control the market price of ADSs, setting a range of fixed prices or minimum international offer prices may have an adverse effect on the price of ADSs and Hong Kong-listed shares.

XII. Permitting pre-listing trading of securities by core connected persons

In accordance with Rule 9.09(b) of the Hong Kong Listing Rules, no core connected person of the issuer shall deal in the securities of the proposed listed company from four business days prior to the date of hearing until the listing is approved.

Major shareholders, directors and officers ("insiders") of Chinese ccompanies will establish a trading plan ("Rule 10b5-1 plan") in compliance with Rule 10b5-1 of the U.S.

Securities Exchange Act after listing in the U.S., to legally trade in the companies' securities. Rule 10b5-1 plan is a written plan for trading in securities established with a broker. The plan:

(i) is entered into at a time when insiders do not possess material non-public information;

(ii) specifies in advance the number of securities to be purchased and sold, the selling price and date of sale; and

(iii) does not allow insiders to interfere with the method and timing of trading. A person who trades in the securities under Rule 10b5-1 will not normally be viewed as an insider trading participant under the U.S. securities laws.

Most U.S.-listed Chinese companies have numerous subsidiaries and connected entities and usually develop a Rule 10b5-1 plan. As many insiders do not have discretion over the purchase and sale of ADRs of U.S.-listed Chinese companies, they will not have a material impact on the global offering in the secondary listing in Hong Kong SAR. Therefore, we recommend that Chinese Issuers apply to the HKEX for an exemption from Rule 9.09(b).

XIII. Allowing existing shareholders to conditionally subscribe for shares

Pursuant to Rule 10.04 of the Hong Kong Listing Rules, the existing shareholders, directors and connected persons of an issuer may subscribe for securities sold by any listing applicant or its representatives, provided, however, that Rule 10.03 is satisfied. Under paragraph 5(2) of Appendix 6 to the Hong Kong Listing Rules, a listed issuer shall obtain the prior written consent of the HKEX if it wants the directors, existing shareholders or close contacts of its subsidiaries to subscribe for or distribute securities.

Even if Overseas-listed Chinese Companies have numerous subsidiaries and connected entities, the directors, officers and major shareholders of some of the non-material subsidiaries are unlikely to hold any non-public inside information and thus they have no real influence over the listed issuer (e.g. they cannot appoint directors). These persons are in fact on the same footing as public investors in Hong Kong SAR. The HKEX may allow such persons to conditionally subscribe for shares if the listed issuer can undertake to the HKEX that the shareholding or voting rights of such persons in the listed issuer will not exceed 5%, that they will participate in the book-building process in the international placing as normal and that they will not be given any special treatment.

XIV. Requirements for audited statements between U.S. GAAP and IFRS

The Hong Kong Listing Rules and the Winding Up and Miscellaneous Provisions, and the *United States Generally Accepted Accounting Principles* ("U.S. GAAP") set out different requirements for the disclosures of historical financial information in the accountants' report. Rules 4.05 and 4.13 of the Hong Kong Listing Rules require disclosure of specific details, including the company balance sheet; an ageing analysis of accounts receivable; an ageing analysis of accounts payable; and adjustments to profit for the track record period made according to the new accounting standards adopted in the most recent financial year.

U.S.-listed Chinese companies are required to apply the modified retrospective method or prospective method during the track record period in accordance with the U.S. GAAP to recognize the impact of the new accounting standards. The relevant accounting standards include ASU 2016-01, ASC 606, and ASC 842.

After adopting the ASU 2016-01 standard, changes in the fair value of available-for-sale equity securities are recorded in the consolidated statements of income and changes in the fair value of securities are recorded in other comprehensive income in the fiscal year prior to adoption of the standard. In addition, equity securities previously accounted for under the cost method were reclassified as investments in securities under ASU 2016-01. As the fair value of these equity securities is not readily determinable, U.S.-listed Chinese companies generally choose to account for such equity securities in future periods using the simplified measurement method and record fair value adjustments (including impairments) in the consolidated statements of income. The U.S. GAAP does not permit full retrospective adjustments upon adoption of ASU 2016-01, so no retrospective adjustments can be made to the consolidated financial statements for comparable periods.

After the adoption of ASU 2016-01 on a full retrospective basis, the adjustment of historical financial information for comparable periods will confuse investors in the U.S. market and may result in a misleading accountants' report accompanying the prospectus of a secondary listing. Thus, a Chinese Issuer may apply for disclosure of new accounting standards effective for the most recent financial year (e.g. the impact of undistributed profits) only in accordance with the U.S. GAAP and also apply for the exemption from disclosure of information in the accountants' report as required by Rules 4.04(3), 4.05(2) and 4.13 of the Hong Kong Listing Rules and paragraph 31(3)(b) of Schedule 3 to the Winding Up and Miscellaneous Provisions.

XV. Permitting Spin-offs and listings within three years of listing

Paragraphs 1 to 3(b) and 3(d) to 5 of Practice Note 15 of the Hong Kong Listing Rules (i.e. the restriction against spin-offs of subsidiaries within 3 years of listing) do not apply to issuers seeking secondary listing. This is because parent companies' initial listing was approved based on the market and investor expectations that they will continue to develop the business portfolios already existed at the time of listing. As such, the Listing Committee of the HKEX will not consider an application for a spin-off if a parent company has been listed for less than three years.

Considering potential business opportunities and ever-changing market conditions, parent companies should seize the opportunity for a spin-off and the listing on the HKEX as a subsidiary is likely to grow rapidly and stronger within three years.

We recommend that Overseas-listed Chinese Companies apply to the HKEX for an exemption from strict compliance with the three-year restriction on spin-offs as set out in paragraph 3(b) of the Practice Note 15 on the following grounds:

(i) The Articles of Association of Overseas-listed Chinese Companies, the U.S. regulations and the NASDAQ and Hong Kong Listing Rules do not provide any special requirements or restrictions on when the spin-off and listing can be made;

(ii) Rule 19C.11 of Hong Kong Listing Rules has already granted an exemption and allowed a spin-off of a Chinese Issuer within three years of listing in Hong Kong SAR. If a spin-off is permitted, it makes little sense to restrict the listing of the spin-off business on the HKEX (the impact of the spin-off on shareholders is not dependent on where the listing takes place, except in relation to the pre-emptive rights of shareholders of the parent company); and

(iii) The listing after the spin-off will still be subject to the financial requirements of Rule 19C.05 of the Hong Kong Listing Rules and the requirements of Practice Note 15.

Conclusion

The return of Overseas-listed Chinese Companies to the Hong Kong stock market may be able to raise the valuation of the Hong Kong listed shares of consumer discretionary and information technology sectors. The U.S.-listed Chinese companies that might seek a secondary listing in Hong Kong SAR are mainly from the new economy sector. Of the 23 companies with a market value greater than USD 3 billion, information technology and consumer discretionary companies collectively account for over 90% of the total market value. The Hong Kong listed shares of consumer discretionary and information technology sectors are currently valued at 22.4 and 15.7 times respectively, while the shares of two leading U.S.-listed Chinese companies expected to seek secondary listing in Hong Kong SAR are valued at 37.4 times and 19.8 times, respectively. Therefore, the successful secondary listing of the leading U.S. listed Chinese companies in Hong Kong SAR is expected to boost the valuation of the Hong Kong listed shares of consumer discretionary and information technology sectors and drive the development of the Hong Kong stock market.

The HKEX has a more flexible discretion as to whether Mainland issuers and other issuers with a primary listing overseas can be granted an exemption from the Listing Rules. After a listed company's application for an exemption has been approved, subsequent listed issuers may follow the precedent. For example, Hong Kong listed companies are required to appoint a member of the Institute of Chartered Secretaries, a solicitor or barrister, or a professional accountant as the company secretary. In 2016, the HKEX exempted Bank of China (Hong Kong) from the said requirement for a period of three years. For another example, the WVR structure in Hong Kong SAR originally provides that shares with super voting rights should be held by natural persons such as founders or directors of new economy companies. Following the listing of Meituan in December 2018, however, such shares may be held in the form of family trusts after being granted an exemption from the Rule 8A.18 of the Hong Kong Listing Rules by the HKEX.

As Overseas-listed Chinese Companies seeking a secondary listing in Hong Kong SAR have different information disclosure obligations, business and practical needs, we recommend that they communicate with the SFC and the HKEX as early as possible and apply for applicable exemptions from the Hong Kong Listing Rules, so as to reduce the uncertainty in listing and post-listing maintenance costs.

Analysis of IPOs of biopharma companies in Hong Kong SAR (for sponsors)

Sam Huang

Sam Huang

Hong Kong has become the world's second largest biotech financing centre since the Stock Exchange of Hong Kong (the "HKEx") introduced Chapter 18A (the biotech chapter) of the Main Board Listing Rules in 2018. Biotech research features long R&D and investment cycles and biotech industry carries higher risks than traditional pharma and other industries. For this reason, the HKEx set up the Biotech Advisory Panel consisting of experienced international experts in the biotech industry. Listing departments may consult the Panel for advice relating to the field.

In recent years, the Hong Kong Securities and Futures Commission (SFC) has been taking frequent actions against sponsors for neglect of duty in listing applications, and has imposed penalties on a number of securities firms due to inadequate due diligence in the listing process. Given the SFC's increasingly stringent regulation, negligence in performing due diligence may result in severe consequences. The key officers of sponsors should be involved and determine the breadth and depth of the due diligence review and the allocation of resources. They should assess the results and adequacy of the due diligence review to ensure that any issues identified are properly addressed. In the listing process of a biopharma company, the key officers are not allowed to delegate their duties as they are ultimately responsible throughout the entire due diligence process. Sponsors should take control of the due diligence process and be attentive and sensitive to attempts to ignore negative due diligence findings or resist further enquiries. They should perform their obligations under the *Code of Conduct for Persons Licensed by or Registered with the SFC*, the *Corporate Finance Adviser Code of Conduct, the Management, Supervision and Internal Control Guidelines for Persons Licensed by Or Registered with the SFC,* and the *Additional Fit and Proper Guidelines for Corporations and Authorised Financial Institutions Applying or Continuing to Act as Sponsors and Compliance Advisers.*

At the beginning of the listing process of biopharma companies, sponsors should work with their counsels to develop a comprehensive due diligence plan covering the following steps:

1. Examining the fundamental principles of drugs
2. Understanding the target market
3. Enquiring about core issues
    a. Assessing clinical development plans
    b. Assessing the regulatory outlook
    c. Ensuring the authenticity and reliability of data
    d. Investigating the company's manufacturing capabilities
4. Takeaways from HKEx's feedback on application review

Given the high degree of specialisation and entry barriers in the biotech and medical device sectors, sponsors should always seek independent, objective and verifiable advice during the due diligence process from, for example, key opinion leaders (KOLs), lead researchers, contract research organisations (CROs), manufacturers, and partners. They are expected to work with the counsel and the company's management to select the proper participants and then conducts due diligence with the company's management withdrawn.

I. Examining the fundamental principles of drugs

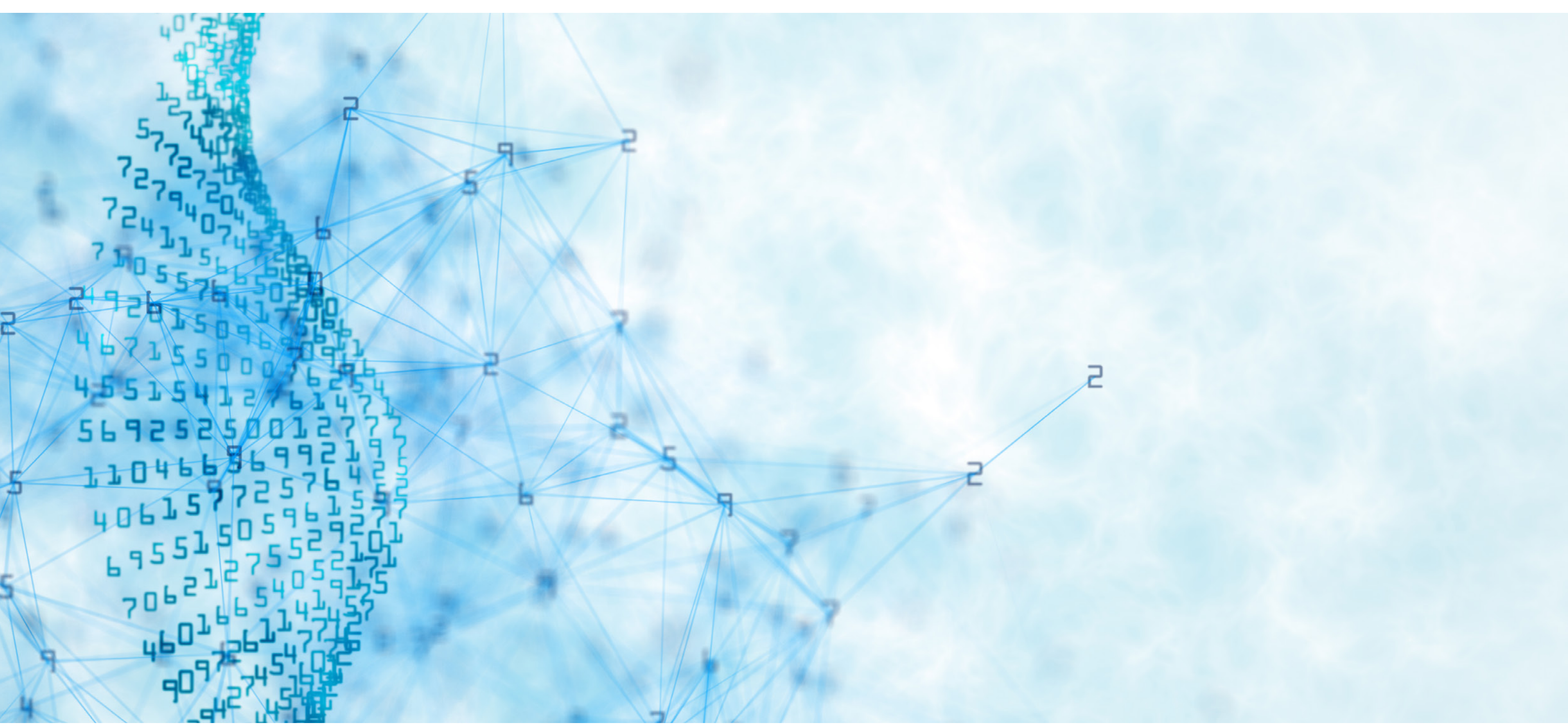
In accordance with the HKEx's due diligence requirements, the sponsor should critically assess the fundamental scientific explanations and rationales. Not relying solely on presentations by the company's management, the sponsor should also seek supporting statements from assessments of its deal team/pharmaceutical research analysts, interviews with KOLs and principal investigators, and third party scientific publications. In addition, the sponsor is required to critically assess clinical development plans and regulatory outlooks and conduct due diligence on clinical trials to ensure the authenticity and reliability of data from clinical trial protocols. The sponsor should also review clinical study reports, scientific papers, government and non-profit research publications, patent research and third party data sources to assess the authenticity of trials.

II. Understanding the target market

The sponsor should understand the target market for the drug or biologic, such as the patient population. It can conduct market research through a patient advocacy group, industry consultant, or even the engaged independent consulting firm. The sponsor can assess drug pricing and penetration estimates which are not disclosed in the prospectus. It should have a good knowledge of the competitive environment, such as other drugs approved or in development, comfort and satisfaction of doctors with current market leaders and standards of care, the efficacy of comparable drugs, the operability of the route of administration, pricing and subsidies. In disclosing barriers to commercialisation, the sponsor should present several aspects of how to penetrate the market, the company's marketing strategy, the target number of doctors, the size of sales force required and pharmacoeconomics.

III. Enquiring about core issues

The sponsor should critically assess the company's objectives, strategies, and required expertise, and ensure that the team is staffed with professionals with expertise in e.g. microbiology, genetics, pharmacokinetics, toxicology, and comparator selection. The sponsor should have an independent, objective assessment of the following core issues:



- What analysis findings should be assessed?
- What are the possible routes of administration (e.g. oral vs. intravenous)?
- Inter-patient (horizontal vs vertical) differences;
- Half-life, plasma/urine concentrations, tissue distribution;
- Bioavailability and food interactions;
- Toxicity, safety and efficacy profile;
- All adverse and serious adverse events;
- Are the test methods and study design appropriate for the intended indication?
- Study design - open-label versus blind trial/placebo controlled? Randomised? Validated (e.g., approved by an institutional review board (IRB))?
- Does the study comply with applicable guidelines (e.g., the good laboratory practice (GLP) or good clinical practice (GCP))?
- Are the route of administration, clinical dose and duration of treatment continuously being improved?

(I) Assessing clinical development plans

The sponsor should understand the following issues: Is the company's proposed trial focus acceptable to the regulator? Are there other drugs already approved on this endpoint? If it is a new endpoint, has the National Medical Products Administration (NMPA) provided any positive feedback or even agreed to a priority review or fast track? What is the company's proposed development timeline? Does the timeline cover key milestones? Is the timeline realistic and achievable, or overly optimistic? What is the company's clinical trial registration process? Is a recruitment centre required? Where are the target regions?

(II) Assessing the regulatory outlook

The sponsor should gain a thorough understanding of the following issues: What messages are conveyed from the communications between the company and the regulator? What is the next plan of communications, including minutes of meetings, informal communications, written correspondence and responses? Are there any regulatory issues with similar drugs in development? Are there any "clinical holds" or other warning signs? Has the regulator inspected the manufacturing facility to ensure compliance with the current good manufacture practices (cGMP)?

(III) Ensuring the authenticity and reliability of data

The sponsor is required to verify the data provided or cited by the company from multiple sources, such as scientific papers, government and non-profit research publications, search reports from intellectual property (IP) offices, independent third party data, clinical study reports (CSRs, published or unpublished, first draft or final version). As required by the HKEx, the sponsor should ensure that the prospectus disclosures accurately and in detail describe all adverse and serious adverse reactions, the adverse events, attributability of the adverse events to the design of the experiment, and the incidence of adverse events in comparable study designs.

(IV) Investigating the company's manufacturing capabilities

The sponsor should conduct an investigation of the company about the following issues: Will the company manufacture the products independently or via an appointed third party contract manufacturing organisation (CMO) in the future? What are the technical challenges in manufacturing drugs, especially large molecule ones? Does the company rely on a single source supplier or is there any back-up supplier that can be a substitute? How will commercial scale-up (plant, land, personnel and local government financial support) be achieved after the drug is launched? Has the manufacturing facility been inspected or approved by the NMPA? Is the staffing for internal process development, chemistry, manufacturing and control (CMC) adequate?

IP due diligence is critical for a biopharma company. During the due diligence exercise, the sponsor should keep a variety of evidence, including written records (e.g., patents and related chain of ownership, IP agreements, employee invention transfer agreements, and IP-related decisions), due diligence interviews, patent protection status, duration and geographical scope, exclusivity or enforceability of proprietary ownership. If the company has an IPR dispute, the sponsor should understand the current status, the timing of key awards and settlements, etc. of the dispute. In addition, the sponsor should also understand whether there is any third party infringement of the company's IPRs and the measures taken, whether the company is using rights of any government or university, and whether there are any issues in the protection of trade secrets.

IV. Takeaways from HKEx's feedback on application review

In the past two years, when reviewing the prospectus of a biopharma company, the primary concerns shown in the HKEx's feedback are as follows:

(I) Biotech

- Defined terms: The company should clarify the meanings of scientific and technical terms when first used.
- A complete and faithful disclosure of adverse reactions: The sponsor should ensure that the company has disclosed all the adverse and serious adverse reactions occurring during the clinical trials without omission and also explained the known and potential unknown side effects.

- A description of the clinical endpoint: How does the company assess the efficacy (based on, e.g., the presence of some biological activity, elimination of disease, symptom reduction, absence of symptoms, and life extension).

(II) Accounting

- Accounting for payments: How does the company account for the preliminary, annual, milestone and royalty payments under licensing and cooperation agreements?
- Breakdown of research and development costs. The costs should be recorded specifically to each core product and pipeline product and to each phase of trials.
- Stock incentive mechanism: How does the company determine the fair value of shares issued to employees? The company is required to explain the difference between the recent common stock valuation and its estimated issue price.
- Use of proceeds: Does the estimated proceeds meet the requirement of the development plan? The HKEx requires the company to ensure it has available sufficient working capital to cover 125% of the costs for at least 12 months from the date of listing.

(III) IP legal advice

During the listing of a company under Chapter 18A, the sponsor should obtain legal advice from the international counsel and the in-house patent counsel of the company. The IP legal advice is to assist the sponsor in the due diligence of the company's IP to confirm it. In addition to disclosures in the prospectus, patent legal advice usually covers the following:

- The company is the registrant and exclusive owner of its patents;
- The company's main product candidates are protected by at least one patent that has been granted to the company;
- No facts have been found to show that the company's patents are unpatentable, invalid or unenforceable;
- There are no IP related lawsuits, disputes or threats; and
- The IP related statement in the prospectus does not contain any major omissions or misstatements.

1. IP due diligence. Due to the long research and development period and high investment, drugs rely heavily on IP and strong IP protection to maximise financial benefits. Since IP is one of the core assets of a biopharma company, it is important for the sponsor to carry out due diligence to evaluate the value and risks of the company's patents in the IPO course. Given the high technology and complex legal requirements of drug patents, due diligence requires to cover many dimensions. Even the slightest omission may lead to a potential hazard in a post-IPO dispute or the investigation by the SFC. In-depth due diligence is time and cost consuming. In order to develop comprehensive findings within the IPO period of months, the sponsor is required to conduct due diligence step by step in order to balance effectiveness, efficiency and cost control.

2. Background investigation of patented technologies. The sponsor can appoint a third party to find out the maturity of industry, the technological development path of key competitors, the hot spots and gaps of the technological development in the industry, and analyse the overall application trend, distribution and key technology of patents.

3. Investigation of potential patent ownership disputes. The sponsor should investigate agreements on ownership of inventions and creations in the employment contract between the inventor and the company and the transfer certification of the inventor's patent application right. The investigation should focus on whether there is a written contract between the company and its third party partner and whether the contract contains a clear agreement on the IP ownership, so as to establish the integrity of the right chain.

4. Investigation on the stability of patents. In pharmaceutical industry, even granted patents may be invalidated. As the criteria of review for drug patents change dynamically, patents are vulnerable to invalidation for some dosage forms and treatment methods. In recent years, an increasing number of requests for invalidation of drug patents has been accepted by China's Patent Reexamination Board. For a biopharma company, the stability of patents is of great importance. The sponsor should conduct investigation carefully to draw a reliable conclusion, taking into account the real-time regulatory review criteria.

5. Reliability of clinical data. The inauthenticity of clinical data or loss of clinical trial data will not only significantly increase the cost of data recovery and retrieval, but also lead to delay or failure in the approval process of regulatory authorities in serious cases. The sponsor should ensure that the company has records of data entry and change and appropriate detection, review and authorization procedures to prevent data from tampering. As any improper disclosure of confidential or patent information will give rise to legal liability, product development and commercialization may also be delayed. The sponsor should pay sufficient attention to the security of the company's trial data.

6. Investigation of third-party partners. The complex process of research and development, clinical trials to commercialisation requires sophisticated scientific research and technical capabilities. It is therefore crucial

for the company to manage its clinical activities in an orderly manner. Failure of third party partners such as CROs, CMOs, sales and marketing agents or distributors to fulfil their obligations or terminate the cooperation agreements without cause will affect not only the business growth ability of the biotech company but also the regulatory approval and commercialization of its products. The sponsor should evaluate the biotech company's mechanism and process for selecting third party partners, including co-outsourcing and outsourcing policies for prequalification evaluation, as well as their expertise and capabilities. The sponsor should also conduct sufficient feasibility studies, including preclinical studies, clinical trials, and the whole process from manufacturing to supply or distribution of drugs or medical devices. In addition, the biopharma company, its CROs, CMOs and designated distributors must establish internal control systems and comply with GCP[1], cGMP and good supply practice (GSP)[2]. The sponsor should urge the biotech company to establish an ongoing performance monitoring mechanism, using key performance indicators (e.g. product development, clinical trial timelines, milestones and costs) to measure performance.

7. Government regulation and compliance. The time required for a biopharma company to obtain approval from the NMPA and foreign regulators is unpredictable, usually long after the start of clinical trials and dependent on many factors. In addition, approval policies, regulations or the type and amount of clinical data required for approval may change in the of a product's clinical development, as well as from jurisdiction to jurisdiction. The sponsor should ensure that biopharma company (i) has established and maintains a complete and up-to-date database of laws and regulations; (ii) actively verify these data to ensure timely updates of any changes in laws and regulations in the database and timely assessment and response to the impacts of those changes; (iii) has a preventive compliance programme, code of conduct, compliance policy and an appointed compliance programme owner for non-compliance, frauds or illegal activities; (iv) provides regular compliance trainings for employees; (v) develops a reporting mechanism to receive reports and complaints and protect whistle-blowers from retaliation; and (vi) formulates policies and procedures for investigating non-compliance or misconduct.

Conclusion

Among a series of reform measures taken by the HKEx, allowing unprofitable biotech companies to go public is one of the biggest highlights. This, however, does not mean lower threshold for listing. Sponsors are relatively unfamiliar with the business, products and expertise of biopharma companies, and the currently small number of companies listed under Chapter 18A provides few precedents and less comparable experiences. Therefore, sponsors may be subject to penalties such as disqualification by the HKEx or even post-IPO investigation by the SFC if they fail to conduct due diligence properly and assess the risks inadequately due to unfamiliarity the company's business.

Before 2018, the United States is the only choice for biopharma companies to go public. Since the introduction of Chapter 18A, however, Hong Kong SAR is providing more advantages. Backed by the resources from China and attracting experienced private equity funds from Europe and the United States, the new potentially preferred destination sees a good prospect for its biotech industry. Due to the high risk of investing in biotech companies, it is difficult for investors to assess the company's value. When the number of such listed companies reaches 30, the HKEx will expand the range of products to include ETFs and structured products based on relevant representative indexes, so as to help retail investors diversify their risks. Sponsors play an important role in the listings of biopharma companies. Good due diligence and sophisticated IP legal advice will not only help sponsors thoroughly understand the expertise of biopharma companies and the ecosystem of the subindustry, but also meet the requirements of the listing rules of the HKEx and security laws and regulations.

[1]GCP includes regulations and guidelines implemented by the NMPA and foreign regulators in clinical development.

[2]GMP and GSP are issued and updated from time to time in accordance with the PRC Drug Administration Law of the People's Republic of China. The purpose of GMP and GSP is to maintain the quality of drugs by reducing pollution, cross-contamination and error risks in the manufacturing course, and ensuring that distributors comply with regulations in their distribution of drugs.

Analysis of IPOs of biopharma companies in Hong Kong SAR (for issuers)

Sam Huang

Sam Huang

Since 30 April 2018 when the Hong Kong Stock Exchange (HKEX) introduced the listing regime under Chapter 18A of the *Main Board Listing Rules* (Chapter 18A), pre-revenue biotech companies have been allowed to list on the HKEX's Main Board. As of June 2020, 18 biotech companies have been listed on the HKEX.

At the beginning of the listing system reform two years ago, the first batch of the listed shares did not perform well and did not show a premium as expected by investment banks. The current highly asymmetrical valuation of biotech companies listed in Hong Kong as well as long R&D cycles, high capital investment and low success rate of product launches facing biopharma companies have become investors' key concerns. The difficulty for investors to assess the P/E ratios and valuations of companies has led to an overall low trading volume. In order to accurately and objectively assess the valuation of a company, investors need to understand the company's chances of successfully

developing products and the potential for future value growth that the products can bring to the company. As a result, comparing with companies in other industries, biopharma companies' prospectuses are more important.

This article introduces the key elements that sponsors should consider in their due diligence for biopharma companies during the Hong Kong listing process.

In April 2020, the HKEX updated two guidance letters (HKEX-GL92-18 and HKEX-GL85-16) and issued a new guidance letter (HKEX-GL107-20) to clarify the HKEX's position on the suitability of listing biopharma companies and the ability of existing shareholders to subscribe for shares in an IPO, and to refine the disclosure of prospectuses for biopharma companies. The IPO Review Group of the Listing Division of the HKEX has two dedicated teams to review biotech companies, both of which are staffed by personnel with professional backgrounds in biology, medicine and chemistry. In general, the HKEX's guidance letters require that companies should use plain language to disclose accurate scientific data in the summary section of the prospectus to make the data more readable and easy to understand. In addition, companies are required to disclose the development timeline of their core products in an objective manner and warn investors of the risk that they may lose all their investment due to R&D failures.

A clear and easy-to-read prospectus needs to have a clear description of a company's business and prospects and, in particular, an adequate elaboration on the following elements:

1. The company's core products and pipeline;
2. Clinical development;
3. Description of competition pattern;
4. Commercialization plan for the approved products;
5. Intellectual property;
6. Assessment of regulatory approaches;
7. Cooperative development agreements;
8. Risk factors;
9. Financial disclosure.

I. A company's core products and pipelines

The essence of a biopharma company is innovation. Whether such a company specialises in chemical entities, biologics, gene therapies, cell therapies or medical devices, its prospectus should show the differences between the company's current products and previous or similar products. When describing innovation, a prospectus should cover what investors focus on, including new mechanisms of action (overall response rate (ORR) and complete response (CR)), new mechanisms, new targets, new clinical indications, new therapeutic principles (limitations of current treatments), undiscovered medical needs, new composition of substances, or new dosing regimens.

If a company's core products are medicines or biologics, it should describe whether the products are going to be used for additional indications (e.g., hepatocellular carcinoma, colorectal cancer, renal cell carcinoma, and gynaecologic cancers) to maximize the commercial potential of its core products. Investors would like to know the company's measures to obtain approval for marketing for candidate medicines in late clinical stages as soon as possible. For products in the preclinical pipeline developed by the company, investors want to know how many new products the company is able to put into clinical trials each year, whether it has sufficient localisation knowledge in designing clinical studies, and whether it has developed new candidate medicines in collaboration with research institutions.

II. Clinical development

Most prospectuses list product pipelines by pre-clinical, mid-clinical, and post-clinical stages in a table. The table should list the different phases (e.g. IND and NDA phases) of a product, the therapeutic area (subdivided into different indications) and the scope of a product's commercialization rights (in China or globally). Obviously, medicines that are in or have completed Phase 3 clinical trials naturally have greater commercialization potential for investors.

For clinical trials, the HKEX requires companies to detail what indications a product is targeting, trial sites, the number of trial sites, the number of current patients, the number of patients planned to be recruited in the future, dosage, and the primary endpoint of each trial (overall survival or progression-free survival, dose-limiting toxicity, tumour response, and clinical and laboratory adverse events, etc.). Companies need to disclose how the results of clinical studies have helped to assess the safety and efficacy of the medicine.

In addition, investors pay attention to how companies accelerate the development of innovative medicines. As China has been struggling to develop innovative medicines through clinical development, most Chinese biopharma companies choose to partner with a globally renowned third-party CRO (Contract Research Organization) to conduct their trials. Whether a biopharma company regularly evaluates the CRO to ensure the safety of trial subjects, the integrity of trial data and regulatory compliance, as well as the achievement of key milestones (patient eligibility review, medical data review and serious adverse event review) need to be disclosed in the prospectus.

Investors will also assess companies' clinical development plan, including the assessment of scientific rationale (e.g., mechanism of action, preclinical data, available clinical data, and study opportunities) and market value (the number of patients that can be treated, market analysis and competition profile). Companies should disclose the following details of the trial protocol: protocol design, study objectives and endpoints, study population (sample size and inclusion/exclusion criteria), study duration, randomization methods, adverse events and serious adverse events, quality control and quality assurance and data management; trial preparation (site selection and laboratory visits); patient recruitment (patient assessment according to the study design and obtaining their informed consent); patient dosing (daily measurements and adverse event monitoring) and outcome measurement (assessment of efficacy and safety endpoint data).

III. Description of competition pattern

It is critical to help investors understand and evaluate the competitive environment in which a company operates. The company can thus recognize product-related indications, new products in development, stages of development and company-sponsored development, as well as the types and progress of biosimilars.

Market research is the basis for evaluating the competitive environment. Market research on biopharma companies falls into the following categories: academic research, research by government agencies (e.g., FDA, CDC, and WHO), research on proprietary data (e.g., from independent research and data analysis providers such as AMR), research commissioned by companies (e.g., company-sponsored reports from third-party consultants), or research conducted by companies themselves. The HKEX requires issuers to include in the prospectus the differences between their products and competitive products in technology, indications, and target markets, and the competition facing their core products and other major pipeline products in the intended target markets (including the names, prices, patent expiration dates, and subsidy and medicine-grant arrangements of competitors' pipeline products for the same indications).

When describing the industry to which its products belong, a company should cite industry reports describing the total incidence rate, cure rate, etc. for the indications related to their products, and may also project the market size in the next five years as well as the sales and compound annual growth rate of such products in the Chinese and foreign markets. Guidance Letter GL107-20 requires companies to introduce the names, indications, and clinical trial stages of their competitors' products. If there are marketed medicines, companies should disclose the current sales, subsidies, medicine grant arrangements, and patent expiration status of the medicine globally or in China.

IV. Commercialization plan for the approved products

Commercialization and potential market prospects are important indicators for investors to estimate the value of a company. The key to competitiveness of a biopharma R&D company lies in its ability to capture the market in time. Whoever can take the lead in successfully developing a product and getting it approved for marketing will win in this market and reap rich profits. Whether the product is a medicine, a biologic or a medical device, it is not easy to get a head start in the market. Take tumour immunotherapy (immune checkpoint) as an example: although different biopharma companies' products are advertised for different indications, in fact, PD-1 medicines, as biological macromolecules, though for different indications, share the same mechanism of action and basic structure in principle, and they are only different in biological preparation and structural details. These differences, however, do not change the therapeutic nature of PD-1 medicines. In the context of medical insurance cost control, the domestic market for PD-1 medicines is shrinking to a certain extent. The PD-1 market in China values at RMB 30.5 billion based on annual medical expenses of RMB 60,000 after medical insurance negotiations; if the price of PD-1 drops to RMB 30,000 on a full year basis, it is expected that the market size may shrink to RMB 23.6 billion. With a limited market size, market competition would become extremely intense. Therefore, in this case, if a company has a large number of existing competing medicines and candidate medicines, it will need to explain in great length why its products have an advantage over those of its competitors. However, considering risks and legal liabilities, most sponsors will not include in prospectuses studies on the penetration rate of patients with indications and price estimates or product models developed by companies based on these studies.

For biopharma companies that have yet to make a profit, the description of manufacturing can be relatively simple. Companies should ensure the source and availability of key supply chain, describing the infrastructure and future expansion plans designed to meet Chinese and international pharmaceutical standards, and manufacturing facilities that comply with international Good Manufacturing Practice (GMP).

For cost and risk management reasons, early-stage biologics companies do not typically have a large sales team. If commercialization is just within 12 months, or before launching the first product, a company should have a long-term plan to scale up the commercialization team and hire a commercial team with sales, marketing and market access. Investors generally believe that an experienced commercialization team will enhance the company's competitiveness. In addition, if the company has co-selling arrangements with international pharmaceutical enterprises, it can consolidate its competitive position in the market by leveraging these enterprises' in-depth knowledge of the Chinese market and their long-established sales networks in the Chinese market.

Commercialization functions of biopharma companies typically include marketing, sales, medical affairs, and market access. If a company plans to begin commercialization within 12 months, it may provide specific steps, such as whether the company intends to build its sales team or to build one through partnerships. If the company is building its own team, it should describe the size of the sales team and the target institutions (e.g., specialty clinics, transplant centres, and tertiary hospitals). The commercialization plan should be developed based on the marketing strategy.

Most biopharma companies have since their inception benchmarked themselves against the world's leading pharmaceutical giants and set out to create a fully integrated platform for the discovery, development, CMC and production and commercialization of candidate medicines to apply their products to multiple diseases. A fully integrated platform enables different functional teams to collaborate seamlessly across key links of a candidate medicine's lifecycle, thereby increasing the speed and success rate of development and reducing development costs. If cooperating with a research institution or a pharmaceutical company, the company need to disclose the background of such cooperation, the details of material terms, the allocation of intellectual property, the markets targeted by the product, and whether the company is prioritizing the development of any products of strategic or commercial significance. For companies that have already commercialized, pricing, insurance coverage and exclusive sales need to be discussed in detail.

V. Intellectual property

The intellectual property of biopharma companies is of great importance. Under Chapter 18A, an applicant must have a registered patent, patent application or intellectual property right in respect of its core products. From the prospectuses of listed biotech companies, it is found that in addition to their registered patents or patent applications, such companies often enter into license-in arrangements with other biotech companies involving their core products. Such biotech issuers have obtained exclusive licenses either to develop, manufacture and commercialize their core products or to market certain commercialized products.

When describing patents, the company should indicate the type and scope of protection of the patents, whether the patents have been issued or are pending, whether the company owns patents licensed to third parties, whether the patents are listed in the FDA's Orange Book, the region in which the patents were filed and issued (whether patent protection is available in the company's primary market for the product), and the duration of patent protection.

In addition to intellectual property, trade secrets can also provide protection for biopharma companies. Trade secrets cover a wide scope, including confidential and unpatented proprietary technology (e.g., manufacturing know-how), confidentiality agreements, confidentiality agreements limiting disclosure, physical operational restrictions (e.g., restricted access, firewalls, access rights), and exclusive, non-competitive and other restrictive contracts.

VI. Assessment of regulatory approaches

Companies should disclose in the prospectus the phases of their core and pipeline products, including preclinical development, application and review of investigational new drug (IND), Phase I, II, III and IV (post-marketing) trials, new drug application (NDA), biologics license application (BLA) and approvals, accelerated development and review process, and abbreviated new drug application (ANDA). The HKEX requires companies to disclose a summary of oral or written communications with the competent authority (e.g., the National Medical Products Administration of the PRC, the "NMPA") regarding clinical trials, including communications at the meeting before NDA, the competent authority's approval for the next phase of clinical trials, and whether the product is included in the priority review process. If the competent authority raises significant concerns about the clinical trial, the company also needs to give a truthful statement. If the company's product is classified as an orphan drug or an innovative therapy, the company needs to disclose the benchmarks for the drug to meet the regulatory pathway, the exemptions granted under that regulatory classification, and the benefits of obtaining approval under this pathway.

VII. Co-development agreements

Whether or not a biopharma company reaches the commercialization stage, its co-development of candidate medicines with major international pharmaceutical companies can not only reduce R&D costs and risks, but also help the company quickly gain market advantage. Investors are very interested in the terms of the company's cooperation agreements with such pharmaceutical companies. Except for the details of candidate medicines restricted from disclosure by the company as set forth in the confidentiality terms of the cooperation agreement, the company should describe the scope and content of the cooperation, for example, whether it is an exclusive license (with or without geographic restrictions), co-development, or a joint sales arrangement. Investors generally believe that cooperation agreements with top tier international pharmaceutical companies such as Lilly and Amgen reflect the high R&D level of biopharma companies. Strategic international partners can provide a strong boost to a company's expansion, including expertise and technology, speed, flexibility and a lower cost structure.

Most cooperation agreements stipulate whether the partners will share the costs of developing medicines in China and share the difference between net sales and expenses equally. International pharmaceutical companies make upfront payments to the company as consideration for medicine development and its rights and obligations under the agreement. If the net sales target is achieved, the biopharma company will be entitled to receive phased payments. Investors take notice of how the parties make decisions regarding the development and commercialization of the Chinese products, i.e., which party has the final say on the development of the Chinese products, or which party has the final decision on commercialization and development after regulatory approval of the products? Do the parties maintain ownership of the intellectual property under their respective development? Is there a one-way or two-way grant of certain patents, know-how and licenses (non-exclusive or exclusive)? And what is the term of the agreements (X years after the first commercial sale, or according to the patent term, or renewed on a yearly basis by region, etc.)?

VIII. Risk factors

Article 18A.05 of the Main Board Listing Rules requires biotech companies to prominently disclose to investors a warning that the relevant core product may not ultimately be successfully developed and marketed. Companies should describe the risks and uncertainties that are common to biopharma companies, especially the sustained net losses in the foreseeable future for companies in the early stage of clinical or technological development. Second, a company’s operations and prospects are heavily dependent on candidate medicines or biologics that have not yet been brought to market (and the possibility that candidate products may never enter the market). Lastly, companies should remind investors that product development and commercialization are dependent on continued financing, which the companies cannot guarantee and which could result in significant share dilution.

(I) Risks related to development and commercialization

A company should describe in the prospectus the following aspects: First, the company’s operations, clinical development, regulatory approval and review, manufacturing processes and commercialization are all still in their early stages and have not yet matured. The company’s operations and prospects are heavily dependent on its capabilities to develop medicines and to commercialize and gain general acceptance for candidate products that are not currently approved or marketed. The company should explain that as market acceptance of a medicine is capricious and it is difficult to predict the pricing of a medicine, the company therefore is not able to control market fluctuations. As a result, even if a medicine in development receives regulatory approval, it may not gain the market acceptance from physicians, patients, third-party payers and other participants that would be required to win commercial success.

(II) Risks related to regulatory approvals and compliance

Companies need to clarify that the marketability and commercial success of their products depend almost entirely on regulatory review, which is unpredictable, and where a regulatory hold is sufficient to undo medicine development. Companies need to make clear that there is significant uncertainty about obtaining regulatory approval for reasons including: 1) the company cannot demonstrate the safety or efficacy of the medicine or biologic; 2) there are delays or difficulties in enrolling patients in clinical trials; 3) clinical trial sites cannot be successfully opened; or 4) there are potential adverse side effects or unexpected characters of the medicine. It is likely to take a lot of time for a candidate medicine to obtain regulatory approval from the U.S. Food and Drug Administration (FDA), the PRC National Medical Products Administration (NMPA), the European Medicines Agency (EMA) or other equivalent medicine authorities. And it is time-consuming for companies to comply with increasing new regulations and policies. Companies will also have to pay a significant amount of money to cope with such ongoing compliance obligations and regulatory scrutiny. Even after the costs are incurred, companies will be subject to significant penalties if they do not comply with healthcare, fraud and other laws.

(III) Risks related to manufacturing and third-party R&D

Whether conducting preclinical studies and trials with third parties or manufacturing medicines in development with CMOs, most biopharma companies rely to some extent on cooperation agreements. If these third parties fail to fulfil the contractual agreements or reach the expected targets, companies may not be able to obtain regulatory approval for or commercialize their medicines, and their medicines in development and business may thus be impaired.

(IV) Risks related to intellectual property

Companies need to pay attention to deficiencies in IP protection or exclusivity, such as inadequate patent protection periods. If a company licenses out third party IP, it should full consider the possible risks of non-compliance with obligations under the license agreement. Companies need to point out to investors the risks posed by the differences in IP protection in different countries or regions. If IP protection is insufficient, competitors will develop and even commercialize in advance the products and technologies similar or identical to those of the company, and compete directly with the company, thereby undermining the company's production prospects.

IX. Financial disclosure

In response to the widespread concern of investors as to whether the proceeds from an IPO are sufficient to reach the next tipping point, the HKEX requires that the IPO proceeds need to cover at least 125% of the company's costs (including general administrative costs, operating costs, and R&D costs) for at least 12 months after its IPO. In addition, the company is required to disclose the following information in the prospectus: (1) the valuation of each round of financing prior to the IPO, with an explanation of significant valuation fluctuations in previous rounds in light of product development and competitive advantages; (2) the background of senior investors and their performance record of investment in the biotech sector; (3) any net liability arising from significant changes in fair value during the performance record period as a result of the conversion of the convertible debenture to net assets at the time of listing; (4) capital consumption rate, i.e. the ability to survive with or without proceeds from listing during a reasonable period; and (5) a schedule for the next round of financing based on the capital consumption rate.

Biopharma companies rely on ongoing equity financing. Under international accounting standards, convertible and redeemable preferred shares and put options on the issuance of common shares are financial instruments and are calculated at fair value, and their changes are accounted for as other financial liabilities in the income statement. For changes in the fair value of financial instruments, in addition to the disclosure that the company should make based on the results of each evaluation round by private equity investors, it is sometimes necessary to refer to the valuation reports of international commercial valuers. Preferred shares will be automatically converted into shares at the time of the IPO and the company may need to revalue the preferred shares prior to pricing. Such changes (losses) in the fair value of the preferred shares may have a material impact on the company's finance and performance and therefore need to be disclosed in the prospectus.

Most of biopharma companies' products have not yet been approved for commercial sales and therefore the companies do not generate sales revenue. The vast majority of a company's operating losses are incurred by R&D expenses, administrative expenses, business development expenses and financing costs. Investors pay close attention to the composition of the company's significant expenses and operating losses in future years, which generally consist of further preclinical R&D for candidate medicines, continued clinical development and pursuit of regulatory approval, commercialization activities for the launch of pipeline products, and the hiring of additional personnel to operate a fully integrated platform with advanced pipeline products for clinical candidate medicines.

Conclusion

High barriers, big investment and long cycles pose opportunities and challenges to most biopharma companies when they list in Hong Kong. China's biotech companies have great potential. Despite a considerable gap between China and developed countries in the R&D of innovative medicines, China is seeing an improving R&D environment and has released policies to support medicine R&D, such as encouraging innovation and opening up green channels for the approval of innovative medicines. The R&D and review period of innovative drugs has been further shortened, extending the effective life cycle of products. A large number of premium biopharma companies have been listed in Hong Kong. Since the release of Chapter 18A in 2018, Hong Kong has become the second largest biotech financing centre in the world. A good and readable prospectus can not only meet the requirements of Hong Kong listing rules and U.S. securities laws, but also fully demonstrate a company's core competence and commercialization prospects.

ESG Guide in effect: key points of "mandatory disclosure"

Wang Jianxue, Anthony Wan, Luo Ai, Tang Xiaojing

Wang Jianxue

Anthony Wan

Luo Ai

I. Introduction

In recent years, how a company manages the long-term environmental and social impacts of its business activities (i.e. the environmental, social and governance or ESG concern) has received increasing attention from regulators and the community. This year, international tensions, global environmental issues such as climate change, and regional social issues such as community development have revealed their political sensitivity and strategic significance in economic development.

Accordingly, it is becoming increasingly significant for companies to make ESG disclosures. In China Mainland, under the current ESG disclosure framework and "green finance" policy, some companies listed on Shanghai and Shenzhen Stock Exchanges are required to make ESG disclosures, and enterprises in a particular industry or of a particular nature are also obligated to do so. The ESG performance is gradually becoming one of the factors influencing investment decisions in the capital market. MSCI, Dow Jones Industrial Average, FTSE Russell, and other international indices give China-listed companies ESG ratings based on their ESG disclosures when selecting their A-share components.

In Hong Kong SAR, the Environmental, Social and Governance Reporting Guide (the "ESG Guide") attached as an Appendix to the Listing Rules of The Stock Exchange of Hong Kong Limited ("HKEx" or the "Exchange"), as amended in December 2019, has taken effect as of 1 July 2020. A company listed or to be listed in Hong Kong SAR (the "issuer") is required to comply with the ESG Guide for ESG reporting for financial years commencing after 1 July 2020. In brief, the new ESG rules introduce mandatory disclosure requirements. To be specific, the ESG Guide requires disclosure of significant climate-related issues; amends some "Environmental" key performance indicators (KPIs) such as emissions, energy consumption, water efficiency and wastes reduction; upgrades the disclosure obligation of all "Social" KPIs to "comply or explain"; and introduces the "Supply Chain Management" and "Anti-corruption" KPIs.

In response, we introduce this series of articles to review the ESG Guide. The new mandatory requirements, including governance and reporting principles, provide guidance for the "Environmental" and "Social" reporting. In this article, we will first provide a brief introduction and explanatory notes of the mandatory ESG disclosures.

II. Introducing mandatory disclosure requirements with a focus on the process and approach

As stated above, it is the first time for the Exchange to introduce mandatory disclosure requirements in the ESG Guide. A brief review of the history of the ESG Guide: When the ESG Guide was issued initially in 2012, the ESG issues were all "recommended disclosures"; in the first amendment in 2015, some ESG issues were upgraded to "comply or explain"; in this second amendment, in addition to upgrading all ESG issues to "comply or explain", mandatory disclosures are introduced. At present, the mandatory disclosures are about the ESG-related governance structure, reporting principles and reporting boundary, which mainly reflect the issuer's governance process and reporting approach on environmental and social issues.

Under the mandatory ESG disclosure requirements, "reporting boundary" identifies which entities or operations are included in the ESG report, which can be selected and explained in regard to specific subject areas and aspects, as is not elaborated herein due to limited space. In this article, we will further explain the "Governance Structure" and "Reporting Principles" below.

(I) Governance structure reflecting "board-level engagement"

The mandatory disclosure of ESG-related governance structure supplements the existing mandatory disclosure requirements under the Corporate Governance Code and Corporate Governance Report attached as an Appendix to the HKEx Listing Rules. In the ESG Guide, the governance structure refers specifically to the board's governance mechanism for ESG issues, which requires a statement in the name of the board, emphasising the board's role of leadership and "full responsibility" for the ESG issues. In support of the new disclosure requirements, the Exchange released an updated step-by-step guide to ESG reporting titled "How to Prepare an ESG Report" (the "Guide to ESG Reporting") and a new guide for board and directors titled "Leadership Role and Accountability in ESG" in March 2020, demonstrating the importance the Exchange attaches to board-level governance.

1. Elements of the statement from the board

Specifically, in an ESG report, a statement from the board contains the following elements:

(i) the board's oversight of ESG issues, which embraces the strategy and organisational structure of the issuer;

(ii) the board's ESG management approach and strategy, including the process used to evaluate, prioritise and manage material ESG-related issues (including risks to the issuer's businesses) and to identify strategic priorities in managing ESG issues for the short and medium-term; and

(iii) how the board reviews progress made against ESG-related goals and targets.

2. Form of the statement from the board

The statement from the board on ESG governance may either stand alone or be disclosed across various sections of the ESG report, so long as it is abundantly clear for readers to understand the board's governance of ESG issues, according to the official response to Query 7 contained in *FAQ Series 18 - Questions Relating to Environmental, Social and Governance Reporting*. In other words, the ESG governance structure can be presented in a separate section or disclosed in other sections as appropriate, e.g. disclosing the board's ESG materiality assessment when explaining how the materiality principle is applied; reflecting the board's governance elements in the disclosure of environmental or social issues; and disclosing the details of the ESG committee in the "Board Committees" section and the board's management of ESG risks in the "Risk Management and Internal Control" section in the corporate governance report.

3. Requirements for IPO applicants

In addition to issuers already listed in Hong Kong SAR, companies to be listed there are also advised to follow the Guidance Letter HKEX-GL86-16 (the "Guidance Letter") updated in July 2020. The Guidance Letter highlights that the boards of IPO applicants are required to ensure that the required corporate governance and ESG mechanisms are in place during the IPO process and that additional disclosure is made in the prospectus to promote sustainable development, good corporate governance and diversity. In the E. "Business" section, paragraphs 3.2 and 3.7(a) and (b) specifically provide that the applicants should: i) include a statement on their compliance culture; and ii) put in place mechanisms that enable them to meet the Exchange's requirements on corporate governance and ESG well in advance. Directors are expected to be involved in the formulation of such mechanisms and related policies. Applicants are therefore recommended to appoint directors (including independent non-executive directors) as early as possible so that directors can engage in the formulation of the necessary mechanisms and policies on corporate governance and ESG.

(II) Application of reporting principles

The ESG Guide sets out four principles of reporting - materiality, quantitative, balance and consistency, and requires a description of the application of the materiality, quantitative and consistency principles in the preparation of the ESG report. The application of the materiality principle imposes substantive requirements on the ESG governance process, as further explained below.

Materiality is defined as the threshold at which ESG issues determined by the board are sufficiently important to investors and other stakeholders that they should be reported. An issuer is now required to explain how the materiality principle is complied with and should disclose: i) the process to identify and the criteria for the selection of material ESG factors; ii) if a stakeholder engagement is conducted, a description of significant stakeholders identified, and the process and results of the issuer's stakeholder engagement—the stakeholder engagement is intended to seek the views of the stakeholders; and iii) for the "comply or explain" environmental and social issues under the ESG Guide, if a certain aspect or KPI is not material to the issuer's business or operations, the issuer may withhold disclosure and explain the non-disclosure on the grounds of "immateriality", stating that the relevant data is not material based on the nature of its own business and operations, rather than deliberately disclosing the irrelevant information, which also reflects the application of the materiality principle.

1. "Materiality assessment" mandatory

At the core of mandatory disclosure is the process of how an issuer identifies material ESG issues, or "materiality assessment". Systematic materiality assessments, which were once good industry practice, are now considered mandatory. Issuers who have conducted materiality assessments will need to improve the steps, for example, from identifying relevant issues, prioritising identified issues to identifying material issues, and to disclose the details of implementation, while those who have not yet done so will need to put it on the agenda.

For the issues to be assessed, issuers can screen out irrelevant issues against all "comply or explain" issues - or, of course, against other more stringent reporting standards and by adopting the usual issues of their peers - and conduct internal and external materiality assessments for each issue. Internal materiality refers to the impact on the business; and external materiality refers to the importance to stakeholders other than investors. Internal materiality is generally assessed by senior managers and/or key employees; and external materiality can be assessed through stakeholder engagement as recommended by the Guide to ESG Reporting.

2. "Stakeholder engagement" recommended

The "stakeholder engagement" for materiality assessment, unlike "board-level engagement", is not mandatory and is a recommended tool for identifying material issues. In addition, stakeholder engagement may already be part of a company's day-to-day operations, and many Hong Kong companies have voluntarily disclosed their stakeholder engagements that cover ESG issues in their ESG reports in previous years. The ESG Guide makes it clear that if a stakeholder engagement is conducted, a description of significant stakeholders, and the process and results of the stakeholder engagement should be disclosed.

Stakeholders are groups or individuals who are expected to affect or rely on the company, such as shareholders, investors, customers (including potential customers), suppliers, business partners, employees, government and regulators, NGOs and lobby groups, local communities, competitors, peers, and experts and specialists. Of these, those with a high degree of influence and reliance on the company are the key stakeholders and the company may conduct stakeholder engagement only with the key stakeholders.

Effective and feasible forms of stakeholder engagement, or stakeholder consultation, are flexible and diverse. It does not have to be a large on-site event, but can be either an all-employee meeting, a representative meeting or individual interviews, a workshop, a round-table or a panel discussion, or simply a telephone interview, a written consultation, or an online questionnaire. Companies can even collect stakeholder views in their daily contact with customers (including potential customers), suppliers, employees, and other stakeholders.

Conclusion

It is easy to see that the Exchange is pushing for "board-level engagement" and "stakeholder engagement" through the mandatory disclosure requirements under the ESG Guide in order to build good corporate governance and market confidence. This motive and movement were already indicated in the *Analysis of Environmental, Social and Governance Practice Disclosure in 2018* released by the Exchange at the end of 2019. The ESG disclosure review, besides "comply or explain" issues, paid special attention to the sample issuer's disclosure in respect of any assessment of materiality and the overall approach to ESG reporting. The focus of the recommendations has been on board-level engagement and materiality assessments.

For Mainland companies, their ESG management or reporting generally does not meet the Exchange's requirement aligning with international best practice. Their ESG reporting is more a matter of public relations, being prepared based on a more casual standard and form that do not comply with the four reporting principles. With regard to mandatory disclosure requirements, it is advisable for the Mainland enterprises listed in Hong Kong SAR, at the beginning of the financial year commencing from 1 July 2020, to start collecting reporting materials early, build the required infrastructure or take the necessary actions to produce an ESG report that meets the requirements in both substance and form.

How should companies report on environmental matters under the new ESG reporting regulations of the HKEx?

Wang Jianxue, Luo Ai, Pan Faluan, Huang Yueyuan

Wang Jianxue

Luo Ai

In recent years, environmental-related policies and regulatory requirements are becoming increasingly stringent. The environmental risks not only have an impact on a company's social responsibility or reputation, but may also directly and adversely affect its financial position. In addition, with the rising environmental awareness and tightened regulation, a company's attitude towards environmental issues also influences investors' evaluation of its growth potential. Environmental issues are increasingly relevant to the development of companies.

Against such backdrop, investors are increasingly concerned about how well companies are identifying and managing their environmental risks. The rating of ESG indexes, such as the MSCI ESG Ratings, Dow Jones Sustainability Indexes and FTSE Russell's ESG Ratings, for a company's ESG profile, also influences the investment decisions of a growing number of investors. ESG refers to Environment, Social and Governance, which are the three main aspects related to corporate sustainability and are the main non-financial factors that investors consider when making investment analysis and decisions. ESG drives companies to maximize both their own interests and the social value. Data proves that companies with good ESG performance tend to perform well in their operation and finance. Such companies are able to anticipate and manage current and future economic, environmental, and social opportunities and risks, and attach importance to innovation in quality and productivity, environmental protection, energy conservation and emission reduction. They are also able to reduce operating costs, and create competitive advantages and long-term value.

To guide companies listed or to be listed in Hong Kong SAR ("issuers") to make more standardized and appropriate disclosure of ESG risks, the Stock Exchange of Hong Kong Limited (the "HKEx") published the new ESG reporting requirements in the *Consultation Conclusions on Review of the Environmental, Social and Governance Reporting Guide and Related Listing Rules* (the "Consultation Conclusions") on 18 December 2019. The new requirements would be implemented for financial years commencing on or after 1 July 2020.

We have sorted out the 2019 edition of the *Environment, Social and Governance Reporting Guide* (the "ESG Guide"), the Consultation Conclusions, the *How to Prepare An ESG Report- A Step-by-Step Guide to ESG Reporting* dated March 2020 (the "Guide") and its Appendices, and made the following recommendations regarding environmental-related disclosures and the preparation of reports by issuers:

I. Learning about the adjustment of environmental-related disclosures in the new regulations

The environmental-related disclosures are subject to “comply or explain” provision as set out in the amendment to the ESG Guide made by the HKEx in December 2015. Based on the 2015 edition of the ESG Guide, the 2019 edition has additionally raised the following requirements for environmental-related disclosures:

- Disclosing direct (Scope 1) and energy indirect (Scope 2) greenhouse gas (GHG) emissions separately;[1]
- Describing the targets set in terms of reducing emissions, waste, and improving energy use and water efficiency;
- Describing the steps taken by the issuers to achieve the targets set in terms of reducing emissions, waste, and improving energy use and water efficiency;
- Making climate change related disclosure, including the policies on identification and mitigation of significant climate-related issues which have impacted, and those which may impact, the issuers.

The adjustments in the 2019 edition of the ESG Guide place a higher disclosure burden on companies listed or to be listed in Hong Kong SAR. For example, in terms of the climate change related disclosure requirement, the issuer may collect relevant data for the first time, and therefore it will take more time to set up the relevant system and accordingly more preparation work is required.

II. Preparing the ESG report by considering the issuer’s reality and geographical location

(I) The ESG report should be prepared “on a case-by-case basis”

While the ESG Guide provides basic guidance on how to present the report, the HKEx has further encouraged issuers to prepare the ESG report based on their own reality in various documents it has issued.

1. The report may refer to standards of the relevant industry

As the relevant reporting standards of an industry are made for that specific industry, the guidance on disclosure of specific ESG-related risks in such industry is more relevant to the actual situation of companies in the industry. In Article 8 of the ESG Guide, HKEx encourages companies to refer to industry reporting guidelines that are more relevant to their own reality on the basis of meeting the requirements of the ESG Guide.

Example:

- A pastoral company, while preparing its 2019 Corporate Annual ESG Report in accordance with the ESG Guide of the HKEx, referred to the Sustainability Reporting Standards of Global Reporting Initiative (GRI) and its supplementary guidance for the industry relevant to the company.

  “Basis of preparation - The report is prepared in accordance with the ESG Guide of the HKEx, with reference to the disclosure indicators set out in the GRI Sustainability Reporting Standards and its supplementary guidance for the food processing industry.”

2. The reporting boundary should be determined according to the business and reality of the company

The ESG Guide does not set criteria for issuers to identify the entities or operations that “should be included in the ESG report”. Companies are expected to determine their own guidelines for defining their reporting boundary based on their own business, including but not limited to:

- Being consistent with that disclosed in the annual report;
- Financial thresholds, such as the subsidiaries or operations contributing to a certain percentage of the issuer group’s total revenue or more; and
- Risk level, such as the operations exceeding a certain risk level despite being a non-major business sector of the issuer’s group.

[1] In accordance with the *Reporting Guidance on Environmental Key Performance Indicators* (KPIs), Scope 1 refers to direct GHG emissions, which mainly includes GHG emissions from fuel combustion and refrigerator and air conditioning equipment of the issuer; Scope 2 refers to energy indirect GHG emissions, which mainly includes GHG emissions from the production of electricity or gas.

The Guide further clarifies that an issuer may adopt a different reporting boundary at different levels or under different provisions in certain circumstances.

Example:

- In determining the reporting boundary of its 2019 ESG Report, a major mining company specifies that "the report disclosures (i.e. the scope of data) are consistent with the company's annual report, with some data being specifically explained". Combined with the company's 2019 annual report, the consolidation scope of the statements of the company is determined on the basis of control.

In addition, the issuer uses the major business as a guideline to determine the scope of GHG emission data disclosure, making it clear that the scope only includes its holding or wholly-owned mining and smelting enterprises, and excludes hotels, property companies, construction companies and office buildings of headquarters and other units.

3. The depth and breadth of disclosing environmental KPIs should depend on the company's reality

In identifying the reporting boundary of environmental-related matters, the ESG Guide states that, in addition to the matters contained therein to which the "comply or explain" principle applies, the HKEx encourages issuers to disclose environment-related matters that they believe have a material impact on the environment or stakeholders. In the *Analysis of Environmental, Social and Governance Practice Disclosure in 2018*, the HKEx explicitly encourages companies to make good use of the "comply or explain" principle to withhold disclosure of immaterial matters.

The Guide further provides a table of the materiality of different sectors at various levels for the reference of issuers, and states that issuers should determine the extent and scope of disclosure according to their own reality.

Example:

- A decorating company explains, with regard to the KPI of total packaging materials used for manufactured goods reported in its 2020 ESG report, that its major business is "providing a wide range of interior decorating solutions" and that "packaging materials are not material to our group's operation as the group does not manufacture such materials. Therefore, the relevant data have not been disclosed."

4. The reporting method should be relevant to the industry in which the company operates or to its business

HKEx encourages issuers to adopt a reporting method that is relevant to their industry or business. For example, with respect to reporting hazardous and non-hazardous waste, t*he Environmental Key Performance Indicator Reporting Guidance* ("Environmental KPI Reporting Guidance") suggests that, if possible, issuers should "report hazardous waste split by waste streams that are relevant to its sector, e.g. construction waste, electronic waste, general office waste, etc.".

Example:

- In its 2019 ESG report, a large mining company uses its industry-related approach to report general solid waste (non-hazardous waste) categorized as tailings, waste rock and domestic waste.

(II) The ESG report should be prepared "according to local conditions"

In the Guide, HKEx specifies that issuers should collect, calculate and report on environmental KPIs taking into account the geographical location of their business and referring to other information, specifically:

1. Definitions related to air emissions and hazardous waste should be adjusted in accordance with the regulations of the country where the business is located

The ESG Guide specifies that air emissions include "NOx, SOx, and other pollutants regulated under national laws and regulations", incorporating pollutants regulated by the countries where the business is located in the reporting boundary.

Example:

- In its 2019 ESG report, an investment company, in addition to the nitrogen oxides and sulfur oxides explicitly required to be disclosed under the ESG Guide, also made a disclosure on the regulated soot in accordance with the *Emission standard of air pollutants for thermal power plants* (GB13223-2011) of the People's Republic of China, where the company's thermal power business is located.

In addition, the Environmental KPI Reporting Guidance states that hazardous waste includes waste that is "considered to be hazardous by domestic legislation" , which specifies that hazardous waste should be determined with reference to the definition of "hazardous waste" in the relevant national laws and regulations of the region where the issuer operates.

2. Indirect GHG factors should be determined with reference to those of the country/region where the business is located

The Environmental KPI Reporting Guidance specifies that issuers operating outside Hong Kong should apply the relevant emission factors in those countries/regions. The *Questions relating to environmental, social and governance reporting* provides calculation methods of emissions from operations in some other countries.

Example:

- In its 2019 ESG report, a major real estate company uses different emission factors based on the location of emissions when calculating its total indirect (Scope 2) GHG emissions.

  "The Environmental KPI Reporting Guidance of HKEx serves a reference for GHG emission factors of the grids in Mainland of China and Hong Kong SAR; for emission factors of the grids in Australia, please refer to the *Australia Government National Greenhouse Accounts Factors Australian National Greenhouse Accounts 2019* by Australian Government Department of the Environment and Energy; for U.S. grid emission factors, please check the *EGRID Summary Table 2018* of the U.S. Environmental Protection Agency; and for other overseas countries' grid emission factors, the *CO Emissions from Fuel Combustion* issued by the International Energy Agency in 2019 is an available reference.

3. Water consumption should be reported by considering the extent of water scarcity in the location of the company

The Environmental KPI Reporting Guidance states that since subsidiaries or operations in water-scarce areas may be more sensitive to changes in water consumption, issuers should, to the extent practicable, specifically provide data on water consumption for subsidiaries or operations in water-scarce areas.

II. Making appropriate use of the disclosure principle of "comply or explain"

As the ESG Guide covers a wide range of environmental, social and governance issues, and the business and geographical locations of the issuers are different, the ESG Guide does not establish "an approach suitable for all companies". The "comply or explain" principle is not mandatory. After careful consideration of the size and complexity of their operations and the risks and challenges they face, issuers may deviate from the ESG Guide and explain in their ESG reports why they have not reported on the matters required by the relevant provisions.

In the *Analysis of Environmental, Social and Governance Practice Disclosure in 2018*, HKEx makes it clear that if some of the provisions of the "comply or explain" principle are not material to an issuer for reporting purposes, it may be better for the issuer to explain such situation. "Explanation" is not a less preferred or secondary option. Indeed if an issuer collects data and make disclosure all based on the principle of "compliance", it may be considered to have not properly considered its own situation, and have not fully thought through the identification and management of ESG risks.

The issuer should note the following points when explaining the reasons for not disclosing required information: Not material, confidentiality constraints, specific legal prohibitions and information not available. Further, the Guide requires the issuer to make further elaboration:

- Not material - Specify the reason(s) why this disclosure is considered to be not material;
- Confidentiality constraints - Describe the specific confidentiality constraints prohibiting this disclosure;
- Specific legal prohibitions - Describe the specific legal prohibitions; and
- Information not available - Explain why the relevant information is not available and describe the specific steps being taken to obtain the information and the expected timeframe for doing so.

Example:

- In its 2020 ESG report, a decoration company explained the failure to disclose its total water consumption as a KPI out of the reason that "the water consumption data for the major business activities is provided by the client/property and it is not provided to our group."

  The major business of the issuer is "providing various interior decoration solutions", and the projects can be broadly classified as rough house decoration, redecoration, restoration, design, etc. With its business mainly carried out in houses and properties under the control of the clients, the issuer cannot know the water consumption data in an objective manner, and thus effectively explained the reason for not owning such information.

Conclusion

Companies listed or to be listed in Hong Kong SAR should prepare their reports in accordance with the 2019 edition of the ESG Guide in order to meet the disclosure requirements of the HKEx. In preparing the report, issuers are recommended to seek professional advice on content planning, which will also enable investors to better understand the efforts made by the company in ESG matters and other aspects.

We understand that it is indeed important for companies to prepare ESG reports to disclose their environmental matters in compliance with the requirements of the Listing Rules. They should also, however, pay attention to governance and reflection on environmental matters. Therefore, only by fully examining the identification and management of their environmental risks or opportunities can companies truly avoid negative impacts of environmental risks on themselves and thus seize opportunities for growth, and achieve a win-win situation for both company development and environmental protection.

How to carry out anti-monopoly compliance in the Asia-Pacific Region? - Comparison between Hong Kong SAR's Competition Ordinance and the Mainland's AML

Susan Ning, Chai Zhifeng, Song Xueying, Zhang Xian

Susan Ning

Chai Zhifeng

Compliance is a prerequisite for stable corporate development and a solid guarantee for enterprises to improve their international competitiveness. With growing awareness of the importance of compliance, enterprises are gradually implementing an integrated global or Asia-Pacific compliance system in their internationalization process. Hong Kong SAR and the Mainland are two important jurisdictions.

This article mainly covers the following issues: 1) the similarities and differences between the competition law of Hong Kong SAR and the anti-monopoly law of the Mainland; 2) anti-competitive practices regulated by these two competition law regimes; and 3) investigation and enforcement approaches of the competition enforcement agencies of the two jurisdictions, the consequences of violations and the compliance tips. This article is intended to provide reference for enterprises to build their anti-monopoly compliance systems in the Asia-Pacific region.

I. Overview of Hong Kong SAR's competition law regime

The Competition Ordinance (the "Ordinance"), the first cross-sector competition law in Hong Kong SAR, was introduced in June 2012 and came into force on 14 December 2015. The Ordinance mainly contains three "competition rules" aiming at prohibiting anti-competitive behaviours in Hong Kong SAR:

Competition rules	Content	Application scope
First Conduct Rule	Prohibition of anti-competitive agreements	The First Conduct Rule and the Second Conduct Rule are applicable to all industries in Hong Kong SAR.
Second Conduct Rule	Prohibition of the abuse of market power	
Merger Rule	Prohibition of anti-competitive merger and acquisition arrangements	At present, the Merger Rule only applies to mergers involving undertakings holding carrier licences issued under the *Telecommunications Ordinance* (Cap. 106) of Hong Kong SAR.

The Competition Commission (the "Commission") is the principal competition authority in Hong Kong responsible for enforcing the Ordinance through enforcement proceedings before the Competition Tribunal (the "Tribunal"). Therefore, the decisions made by the Tribunal and other courts are also important sources of law for the competition regime in Hong Kong.

The Commission provides a series of detailed guidelines[1] and policy documents[2] on how to interpret and give effect to the provisions of the Ordinance, providing practical suggestions and guidance for corporate compliance.

II. First Conduct Rule: Prohibition of anti-competitive agreements

In terms of content, the First Conduct Rule prohibits undertakings (whether competitors or not) from entering into arrangements (including agreements, decisions, and concerted practices, collectively "agreements") that prevent, restrict or distort competition in Hong Kong. This is substantially the same as a monopoly agreement under the *Anti-Monopoly Law of the People's Republic of China* (the "AML").

In terms of form, the First Conduct Rule and the AML differ in the way they classify anti-competitive agreements. The First Conduct Rule categorises specific conduct into "serious anti-competitive conduct"[3] such as fixing price, allocating market, limiting production and bid-rigging, and other anti-competitive conduct based on the severity of the harm to competition. Both categories of conducts may include horizontal monopoly agreements and vertical monopoly agreements. The AML classifies relevant conducts into horizontal monopoly agreements and vertical monopoly agreements from the perspective of whether there is a competitive relationship between participants.

The Ordinance	The AML
Serious anti-competitive conduct • Fixing price "Fixing, maintaining, increasing or controlling the price for the supply of goods or services"; • Allocating markets "Allocating sales, territories, customers or markets for the production or supply of goods or services"; • Limiting production "Fixing, maintaining, controlling, preventing, limiting or eliminating the production or supply of goods or services"; • Bid-rigging, i.e., collusion in bidding. Other anti-competitive conduct	Horizontal monopoly agreements • Fixing or changing commodity prices • Restricting the production volume or sales volume of commodities • Allocating the sales market or the purchasing market for raw materials • Restricting the purchase of new technologies or equipment, or the development of new technologies or products • Group boycotts • Other monopoly agreements recognized as such by the anti-monopoly enforcement agency of the State Council Vertical monopoly agreements • Fixing the resale prices of commodities to a third party • Restricting the minimum resale prices of commodities to a third party • Other monopoly agreements recognized as such by the anti-monopoly enforcement agency of the State Council

Comments and analysis

- Fixing price, allocating markets, limiting production

  Under the Ordinance and the AML, price fixing, market allocation and production limitation are all conducts that seriously harm competition. In addition, the Commission clarifies in its *Guideline on the First Conduct Rule* that serious anti-competitive conduct may be presumed to be illegal, and that the general exclusion for agreements enhancing economic efficiency is in general unlikely to apply to such conduct. This is consistent with the enforcement approach towards such conduct of the anti-monopoly agencies in the Mainland.

- Bid-rigging

  The Ordinance clearly identifies bid-rigging as serious anti-competitive conduct.

  The AML does not explicitly list bid-rigging in horizontal monopoly agreements. It is noteworthy that in the *Shanghai Anti-Monopoly Compliance Guide for Undertakings* issued by the Shanghai Municipal Administration for Market Regulation on 26 December 2019, the "bid-rigging" is separately listed for the first time as a parallel to other typical conduct of horizontal monopoly agreements such as "fixing commodity prices", which provides some guidance for anti-monopoly compliance of local enterprises.

[1] Including the *Guideline on the First Conduct Rule*, the *Guideline on the Second Conduct Rule*, the *Guideline on the Merger Rule*, the *Guideline on Complaints*, the *Guideline on Investigations*, the *Guideline on Applications*, etc.

[2] Including the *Enforcement Policy*, the *Leniency Policy*, the *Cooperation and Settlement Policy for Undertakings Engaged in Cartel Conduct*, the *Policy on Recommended Pecuniary Penalties*, etc.

[3] See the definition of "serious anti-competitive conduct" in Article 2 Interpretation of the Ordinance.

Comments and analysis

- Group boycotts

  The Ordinance does not explicitly list "group boycotts" as a serious anti-competitive conduct. The Commission, however, clarifies in the Guideline on the First Conduct Rule that the Commission will consider it a serious anti-competitive conduct of "fixing, maintaining, controlling, preventing, limiting or eliminating the production or supply of goods or services" under the Ordinance when a group of competitors by engaging in group boycott agree to exclude an actual or potential competitor[4]. However, the AML lists "group boycotts" and "restricting the production volume or sales volume of commodities" respectively as two different types of horizontal monopoly agreements.

- Fixing the resale price; restricting the minimum resale price

  In the Ordinance, fixing the resale price to a third party or restricting the minimum resale price is not an explicit example of serious anti-competitive conduct. However, the Commission explicitly states in the *Guideline on the First Conduct Rule* that vertical price restraints such as resale price maintenance (the "RPM", which means suppliers establishing a fixed or minimum resale price to be observed by the distributors when reselling the relevant products)5 may be considered as serious anti-competitive conducts in certain cases. The AML explicitly prohibits such vertical resale price restraints as fixing the resale price or restricting the minimum resale price. It can be seen that the enforcement agencies in both Hong Kong and the Mainland take a strict enforcement stance against vertical price restraints.

- Exemptions

  Small and medium-sized enterprises ("SMEs") with an annual turnover not exceeding HK$200 million are exempted from the non-serious anti-competitive conduct in the First Conduct Rule.

  The AML also provides exemptions for SMEs. Unlike the Ordinance, the exemptions for SMEs under the AML do not have a specific turnover threshold or restriction on the scope of application, which means the exemptions could apply to all horizontal and vertical monopoly agreements. Nonetheless, the criteria for the application of the exemptions for SMEs under the AML are relatively strict: firstly, the purpose of such agreements should be to increase the efficiency and competitiveness of SMEs; and secondly, SMEs should prove that the agreements reached will not substantially restrict competition in the relevant market and that they can enable consumers to share the benefits derived therefrom.

III. Second Conduct Rule: Prohibition of the abuse of market power

In accordance with the Ordinance, an undertaking that has a substantial degree of market power must not abuse that power to harm competition.

The Ordinance	The AML
An undertaking that has a substantial degree of market power in a market must not abuse that power by engaging in conduct that has as its object or effect the prevention, restriction or distortion of competition in Hong Kong: • If the conduct involves predatory behaviour towards competitors; or • If the conduct involves limiting production, markets or technical development to the prejudice of consumers.	Undertakings holding dominant market positions are prohibited from doing the following by abusing their dominant market positions： • Selling or buying commodities at unfairly prices; • Selling commodities at prices below cost; • Refusal to deal; • Exclusive/Designated dealing; • Tying or imposing other unreasonable trading conditions; • Differential treatment; or • Other acts of abuse of dominant market positions recognized as such by the anti-monopoly enforcement agency of the State Council.

Comments and analysis

While the AML uses the concept of "dominance", the Ordinance adopts the concept of "a substantial degree of market power". The Ordinance does not specify how to assess whether an undertaking has a substantial degree of market power, but instead lists a number of factors to be considered, including: "the market share of the undertaking", "the undertaking's power to make pricing and other decisions", "any barriers to entry to competitors into the relevant market" and any other relevant factors. The AML provides that an undertaking is presumed to hold a dominant market position if its market share reaches a certain percentage (e.g. 50%), whereas there is no similar provision in the Ordinance or the *Guideline on the Second Conduct Rule*.

[4]See paragraph 6.5 and footnote 33 of the *Guideline on the First Conduct Rule*.

[5]See paragraph 6.71 of the *Guideline on the First Conduct Rule*.

Comments and analysis

Although the Ordinance does not specifically list abuses of market power, the Commission gives the following examples of conducts that may constitute an abuse of market power in the *Guideline on the Second Conduct Rule*: predatory pricing, tying and bundling, margin squeeze conduct, refusals to deal, and exclusive dealing. These acts may also constitute abuses of dominant market position under the AML.

• Exemptions

SMEs with an annual turnover not exceeding HK$40 million are exempted from the Second Conduct Rule. There is no such exemption for abusive conduct under the AML.

IV. Merger Rule: Prohibition of anti-competitive merger and acquisition arrangements

The Ordinance prohibits mergers that have, or are likely to have, the effect of substantially lessening competition in Hong Kong. Currently, the Merger Rule only applies to mergers between undertakings that directly or indirectly hold a carrier license under the *Telecommunications Ordinance* (Cap. 106), and there is no mandatory reporting obligation for such undertakings. In addition, undertakings in other industries are not obliged to report to the Commission for merger approval.

The AML stipulates that when the proposed concentration meets the merger filing thresholds as set by the State Council, concentrating parties shall notify in advance to the anti-monopoly law enforcement agency of the State Council, and shall not implement the concentration in the absence of such notification and approval.

Unlike the voluntary notification requirement stipulated in the Merger Rule that only applies to telecommunications industry, the mandatory merger filing system provided in the AML is applicable to all industrials.

V. Brief Summary

Both the Ordinance and the AML essentially regulate monopoly agreements (including horizontal and vertical monopoly agreements) and abuse of dominant market positions or substantial degree of market power. However, the two differ in stylistic arrangement, application of exemptions, and criteria for determining specific acts. The merger filing requirements of the Merger Rule are also significantly different from those under the AML. The above comparison will provide a better understanding of the anti-competition conducts regulated in the two jurisdictions.

VI. Investigation and law enforcement

(I) “Dawn raids”

Competition/anti-monopoly enforcement agencies in both Hong Kong SAR and the Mainland may conduct on-site raids on undertakings without prior notice (i.e. “dawn raids”).

In the event of a “dawn raid”, some undertakings may take chances and refuse to cooperate with the enforcement agency and even obstruct the investigation. However, refusal to cooperate or violent resistance to enforcement will not bring about the desired result, but may lead to increased penalties and even criminal liability.

The Ordinance	The AML
Penalties for failure to comply with the investigative power of the Commission: • A person who, without reasonable excuse, fails to comply with a requirement or prohibition imposed on that person by the Commission under its investigative powers commits an offence. Offenders are liable to a fine of up to HK$200,000 and to imprisonment for 1 year; • A person who provides false or misleading documents or information[6], destroys, falsifies or conceals documents[7], obstructs a search[8], discloses confidential information received from the Commission[9] commits a criminal offence, and may be liable to a fine of up to HK$1 million and to imprisonment for 2 years.	Where, during the review and investigation conducted by the anti-monopoly law enforcement agency, an entity or individual refuses to provide relevant materials or information, or provides false materials or information, or conceals, or destroys, or transfers evidence, or refuses to submit to or obstructs investigation in any other manner: • The anti-monopoly law enforcement agency shall instruct the entity/individual to rectify, and a fine of not more than RMB 20,000 shall be imposed on the individual and not more than RMB 200,000 on the entity; • If the circumstances are serious, a fine of not less than RMB 20,000 but not more than RMB 100,000 shall be imposed on the individual and not less than RMB 200,000 but not more than RMB 1 million on the entity; and • If a crime is constituted, criminal liability shall be investigated for in accordance with the law.

Both the Ordinance and the AML establish fines for refusal to cooperate with enforcement agencies. In particular, the Ordinance expressly makes it an offence to "fail to comply with a requirement or prohibition imposed by the Commission under its investigative powers without reasonable excuse", to "provide false or misleading documents or information," and to "destroy, falsify or conceal documents". It can be seen that the Ordinance takes a tougher enforcement stance on these acts.

It is worth noting that the *Draft Amendment to the Anti-Monopoly Law* (for Public Comments) (the "Draft AML Amendment") issued by the State Administration for Market Regulation on 2 January 2020 significantly increases the fines for refusal to cooperate with law enforcement, raising the fines for an entity to a maximum of 1% of its sales revenue of the previous year (in the absence of sales revenue in the previous year or if it is difficult to calculate the sales revenue, the anti-monopoly enforcement agency may impose a fine of not more than RMB 5 million on the entity); In the case of an individual, a fine of not more than RMB 1 million may be imposed. In addition, the Draft AML Amendment specifically states that entities or individuals shall not threaten the personal safety of law enforcement officers during the investigation process, and that public security organs shall, when necessary, assist in the investigation in accordance with the law. Although the AML is still under revision, the foregoing provisions reflect the increasingly severe punishment for refusal to cooperate with law enforcement in the Mainland, which will be of guidance for future practice.

(II) Acceptance of commitments

The Ordinance and the AML both grant their respective enforcement agencies the power to accept commitments to terminate investigations.

The Ordinance	The AML
• Acceptance of commitments Undertakings may make a commitment to the Commission to rectify its misconduct. If the Commission accepts the commitment, it agrees not to commence or continue an investigation or initiate proceedings before the Tribunal.	• Suspension of investigation With respect to the suspected monopolistic conduct which is under investigation by the anti-monopoly law enforcement agency, if the undertakings under investigation commit themselves to adopt specific measures to eliminate the consequences of its conduct within a certain period of time which is accepted by the said authority, the anti-monopoly law enforcement agency may decide to suspend the investigation. • Termination of investigation Where the anti-monopoly law enforcement agency decides to suspend investigation, it shall oversee the fulfilment of the commitments made by the undertaking. Where the undertaking fulfils its commitments, the anti-monopoly law enforcement agency may decide to terminate the investigation.

[6] Article 55 of the Ordinance.
[7] Article 53 of the Ordinance.
[8] Article 54 of the Ordinance.
[9] Article 128 (3) of the Ordinance.

Neither the Ordinance nor the AML clearly defines the scope of anti-competitive conduct to which the acceptance of commitments applies. It is noteworthy that in accordance with Article 22 of the *Interim Provisions on Prohibition of Monopoly Agreements* of the Mainland, the anti-monopoly law enforcement agency shall not accept the application for suspension of investigation in the case of price fixing, production volume restriction or market allocation. Due to the limited enforcement cases of the Commission (there is only one enforcement case in which a commitment was accepted under Article 60 of the Ordinance[10]), the enforcement attitude of the Commission on whether the commitment rules apply to the aforementioned three serious anti-competitive conducts remains unclear.

VII. Consequences of violations

(I) Penalties

The Ordinance	The AML
Commission may apply for pecuniary penalty[11] • The Commission may apply to the Tribunal for a pecuniary penalty to be imposed on any person[12] it has reasonable cause to believe has "contravened a competition rule" or "has been involved in a contravention of a competition rule". Tribunal may impose pecuniary penalty[13] • The amount of a pecuniary penalty imposed in relation to conduct that constitutes a single contravention may not exceed in total 10% of the turnover of the undertaking in Hong Kong concerned for each year in which the contravention occurred, for a maximum of 3 years. If the contravention occurred in more than 3 years, 10% of the turnover of the undertaking concerned for the 3 years in which the contravention occurred that saw the highest, second highest and third highest turnover.	Monopoly agreements • The anti-monopoly law enforcement agency may impose a fine of not less than 1% but not more than 10% of the undertaking's sales generated in the preceding year. • If such monopoly agreement has not been implemented, the undertaking may be fined not more than RMB 500,000. Abuse of dominant market position • The anti-monopoly law enforcement agency may impose a fine of not less than 1% but not more than 10% of the undertaking's sales generated in the preceding year. Implementing concentration in violation of laws • The anti-monopoly law enforcement agency of the State Council may impose a fine of not more than RMB 500,000.

Comments and analysis

- Agencies determining the amount of the fine and making the fine decision

  While the AML grants the anti-monopoly enforcement agency the power to directly determine the amount of fines and make decisions on fines, the Ordinance does not give the Commission the authority to make direct decisions on fines. The Commission must apply to the Tribunal for the imposition of a fine and recommend to the Tribunal at the appropriate stage the amount it considers appropriate (the "Recommended Fine"), and the Tribunal has the final authority to determine the appropriate amount of the fine.

  On 29 April 2020, the Tribunal issued the first fine ruling on a case involving ten renovation and engineering companies who allocated the market and conspired to fix prices (the "Renovation Case")[14]. All these ten construction companies were fined, with seven of them being fined the maximum penalty. In determining the amount of fines, the Tribunal basically adopted the calculation method proposed by the Commission and clarified the four steps to be followed in determining the amount of fines: (1) determining the basic amount of fines; (2) making adjustments based on aggravating and mitigating factors; (3) applying the statutory cap on fines; and (4) granting reduction on account of cooperation.

  On 22 June 2020, the Commission published the Policy on Recommended Pecuniary Penalties, which outlines the general principles and calculation methods that the Commission uses when recommending amount of fines to the Tribunal[15]. These principles and methods are generally consistent with the Tribunal's four-step approach in the Renovation Case.

- Amount of fines

  The Ordinance provides for different upper limits of fines according to the duration of the violation and specifies that the amount of fine can be up to 10% of the total turnover of three years, but no minimum lower limit is set. In the AML, fines for monopoly agreements and abuse of dominant market position are calculated on the basis of the undertaking's turnover of the previous year, and 1% is set as the minimum rate.

[10]See the press release on the Commission's official website: Competition Commission accepts the commitment of online travel agencies (13 May 2020).

[11]See Article 92 of the Ordinance.

[12]According to Article 2 of the Ordinance, "Person" includes an undertaking and an individual who is not an undertaking.

[13]See Article 93 of the Ordinance.

[14]See *CTEA2D/2017 COMPETITION COMMISSION V. W. HING CONSTRUCTION CO LTD AND OTHERS* (Date of judgement: 29 April 2020). The Tribunal rendered a judgment in the Renovation Case in May 2019, ruling that all ten companies involved in the case had engaged in market allocation and collusive pricing practices when providing renovation services at On Tat Village (Phase I), a public housing estate located in Kwun Tong, Kowloon, Hong Kong SAR, and therefore violated the First Conduct Rule of the Ordinance.

[15]See the *Policy on Recommended Pecuniary Penalties*, https://www.compcomm.hk/en/legislation_guidance/policy_doc/files/Policy_on_Recommended_Pecuniary_Penalties_Eng.pdf

(II) Disqualification orders[16]:

Under Article 101 of the Ordinance, if the Tribunal determines that a company of which a person is a director has contravened a competition rule and considers that the person's conduct as a director makes the person unfit to be concerned in the management of a company, it may disqualify the person from: being or continuing to be a director of a company; being a liquidator or provisional liquidator of a company; or being a receiver or manager of a company's property, etc. Such disqualification orders could last for a period of up to 5 years.

It is worth noting that although the first two decisions announced by the Tribunal have not mentioned disqualification orders, the Commission has applied for disqualification orders against directors of companies involved in conspiracy in a number of recent cases instituted before the Tribunal, such as the ongoing IT conspiracy case[17] and the Textbook cartel case[18]. We will continue to follow up on these cases.

The disqualification order as we understand is an enforcement measure specific to the Ordinance and that there is no similar order under the AML. The application of disqualification orders means that individuals who engage in conduct that violates the competition rule will also face legal sanctions. This increases the deterrent effect of the Ordinance on violations to a certain extent.

VIII. Compliance tips

Since the release of the Ordinance, we have been seeing increasingly active law enforcement activities. In April 2020, the Tribunal issued the first fine, and in June, the Commission issued the *Policy on Recommended Pecuniary Penalties*. In addition, the Commission applied for director disqualification orders in a series of cases brought before the Tribunal. With the full application of the Ordinance and the issuance of a number of landmark decisions and policy guidelines, the Commission and the Tribunal's competition enforcement efforts will intensify.

Given the differences between the competition law of Hong Kong and the AML of the Mainland, it is advisable that in the process of building their compliance system in the Asia-Pacific region, enterprises pay close attention to the interpretation and enforcement developments in Hong Kong SAR and the Mainland, timely review and update their internal compliance manuals, and provide regular competition training to enhance the compliance awareness of their employees. It should be noted that this series of articles only provides a general overview of the similarities and differences between the Ordinance and the AML. Enterprises are recommended to regularly seek expert advice on competition compliance and implement tailored plans.

[16] See Article 101 of the Ordinance.

[17] See the press release on the Commission's official website: Competition Commission appeals Competition Tribunal in IT Conspiracy Case and issues the First Notice of Infringement, 22 January 2020.

[18] See the press release on the Commission's official website: Competition Commission takes Textbook cartel case to Competition Tribunal, 20 March 2020.

The first parallel importation case in Guangzhou IP Court closed: no trademark infringement; no unfair competition

Jiao Hongbin, Liu Yuxin

Jiao Hongbin

Introduction

On 12 May 2020, Guangzhou Intellectual Property Court (the “Guangzhou IP Court”) decided that parallel importation did not constitute trademark infringement or unfair competition for the first time.

Parallel importation generally refers to the act of “importing the products lawfully manufactured in foreign countries into China without the consent of the IP owner”. China has no clear regulations on the legality of such act. In the above case, both the first- and second-instance courts - Guangzhou Nansha Primary People’s Court and Guangzhou IP Court - held that parallel importation did not constitute trademark infringement or unfair competition, as the parallel imports were genuine products lawfully manufactured aboard. The opinions of the courts are summarized as follows:

I. The first-instance judgement

(I) Trademark infringement

The function of a trademark is to identify the source of a product or service and denote quality assurance. In another word, a trademark conveys the message to consumers that the products or services bearing the same trademark have the same quality. If a parallel import and a domestically distributed product are not different in terms of the mark on the product and the product characteristics, and if the parallel importer does not change any product characteristics or the mark, or disassemble, alter or damage the product, then the parallel importation neither cut off the connection between the product and the trademark owner, nor damage the identification function of the trademark. In terms of the quality assurance function, it is necessary to determine whether the parallel import has the same quality as the domestically distributed product by examining whether their quality is substantially different and whether they are completely substitutable. Specifically, it is necessary to consider the marks on the products, their product characteristics, quality levels and other elements. Finally, according to the principle of exhaustion of trademark rights, if the trademark owner has realised the commercial value of the trademark in the “first” sale of the products, the owner should not be entitled to prevent others from making “secondary” sales.

(II) Unfair competition

In this case, the plaintiff alleged unfair competition on the same factual basis as the alleged trademark infringement. The Anti-Unfair Competition Law supplements other relevant laws and regulations, and the special intellectual property law shall prevail if applicable in dispute resolution. The Anti-Unfair Competition Law is aimed at coordinating and balancing the interests of the public, business operators and consumers rather than maximizing a certain interest. In applying the Anti-Unfair Competition Law, the concept of tolerance and prudent intervention should be followed to encourage fair competition and promote healthy development of the market.

II. The second-instance judgement

(I) Trademark infringement

From the perspective of protecting trademark rights, trademark is a mark to distinguish the business subjects. What is recognized and protected by the law is not the mark itself, but the unique and definite relationship between the mark and the business subject. The parallel importation does not damage the trademark function of identification, quality assurance or bearing goodwill.

From the perspective of protecting the interests of consumers, the fundamental purpose of trademark rights is to establish and consolidate the specific connection between products and consumers. If parallel imports lawfully sourced from the trademark owner are truly and clearly marked with quality guaranteed, the parallel importation will not harm the rights or interests of consumers. Instead, it will provide more choices for consumers and stimulate market competition due to the increased varieties of products. In the long run, parallel importation will benefit consumers.

From the perspective of promoting the development of market economy, the Trademark Law protects trademark rights by combating infringement and thus creating a fair and competitive market economic order, rather than restricting free competition by granting monopoly rights to trademark owners. When the trademark owner has already realised financial benefits through sales, parallel importation will cause limited damage to the trademark owner. It is inappropriate to grant more monopoly benefits to the trademark owner in the subsequent distribution of the product.

With regard to the application by the first-instance court of the principle of exhaustion of rights, however, Guangzhou IP Court pointed out that the principle has not become a common or generally recognized academic view in the field of trademark law. Further considering that neither the Trademark Law nor any judicial interpretation has explicitly adopted the principle, it is inappropriate to cite it directly as a ground for justification.

(II) Unfair competition

Guangzhou IP Court also held that parallel importation was not in violation of the principle of good faith or the generally accepted business ethics. The court concluded that the parallel importation did not constitute unfair competition after analysing the parallel importation from the root cause of its formation, the reasonable care duty of the parallel importer, the legitimacy of the parallel importer’s behaviour, the protection of consumers’ rights and interests, and the damage to the interests of the domestic right holder.

Finally, Guangzhou IP Court particularly emphasised that the allegedly infringing product was a typical parallel import which was of the same quality as the domestically distributed product and was of proper origin. In addition, the parallel importer had performed a high degree of care by transacting in a relatively standard manner, making the transaction process clear and well documented, and entering into agreements to avoid legal risks. However, whether parallel importation constitutes infringement cannot be generalised by merely analysing this case. It is advisable to carefully examine the quality and origin of the product and the legitimacy of the importation based on the facts. Any replacement or cover-up of the trademark, change in the product quality or improper seizure others’ business opportunities or free ride should be regulated in accordance with the Trademark Law and the Anti-Unfair Competition Law.

Obligations and issues from an employment law perspective in Hong Kong SAR after COVID-19 outbreak

Ricky Lioe, Crystal Luk

Ricky Lioe

Crystal Luk

Declared by the World Health Organisation as a “public health emergency of international concern” on 30 January 2020, the outbreak of COVID-19 posed great challenges to employers and employees in various sectors in Hong Kong SAR. In this article, we look at the legal implications, rights and obligations of employers and employees from an employment law perspective.

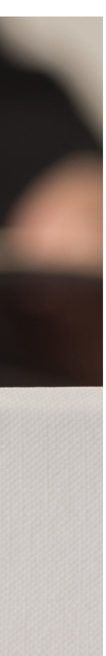
I. Protection under the *Employees’ Compensation Ordinance (ECO)*

The ECO applies to all full-time or part-time employees who are employed under contracts of service or apprenticeship as well as employees employed in Hong Kong by local employers injured while working outside Hong Kong.

Under the ECO, no employer shall employ any employee in any employment unless there is in force a policy of insurance to cover its liabilities under the laws for injuries at work in respect of all employees, irrespective of the length of employment contract or working hours, full-time or part-time employment (section 40). An employer who fails to comply with ECO to secure an insurance cover would be liable to prosecution and, upon conviction, to a maximum fine of HK$100,000 and imprisonment for two years.

However, subject to individual insurance coverage, having an insurance in place does not automatically relieve the employer from all liabilities and potential claims from employees for compensation. Under section 32 of the ECO, an employee suffering incapacity arising from an occupational disease is entitled to receive compensation from his/her employer, if the disease is (i) due to the nature of any occupation in which he was employed[1] (ii) at any time within the prescribed period immediately preceding the incapacity caused. The occupational diseases covered and the prescribed period are specified in the Second Schedule annexed to the ECO.

While some call for the Hong Kong Government to include COVID-19 as an “occupational disease” within the meaning of the ECO, the Labour Department, on 10 February 2020, issued a press release[2] stating that it was looking into the issue. No changes to the ECO has been made thus far.



[1]Note in the case of severe acute respiratory syndrome (SARS), while it is categorised as an “occupational disease”, it is only applicable to occupations involving close and frequent contacts with a source or sources of SARS infection by reason of employment of very specific scenarios (see B11 of Schedule 2 of the ECO).

[2]https://www.info.gov.hk/gia/general/202002/10/P2020021000730.htm?fontSize=1

That stated, an employee may still claim compensation under section 5 of the ECO for a disease outside the Second Schedule if it is certified to be a personal injury *by accident arising out of and in the course of employment*.

For the contraction of COVID-19 to amount to a personal injury "by accident":

(i) there would have to be a causal connection between the accident and the injury (or disease);

(ii) the "accident" should be distinct from the injury (or disease); and

(iii) the accident must have been at least a contributory cause of the injury.

The phrase "*arising out of and in the course of employment*" means arising out of the work the employee is employed to do and what is incidental to it, in other words, out of his/her service. It is not necessary to prove that the accident arose *directly* out of employment. All that is necessary to show is that the employee was doing something which happened as part of the employment or is *incidental* to it even if he/she might be under no duty to do it[3]. This is a question of fact and degree. The paramount principle in law remains that an employee travelling on the street will be acting in the course of employment if, and only if, at the material time going about the employer's business or in pursuance of a duty owed to the employer[4].

Note that the minimum amount of insurance cover specified in the ECO is not the maximum liability that the party concerned is required to bear under the law. The party concerned should therefore carefully assess the possible risk and consult insurers for professional advice on whether an insurance policy for an amount more than the minimum under the ECO should be taken out. To minimise potential loss, employers should also be aware of their respective obligations and take precautionary measures as discussed in the sections below.

II. A reminder of employers' obligations, precautions and possible issues

- Obligation to take reasonable care of employee's health and safety

  Employers bear a general common law obligation to take reasonable care regarding their employees' health and safety, including a duty to provide and maintain a reasonably safe workplace. Failure to comply with such obligation may expose employers to potential tortious and/or contractual claims.

  Alongside the common law obligation, under the *Occupational Safety and Health Ordinance* (OSHO), employers must, so far as reasonably practicable, ensure the safety and health at work of all employees.

  Given the common law and statutory obligations, employers are reminded that they should not compel employees to attend the workplace if they cannot provide a safe working environment. Upon complaint or request, employers are reminded to conduct examination/evaluation as to the safety of the work environment. If, however, an employee persistently refuses to return to office without valid reason, this may amount to a breach of the employment contract.

- Duty to pay wages

  We note media reports that some corporations have taken out measures regarding unpaid leave and reduction in wages. The duty to pay wages pursuant to employment contracts and/or the *Employment Ordinance* (EO) continues during the COVID-19 outbreak. In general, employers also have an implied duty to provide work and employees have an implied right to work. As such, a decision requiring employees to take unpaid leave without their prior consent may be a breach. Similarly, unless genuine operational requirements of the business can be demonstrated, a unilateral reduction in wages without employees' consent may constitute an unreasonable variation of employment terms. In essence, while balancing the various business considerations during this difficult climate, employers should remain aware of potential claims and legal risks if such measures are implemented unilaterally without their employees' consent.

- Request for medical consultation

  If an employer reasonably suspects that a certain employee may have contracted COVID-19 (e.g. that the employee has developed symptoms such as fever and coughing), in the context of the overriding duty to ensure the health and safety of employees,

[3]See Charles R Davidson & Co v M' Robb [1918] AC 304 at 314; and R v National Insurance Commissioner, ex p Michael [1977] 2 All ER 420, [1977] 1 WLR 109 (CA), both followed in Lau Kam Nui v Sau Kee Co Ltd [1998] 4 HKC 612, [1999] 1 HKLRD 163 (CA).

[4]An employee, however, is not considered to be in the course of her employment when she has finished work after leaving her place of employment, and was on the road as a member of the public and not as an employee of her employer: see Check Chor Ching v Wik Far East Ltd [1991] HKDCLR 71 (DC); [1991] 1 HKC 296, [1991] 2 HKLR 224 (CA). On the contrary, in Chow Shu Ki v Osram Prosperity Co Ltd (unreported, DCEC 1059/2000, 21 November 2001) (DC), the deceased employee sustained fatal injury while on a bus trip one evening after leaving his office. As the Court was satisfied on the evidence that the deceased was on his way to visit customers, it was held that at the material time the deceased was still acting in the course of employment and an award of compensation was made.

Note also section 5(4) of the ECO which details circumstances of which an accident to an employee resulting in injury or death is deemed to arise out of and in the course of his employment.

the employer may reasonably request the employee to see a doctor. In addition, the employer will have a contractual basis if the employment contract allows for such a request.

- Data privacy

  Attention is drawn to the issue of data privacy, where employers may want to take preventative measures such as temperature checks or medical screening. Given the sensitive and personal nature of health-related data, employers should explain the purpose, the recipient(s) of such data to employees, as well as how long it will be held. Any data collected should be limited to information showing whether an employee has symptoms of COVID-19. Employers are reminded to comply with the data protection obligation under the *Personal Data (Privacy) Ordinance* and that any records should be properly kept and only be accessed on a need-to-know basis.

III. Alternative work arrangements

It is important to note employers' and employees' duty when Work From Home (WFH) is in place. Though a special arrangement, WFH should be treated similar to work at the place of employment. Employers still need to pay wages and employees must still perform their work duties to the extent practicable. There have been incidents where employees were found not to be "at work" during their usual work hours when working from home. Some form of disciplinary measures or the issuance of warning letters may be carried out if employees are found to be neglectful in their duties. However, employers should be careful not to terminate employees hastily, as summary dismissal (being a serious disciplinary action) should only be considered in exceptional cases, such as very serious misconduct.

It is advisable for employers to communicate clearly their WFH policy and provide proactive support (such as IT support) to make WFH accessible and convenient.

IV. Things to note if an employee contracts COVID-19

If an employee contracts (or is suspected of contracting) COVID-19, it is prudent for the employer to require them to stay at home and refrain from coming to the workplace in order to minimize the risk of other employees getting infected. This is in line with the employer's general obligation to provide a safe working environment as outlined above.

Whilst an employee is on paid sick leave, the employer shall not dismiss the employee. This will expose the employer to claims under the EO and possibly complaints or claims under the *Disability Discrimination Ordinance*.

V. Final note

Employers should be aware of any quarantine restriction imposed or advised by the Hong Kong Government. Since early 2020, the Hong Kong Government has imposed compulsory quarantine requirements upon people entering Hong Kong (subject to certain exemptions).

This is indeed a difficult time for both employers and employees – intertwined with issues and concerns of both business and a personal nature. With more understanding and consideration, including the perspective of employers' reputational and corporate images, we trust challenges can be overcome by the joint effort of employers and employees.

New investment insights: how to set up a company in Macau SAR

James Zeng, Zhang Chengcheng


James Zeng

Introduction: Business environment in Macau SAR

Since its return to China, Macau SAR has enjoyed steady economic development in a stable socio-political environment. As a free port and separate customs territory, Macau SAR has been implementing simplified low-tax systems and policies. It has a privileged geographical location as well as a well-developed infrastructure. The Hong Kong-Zhuhai-Macau Bridge, a major cross-sea passage linking Hong Kong SAR, Macau SAR and Zhuhai, was officially opened to traffic in 2018. The construction of Macau Light Rapid Transit (LRT) has also been in full swing, with the Taipa Line officially opened for operation in December 2019. Supported by the policy of “one country, two systems”, the status as an international free port and its natural ties with Portuguese-speaking countries, Macau SAR further expands its development by participating in the Belt and Road construction. In addition, the deepening cooperation in the GBA has also brought new opportunities for Macau’s development. At present, Macau SAR is entering a new stage of rapid development in its economic cooperation with Hong Kong SAR and China Mainland, including the entire Pan-Pearl River Delta region.

I. Main types of companies in Macau SAR

With the deepening of economic cooperation between China Mainland and Macau SAR, more and more Mainland enterprises and investors set up companies, joint ventures, subsidiaries, permanent representative offices, etc. in Macau SAR to improve their strategic layout while also enjoying a series of preferential policies and industrial support policies.

The two most common types of companies established in Macau SAR are limited liability companies (LLC or “Sociedade por Quotas) and joint stock companies (JSC or “Sociedade Anónima”). Establishing an LLC, although relatively low in cost and simple in establishment procedures, requires share transfer registration. By contrast, the transfer of shares of a JSC is not subject to registration and the confidentiality of shareholders’ information can be guaranteed.

In terms of registered capital and the number of shareholders, there are different legal requirements for LLCs and JSCs as follows:

	Registered capital	Number of shareholders
LLC	Not less than MOP 25,000	An LLC shall have at least one shareholder (if there is only one shareholder, the company’s name shall bear the words “one-person limited company”)
JSC	Not less than MOP 1,000,000	At least three shareholders

A JSC is usually established for specific business activities, such as real estate development, energy (e.g. electricity, water, and gas) business or regulated activities (e.g. banking and finance, insurance, and telecommunications). In accordance with the law, financial companies (credit institutions), investment fund management companies, property management companies, venture capital companies, insurance companies domiciled in Macau SAR and other companies of the kind must established in the corporate form of a JSC.

II. Main steps to set up a company in Macau SAR

Procedures for setting up a company in Macau SAR include:

(i) Application for a certificate of admissibility of trade name;

(ii) Execution of a company establishment notarial certificate/deed;

(iii) Registration of a corporate business owner with the Commerce and Movable Property Registry; and

(iv) Filing a Business Tax - Form M1 at the Financial Services Bureau to declare the opening of the business.

Local and foreign individuals or institutions intending to establish a company in Macau SAR are required to follow the same legal or administrative procedures.

For companies carrying out regulated business, such as financial companies (credit institutions), investment fund management companies, property management companies, venture capital companies, insurance companies domiciled in Macau SAR and other companies of the kind, they are also required to register with the Monetary Authority of Macau SAR before opening for business.

Companies in Macau SAR also have a tradition of setting up company secretaries. Company secretarial services usually include the following: organizing shareholders' and board meetings and processing minutes and related documents; providing registered addresses; handling company deregistration; recruiting local and overseas employees; employment and termination of employment declarations; occupational tax declarations; social security fund payments and other personnel services.

III. Significance of establishing a company in Macau SAR

Advantages of Macau's business environment: Macau SAR enjoys political stability and social harmony, and has a favorable business environment with simple tax types, low tax rates and free inflow and outflow of capital. Investment and business procedures are simple in Macau SAR. Enterprises may consider setting up logistics service bases and local offices in Macau SAR to obtain tax exemptions.

Access to international markets through Macau SAR: Macau SAR has strong ties with Portuguese-speaking countries and its role as a service platform for Sino-Portuguese trade cooperation is increasingly recognized and affirmed by many parties. In addition, as one of the most open trade and investment economies in the world, Macau SAR has established stable economic and trade relations with more than 120 countries and regions. As a member of 30 international economic organizations, Macau SAR has woven itself into an extensive network of international markets. An increasing number of Mainland enterprises see Macau SAR as an ideal entry point and financing platform to enter the international market.

Prospects for the development of Macau's finance industry: In order to support the further development of Macau SAR, the Central Government has introduced a series of supportive policies for Macau's finance industry. Guangdong will also work with Macau SAR to deepen financial construction and cooperation in the GBA in accordance with the Central Government's planning and deployment, especially to help establish a RMB-denominated and settled securities market in Macau SAR. Macau's finance industry continues to develop rapidly and will become a new economic growth driver for Macau SAR in the future.

Policies of Hengqin, Zhuhai: In the first 2020 policy address of the new Chief Executive of Macau SAR, it is mentioned that, Combining Macau's advantages, such as the principle of "One country, two systems" and its status as an international free port, with Hengqin's advantages in terms of resources and space, the government will establish a Guangdong-Macau in-depth cooperation zone in Hengqin, and extend some of the policies and measures of Macau's free port to Hengqin. We believe that Hengqin will continue to expand its openness in the future, form an international business environment, and open up a broader space for enterprises to "go global" through Macau SAR and Hengqin.

At the same time, Macau enterprises are also able to enter China Mainland through Hengqin to carry out business activities. In April 2020, Hengqin issued the first permit for Hong Kong and Macau construction enterprises to enter the Mainland market - China Construction Engineering (Macau) Company Limited officially obtained a business license from the Administration for Industry and Commerce of Hengqin New Area, Zhuhai City. The company plans to launch its main business in the Macau market and expand outward to the GBA market. More and more Hong Kong and Macau enterprises plan to enter the GBA market, and Macau's advantageous position will be further highlighted.

Developments in the aviation industry in the Greater Bay Area

Ashley Wong, Adam Smart

Ashley Wong

The outbreak of COVID-19 has had a significant impact on the global aviation industry. Airlines globally have been forced to reduce their flight operations and the International Air Transport Association ("IATA") reported a 65.9%[1] drop in air travel globally in 2020 (year on year). Until countries around the world remove their current quarantine and travel restrictions, the overall impact of COVID-19 on the aviation industry remains unknown. Nevertheless, aviation is a resilient industry and has previously managed to overcome the challenges posed by 9/11, SARS and the 2008/9 financial crisis and thrive.

Whilst it is difficult to predict how quickly the aviation industry as a whole will re-emerge from this crisis, the aviation industry in the Guangdong-Hong Kong-Macao Greater Bay Area (the "GBA") may be a step ahead having the benefit of a recovering domestic market in the China Mainland. In addition, new measures have been announced by the People's Bank of China, together with the China Mainland's banking, securities and foreign exchange regulators in April 2020 (the "2020 Guidance"), which provide the potential for the aviation industry to adapt to the new economic/global environment and to explore new opportunities in the GBA. This article recaps the *Outline Development Plan for the Guangdong-Hong Kong-Macao Greater Bay Area* released on 18 February 2019 (the "Outline"), highlights certain developments in the GBA since the publication of the Outline and identifies new opportunities from the 2020 Guidance, each with a focus on the aviation sector.

I. A brief overview of the GBA and the Outline in the context of aviation[2]

The GBA consists of Hong Kong SAR, Macao SAR, as well as the municipalities of Guangzhou, Shenzhen, Zhuhai, Foshan, Huizhou, Dongguan, Zhongshan, Jiangmen and Zhaoqing in the Guangdong Province, with a combined population of approximately 86.17 million at the end of 2020.[3] As one of the most open and economically vibrant regions in China[4] with an aggregated GDP of US$1,668.86 billion and a GDP per capita of US$19,367 in 2020, the GBA plays a significant strategic role in the overall development of China.

The Outline was jointly prepared by the relevant departments of the central government of China together with the governments of the Guangdong Province, Hong Kong SAR and Macao SAR. The Outline set out an economic development plan for the GBA, including a vision of developing an international innovation and technology hub, expediting infrastructural connectivity, promoting ecological conservation, and jointly developing Guangdong-Hong Kong-Macao cooperation platforms. As part of these development objectives, the Outline sets out a vision for developing an international aviation hub in the GBA.

The Outline also sets out a goal for each of the key GBA cities, several of which are

[1]Reference: https://www.iata.org/en/pressroom/pr/2021-02-03-02/

[2]Reference: https://www.kwm.com/en/hk/knowledge/downloads/law-and-practice-in-the-greater-bay-area-ii-20190920

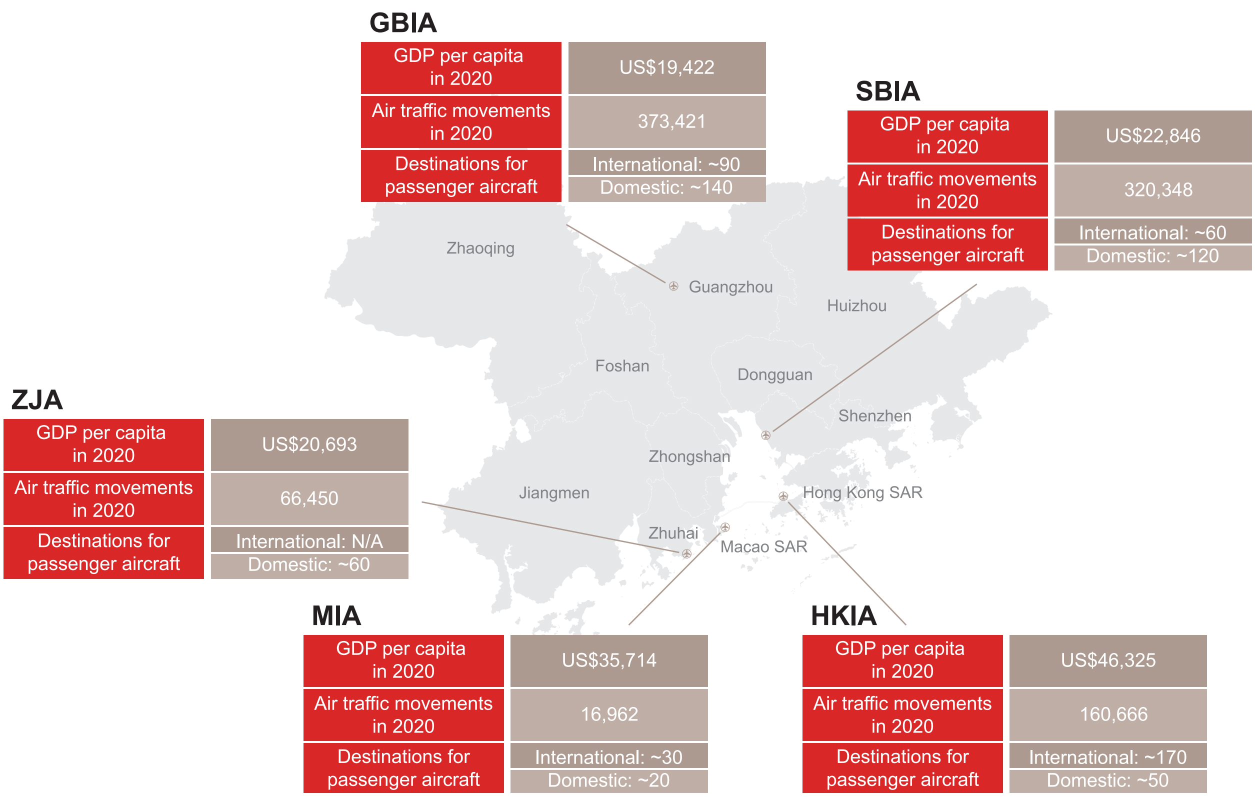
[3]Reference: https://research.hktdc.com/en/article/MzYzMDE5NzQ5

[4]Reference: https://research.hktdc.com/en/article/MzYzMDE5NzQ5

focused on the development of the aviation industry in the GBA: Hong Kong SAR should position itself as an international financial centre, an international aviation hub and an international legal and dispute resolution hub in the Asia-Pacific region; Shenzhen should position itself as a national core economic city and innovation hub; whilst Guangzhou should position itself as an integrated transportation hub.

II. The aviation sector in the GBA

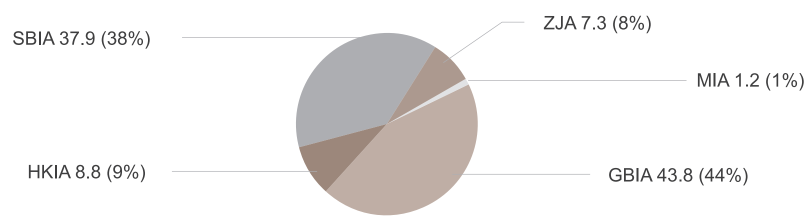
Even before expansion pursuant to the Outline, the GBA was already a significant aviation hub both in China and the wider Asia-Pacific region. There are ten civil airports in the GBA, with Hong Kong International Airport ("HKIA"), Macau International Airport ("MIA"), Shenzhen Bao'an International Airport ("SBIA"), Guangzhou Baiyun International Airport ("GBIA") and Zhuhai Jinwan Airport ("ZJA") being the most significant airports in the region (the "GBA A5").



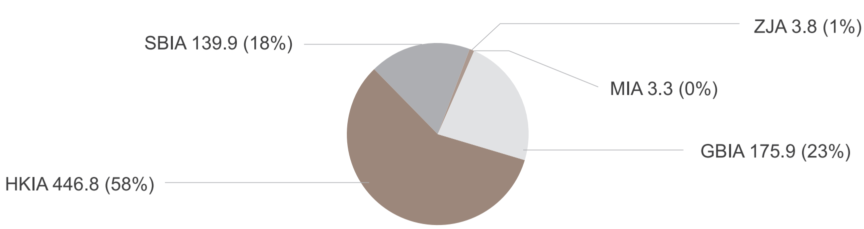
(I) Comparison of the GBA A5[5]

HKIA, GBIA and SBIA are the most significant airports amongst the GBA A5, with notably higher annual traffic (in terms of both passenger traffic and cargo throughput). HKIA, GBIA and SBIA are therefore key focus airports for development by the regions of the GBA. As can be seen from the figures below (and the number of international routes noted above), SBIA is currently relatively underdeveloped compared to its neighbours. In light of the Outline's specific requirements for developing SBIA (such as enhancing its competitiveness as an international hub and building a demonstration zone for Shenzhen's general aviation industry), SBIA has significant room for potential growth in the near future.

NUMBER OF PASSENGERS 2020 ('000,000)



CARGOES AND AIRMAILS THROUGHPUT 2020 (0'000 TONNES)



Source: 2020 Statistics of Civil Aviation Administration of China, Macau International Airport Co. Ltd.,

(II) Significance of the GBA A5 in China[6]

HKIA, GBIA and SBIA also play key roles in the overall Chinese aviation sector, both in relation to passenger and cargo traffic. HKIA, GBIA and SBIA account for approximately 33% of the number of passengers handled by the top 10 airports in China, whilst HKIA, GBIA and SBIA account for approximately 51% of the cargo handled by the top 10 airports in China. With the resurgence of the China Mainland domestic market following the COVID-19 crisis, it can be expected that airports in the GBA (in particular GBIA and SBIA) will recover faster than competitor airports in the Asia-Pacific region.

(III) Planned developments of the GBA A5[7]

In addition to the completed expansion of passenger terminals at both SBIA and GBIA, each of the GBA A5 are taking significant steps to expand their physical infrastructure over the coming years, as encouraged in the Outline.

[5]Reference: https://www.mot.gov.cn/tongjishuju/minhang/202104/t20210419_3573714.html; https://www.camacau.com/en/OurBusiness/TrafficStatsPassengers; https://www.camacau.com/en/OurBusiness/TrafficStatsCargo; https://www.hongkongairport.com/iwov-resources/file/the-airport/hkia-at-a-glance/facts-figures/2020e.pdf

[6]Reference: https://www.mot.gov.cn/tongjishuju/minhang/202104/t20210419_3573714.html

[7]Reference: HKIA - https://www.threerunwaysystem.com/en/three-runway-system/project-overview/; MIA - https://www.macau-airport.com/en/media-centre/news/news/23932; SBIA -http://www.sz.gov.cn/en_szgov/news/latest/content/post_6989831.html; GBIA - https://www.gbiac.net/byairport-web/menu/index?urlKey=airport-basic-facts_en; ZJA -http://www.caacnews.com.cn/1/5/201911/t20191129_1286621.html.

Airport	Plan
HKIA	Increase the number of runways from 2 to 3
MIA	Construct a south extension of the passenger terminal building
SBIA	Increase the number of runways from 2 to 3
GBIA	Increase the number of runways from 3 to 5 and construct a third passenger terminal building
ZJA	Construct a second passenger terminal building

These planned infrastructure developments will necessitate the growth of related industries in the GBA, including ground services, logistics, air traffic control, aircraft maintenance and crew training facilities.[8] In addition, technology companies may also have a role to play as airports in the GBA, in particular HKIA, aim to become smart airports.[9] The COVID-19 crisis is likely to mean that the development of technological advances in airports occurs faster than it may otherwise have done, given the need to minimise interaction amongst passengers and between passengers and staff.

III. Developments since the publication of the Outline

(I) Expansion of the intermodal code-sharing services between the China Mainland and Hong Kong SAR[10]

As highlighted above, one of the Outline's focuses is on building a modern comprehensive transportation system in the GBA, including developing a world-class airport cluster. Chapter 5 of the Outline also aims to ensure the smooth linkage of different modes of transportation within the GBA and raise the standards of passenger and cargo transportation services, with the goal of reducing the travel time between any two major cities in the GBA to one hour or less. Effort has already been made by cities in the GBA to implement this aspect of the Outline. One example is the expansion of "intermodal code-sharing" between transportation companies in the China Mainland, Macao SAR and Hong Kong SAR.

The intermodal code-sharing scheme allows a passenger travelling by air to take another mode of transport (e.g. cross-boundary buses or high-speed ferries) using the same air ticket, which helps to make travel planning more convenient and efficient for travellers and encourages the use of multiple forms of public transportation by passengers in the GBA.

Prior to the introduction of the Outline, designated airlines were only permitted to operate air-to-land intermodal services in conjunction with cross-boundary buses running between Hong Kong SAR and Shenzhen. However, following the issuance of the Outline, designated airlines are now allowed to enter into code-sharing arrangements with operators of all kinds of land transportation (including railway services, passenger vehicles and coaches) to all cities in the China Mainland. In addition, airlines are permitted to enter into air-to-sea intermodal code-sharing arrangements. The China Mainland and Hong Kong SAR now have increased sea transportation options between HKIA and cities in the GBA, including Macao SAR, Fuyong, Humen, Jiuzhou, Lianhuashan, Nansha, Shekou and Zhongshan. This includes airport check-in facilities at Shenzhen Shekou Cruise & Ferry Terminal, Zhuhai Jiuzhou Port and Guangzhou Lianhuashan Port, allowing passengers to go directly to the departure hall upon arrival at HKIA.

Separately, measures have been introduced to streamline boundary crossing rules within the GBA. Check-in facilities for HKIA have also been introduced at the Hong Kong Port of the Hong Kong-Zuhai- Macao Bridge and at West Kowloon Station. Cross-boundary helicopter services are now also permitted between Hong Kong SAR and the rest of the GBA.

The expansion of the intermodal code-sharing services allows airlines operating from HKIA to offer seamless air-to-land and air-to-sea connections with other destinations in the GBA, further enhancing Hong Kong SAR's position as an international aviation hub within the GBA. This offers significant growth potential for airlines in Hong Kong SAR, given that GBA passengers (excluding Hong Kong SAR passengers) accounted for less than 10% of one major Hong Kong SAR based airline's passenger numbers in 2019. A more comprehensive transportation system in the GBA will naturally also provide increased opportunities for other aviation/transportation related businesses to grow, both at HKIA and also

[8] Reference: https://www.info.gov.hk/gia/general/201907/30/P2019073000632.htm.

[9] Reference: https://www.thb.gov.hk/eng/blog/index_id_10.htm.

[10] Reference: https://www.info.gov.hk/gia/general/201802/01/P2018020100693.htm?fontSize=1 and https://www.info.gov.hk/gia/general/201902/19/P2019021900578.htm?fontSize=1.

at the other airports in the GBA (in particular GBIA and SBIA). This might even include a helicopter ride-hailing service and electric pilotless aircraft in the GBA if Airbus' plans come to fruition.[11]

(II) Introduction of the 144-Hour Transit Visa Exemption Policy[12]

In order to encourage tourism in the GBA and the development of GBIA and SBIA as international aviation hubs, from May 2019 foreign visitors from 53 countries can visit Shenzhen, Guangzhou or any other city in Guangdong without the need for a visa for 144 hours (this includes visitors from countries in the European Union, the United Kingdom, Australia and the United States).

In order to do so, visitors need to hold a valid international travel document and a connecting ticket to a third country or region. Hong Kong SAR and Macao SAR are considered as a third regions from the China Mainland under this policy. Visitors need to enter the GBA via GBIA, Jieyang Chaoshan Airport or SBIA. This policy makes transiting at GBA airports more convenient and gives visitors the ability to explore the GBA without the need for a visa.

From the perspective of airlines based at GBIA and SBIA, including China Southern Airlines and Shenzhen Airlines, this policy offers the opportunity to increase their share of valuable international transfer customers transiting at GBIA and SBIA. Currently this market is underdeveloped by airlines and airports in the GBA, other than by Cathay Pacific at HKIA, given most international traffic is either currently point-to-point in nature or limited to international-to-domestic transfers within the China Mainland. The physical expansion of both at GBIA and SBIA should provide the capacity needed for the growth of transit passengers to take place.

(III) Aircraft leasing in the Nansha Free Trade Zone and Hong Kong SAR[13]

Another key focus of the Outline is to develop the China Guangdong Free Trade Zone (the "**GFTZ**"). The Nansha Free Trade Zone (the "**Nansha FTZ**") in Guangzhou is one of the three areas of the GFTZ. The Outline aims to develop financial services within the Nansha FTZ, including fintech, aviation finance and aviation leasing. The Outline also advocates close cooperation between Hong Kong SAR and Nansha FTZ, in order for Nansha FTZ to become a gateway to the China Mainland.

Market participants have begun structuring their transactions with China Mainland airlines (as lessees) via both Hong Kong SAR (at the owner level) and Nansha FTZ (at the lessor level), with a similar lease-in and lease out structure in other free trade zones in the PRC. By transacting through the Hong Kong SAR plus Nansha FTZ cross-border leasing structure, aviation leasing companies can enjoy the advantages of access to the international financial markets in Hong Kong SAR and the dedicated concessionary tax regime for qualifying aircraft lessors. The dedicated tax regime in Hong Kong SAR provides a concessionary tax rate of 8.25%, which is 50% of the current profits tax rate of 16.5%, for both qualifying aircraft lessors and qualifying aircraft leasing managers. Only 20% of the tax base (gross rentals minus deductible expenses (but excluding depreciation)) of qualifying aircraft lessors will be subject to profits tax, resulting in a net tax rate of 1.65% (that is, 20% x 8.25%). Furthermore, the double taxation agreement between the China Mainland and Hong Kong SAR offers a lower withholding tax rate of 5%, making Hong Kong SAR the jurisdiction with the lowest

[11]Reference: https://asiatimes.com/2019/09/airbus-eyes-hail-a-copter-service-for-greater-bay/.

[12]Reference: http://gdga.gd.gov.cn/xxgk/zcjd/wjjd/content/post_2286867.html and https://www.chinadiscovery.com/shenzhen-tours/shenzhen-144-hour-twov.html.

[13]Reference: http://nansha.guangdong.chinadaily.com.cn/2019-07/05/c_386186.htm and http://www.chinadaily.com.cn/a/201904/01/WS5ca1d166a3104842260b3bd6.html.

withholding tax applied on lease rentals paid by China Mainland lessees, followed by Singapore and Ireland with a rate of 6% withholding tax.[14]

The Nansha FTZ company can also benefit from preferential import duty and customs clearance policies in the Nansha FTZ. To date more than 120 commercial aircraft have been bought into the Nansha FTZ (within the past five years), including aircraft operated by China Southern Airlines.[15] In terms of leasing companies set up in the Nansha FTZ, the number of financial leasing companies in the Nansha FTZ has increased from about 30 at the beginning of 2015 to more than 2,100 in 2019, including Skyco International Financial Leasing Company and China Southern International Leasing. Many of the state-owned enterprises have also set up financial leasing operations in the Nansha FTZ.[16]

As part of the development of the GBA as an aviation hub, it is expected that Nansha FTZ/Hong Kong SAR will further develop as a key leasing structure into the China Mainland for aviation transactions, in particular for airlines based in the GBA.

(IV) 2020 guidance on financial support for the GBA[17]

In April 2020, the People's Bank of China, together with the China Mainland's banking, securities and foreign exchange regulators announced several new measures to encourage the growth of the GBA in the 2020 Guidance. One of the key principles included in the 2020 Guidance is to encourage financial co-operation between the China Mainland, Hong Kong SAR and Macau SAR and to enhance the position of Hong Kong SAR as an international financial centre.[18]

In addition, the 2020 Guidance encourages the growth of cross-border lending in the GBA, both from China Mainland banks to entities in Hong Kong SAR and Macau SAR and from branches of Hong Kong SAR and Macau SAR banks in the China Mainland to entities in the GBA. The 2020 Guidance also suggests increased support for other non-banking cross-border businesses, including financial leasing companies.

The 2020 Guidance, since its implementation, has further enhanced financial co-operation within the GBA. From an aviation leasing perspective, the advantages of the Nansha FTZ / Hong Kong SAR leasing structure may become even greater if lending costs are reduced or if further financial or tax incentives are offered by authorities in the GBA.

(V) Development of related industries in the GBA

It is reported that China's maintenance, repair, and overhaul ("MRO") market stood at RMB 128.68 billion in 2018, generating a compound annual growth rate of 9.32% between 2010 and 2018.[19] With the development of aviation industry in the GBA, in particular, with increasing demand for aircraft in the GBA in order to support increased air traffic, there is a significant market for aircraft MRO businesses.

One example of this is Guangzhou Aircraft Maintenance Engineering Co., Ltd. ("GAMECO"), jointly owned by China Southern Airlines, Hutchison Whampoa (China) Ltd., which is investing and building a third hangar, a component repair centre and a composite centre in the GBA. The building of the third hangar is expected to be finished in 2021, and it is located near GBIA and can accommodate six wide-body aircraft and five narrow-body aircraft for heavy maintenance at the same time. GAMECO's new component repair centre and the composite centre, which are located in Guangzhou, are expected to come into service in 2022.

It is anticipated that additional MRO operators will open, or existing MRO operators will expand, within the GBA in the foreseeable future. Given one of the aims of the Outline is to develop the GBA as a centre for technology and innovation, this expansion may also involve the increased use of augmented and virtual reality technologies, both in relation to training and possibly remote maintenance and inspection of aircraft.[20] Both MROs and technology companies may therefore have a role to play in the expansion of this area.

Besides MRO services, the GBA can also develop other aviation-industry related services, including ground handling service, airport infrastructure, pilot training, airport management training and aviation business management training etc with a view to creating an integrated development of the aviation industry supply chain.

The authors would like to thank Ma Feng, Yan Qiong, Alison Chan and Sunny Wong for their assistance on this article.

[14] Reference: https://www.ird.gov.hk/eng/tax/bus_ala.htm; http://www.hkala.com.hk/docs/Event%20Presentations%20-%20Taxation%20workshop.pdf (see slide 7); and https://www.kwm.com/en/cn/knowledge/insights/hk-s-proposed-dedicated-tax-regime-for-offshore-aircraft-leasing-20170306.

[15] Reference: http://subsites.chinadaily.com.cn/guangzhou/nansha/2019-08/23/c_398934.htm.

[16] Reference: http://nansha.guangdong.chinadaily.com.cn/2019-01/02/c_312574.htm.

[17] Reference: http://www.cnbayarea.org.cn/policy/policy%20release/policies/content/post_258474.html.

[18] Reference: https://kwm.com/en/hk/knowledge/downloads/new-plans-to-support-gba-unveiled-20200608.

[19] Reference: http://global.chinadaily.com.cn/a/201906/17/WS5d06f2eba3103dbf143288e6.html.

[20] Reference: https://www.sciencedirect.com/science/article/pii/S2351978918300222.

About King & Wood Mallesons

Recognised as one of the world's most innovative law firms, King & Wood Mallesons offers a different perspective to commercial thinking and the client experience. With access to a global platform, a team of over 2,900 lawyers in 29 locations around the world, works with clients to help them understand local challenges, navigate through regional complexity, and to find commercial solutions that deliver a competitive advantage for our clients.

As a leading international law firm headquartered in Asia, we help clients to open doors and unlock opportunities as they look to Asian markets to unleash their full potential. Combining an unrivalled depth of expertise and breadth of relationships in our core markets, we are connecting Asia to the world, and the world to Asia.

We take a partnership approach in working with clients, focusing not just what they want, but how they want it. Always pushing the boundaries of what can be achieved, we are reshaping the legal market and challenging our clients to think differently about what a law firm can be.

KWM Institute is a non-profit research organization co-sponsored and -founded by KWM and KWM Pro Bono Foundation. Since its establishment, KWM Institute is committed to building a new type of think tank with Chinese characteristics and international influence. Over the recent 25 years, KWM has accumulated extensive practical experience and professional insights in the course of providing services for the national economic and legal development. With such experience and insights, KWM Institute analyzes and studies the major issues that businesses may come across in implementing their "going global" strategy, so as to provide constructive and pragmatic policy recommendations and advice.

金杜研究院
KWM_China