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Hong Kong's potential as a new hub for private credit funds

Sarah Lau

With the Hong Kong Government's commitment to creating a conducive environment for the wealth and asset management industry and to develop Hong Kong as an international asset management hub, the Financial Services and Treasury Bureau has, on 25 November 2024, issued a long-awaited industry consultation paper (**Consultation**) dealing with proposed changes to the unified fund exemption regime (**UFR**), the family-owned investment holding vehicle (**FIHV**) tax concession regime and the carried interest tax concession regime.

We highlight below some of the proposed changes that may help bring private credit funds and debt funds back to Hong Kong.

Background - Under the current UFR, there is no profits tax exemption for private credit funds as "loans" are not included as qualifying investments under Schedule 16C of the Inland Revenue Ordinance (Cap. 112) (**IRO**) (which covers a list of qualifying assets exempt from the payment of profits tax) and interest income from "loan" transactions are not considered incidental income. In addition, the Inland Revenue Department (**IRD**) has long considered that the holding of debt instruments (for instance, debentures, loan stocks, bonds or notes) to earn interest income to fall outside the definition of a qualifying transaction and that the receipt of interest income from such instruments would be an incidental transaction subject to a 5% threshold.

The restrictions under the current UFR in relation to the loan and private credit investments and 5% threshold on interest income derived from the holding of debt instruments have long undermined the attractiveness of Hong Kong as a destination for setting up private credit funds in comparison to other competing jurisdictions.

Proposed changes to include loans and private credit investments as qualifying assets/transactions under UFR

- Amongst others, the Consultation proposes to expand the list of qualifying assets under the UFR to include loans and private credit investments. This would make transactions in loans and private credit investments (and interest income from the holding of such instruments) eligible for profits tax exemption under the UFR. In addition, the Consultation proposes to expand income exempt from profits tax to include all income from qualifying transactions (including interest income from bonds, marketable debt securities, loans and private credit investments), therefore removing the previous 5% threshold.

The above proposals would be a positive move to bring private credit funds and debt funds back to Hong Kong.

Without prejudice to the above, the Consultation mentions that an exclusion list will be formulated setting out in detail income not qualifying for tax exemption and the industry is yet to have sight of the full list of excluded investments contemplated.

It is also noteworthy that the Consultation proposed to introduce a new anti-round tripping provision catered for loan and private credit investments where an insurance business, a money lending business Hong Kong and/or an insurance business, either alone or jointly with associates has a beneficial interest of 10% or more in a tax-exempt fund (or any percentage if the fund is the person's associate), then such persons will be deemed to have derived assessable profits in respect of income derived by the fund from loan or private credit investments.

FIHVs - The tax concession regime for FIHVs is largely modelled on the UFR. The proposed changes set out above, if adopted, will also be brought across to the FIHV tax concession regime.

Carried interest - The Consultation has proposed, amongst other changes, to broaden the types of transactions that can generate eligible carried interest under the carried interest tax concession regime beyond private equity transactions to cover profits arising from all classes of assets specified under Schedule 16C of the IRO which are exempted from profits tax under the UFE regime (which will include loan and private credit investments), other non-taxable income (such as dividend income and offshore income) and other taxable income.

This could possibly represent positive news for fund managers with strategies in private credit who may be eligible under the revamped carried interest concession regime to be introduced provided that other qualifying conditions are met.

Our view - Overall the proposed amendments under the Consultation represent an encouraging move for the asset management industry in particular from the perspective of private credit fund managers. This may open up possibilities for developing Hong Kong into a new hub for private credit investments and making Hong Kong domiciled fund structures such as open-ended fund companies (OFCs) and Hong Kong limited partnership funds (HKLPFs) a more attractive and viable option for loan and private credit investments in the near future.

FTSB's Roadmap on Sustainability Disclosure in Hong Kong

Ming Chiu Li

The Financial Services and the Treasury Bureau (**FSTB**) has issued a Roadmap on Sustainability Disclosure in Hong Kong (**Roadmap**), to align Hong Kong reporting standards with the International Financial Reporting Standards - Sustainability Disclosure Standards (**ISSB Standards**).

The ISSB Standards specifically targets publicly accountable entities (**PAEs**). PAEs include (i) public or listed entities, and (ii) entities which hold assets in a fiduciary capacity for a broad group of outsiders as one of their primary businesses (including but not limited to banks, credit unions, insurance companies, securities brokers/dealers, mutual funds and investment banks).

In Hong Kong, the Roadmap proposes the adoption of ISSB Standards by large PAEs, which fall into 2 categories:

Category 1 – issuers that are Hang Seng Composite Large Cap Index constituents

Category 2 – non-listed PAEs which are financial institutions carrying a significant weight in Hong Kong.

No later than 2028, large PAEs (both Category 1 & Category 2) will be required to apply the Hong Kong standards, in alignment with the ISSB Standards.

The Roadmap aims to provide a transparent and well-defined pathway on sustainability reporting for PAEs in Hong Kong.

On the technical level, the Hong Kong Institute of Certified Public Accountants has been developing the Hong Kong standards on a full alignment basis with the ISSB Standards. It is expected to issue the new Hong Kong standards under HKFRS, relating to sustainability-related financial information, by the end of 2024.

Financial regulators of different sectors will require financial institutions carrying a significant weight to apply the Hong Kong standards within the above timeline. For the asset management entities, the Securities and Futures Commission is anticipated to further engage with the industry in connection with the adoption of the Hong Kong standards. Once formalised, these standards need to be followed when financial reporting information is compiled.

What are your due diligence responsibilities when engaging ESG ratings and data products providers?

Joyce Li

While the appeal of environmental, social and governance (**ESG**) credentials may still be subject to debate, it is certain that ESG factors play an increasingly important role in financial markets (including in the asset management sector). The demand and need for reliable and high quality ESG ratings and data products have also increased, especially amidst increasing allegations of greenwashing.

Recognising the importance and growing demand from industry for guidance on baseline standards on how providers of ESG ratings and data conduct business, the Securities and Futures Commission (**SFC**) supported and sponsored the development of a voluntary code of conduct (**VCoC**) for ESG ratings and data products providers providing products and services in Hong Kong (**ESG Service Providers**).

Following the publication of the VCoC, the SFC in its recent guidance to asset managers on due diligence expectations for ESG Service Providers encourages asset managers to take into account adherence of the ESG Service Providers to the VCoC or any similar or higher standards.

We set out below a brief update of the VCoC and the SFC's guidance to asset managers regarding due diligence expectations for third-party ESG Service Providers (**Guidance**).

The voluntary code of conduct for ESG Service Providers

The **VCoC**, published in October 2024, was officially launched on 29 November 2024. It aims to foster a trusted, efficient and transparent market by introducing clear standards for ESG Service Providers and focusing on achieving four key outcomes: good governance, management of conflicts of interest, transparency and strengthening systems and controls in the sector.

The VCoC was modelled on international best practices recommended by the International Organisation of Securities Commission ensuring that the VCoC is interoperable and consistent with the expectations introduced in other major financial jurisdictions. It is hosted and maintained by the International Capital Market Association (**ICMA**).

ESG Service Providers who signed up to the VCoC will make available publicly (on ICMA's VCoC webpage) a self-attestation document explaining their approach and actions taken to adhere to the principles of the VCoC. Such self-attestation document not only promotes transparency but is also a critical bridge to the availability and consistency of information concerning the methodologies and operations of ESG Service Providers and the information and product they produce.

Expectations on asset managers using data and products provided by ESG Service Providers

Asset managers are expected to exercise due skill, care and diligence when engaging third-party service providers, and this will include ESG Service Providers if an asset manager uses ESG data in its performance of its business activities.

Understanding the products - To meet the SFC's expectations, asset managers should conduct reasonable due diligence and ongoing assessments on third-party ESG Service Providers which would allow them to reasonably understand the ESG products provided, including:

- how such products are produced (for instance, the source and timeliness of the underlying information used, any use of estimates, methodologies applied, and the criteria and approach for assessing the covered entity);
- limitations and the purposes for which the product is being used.

Having clear understanding of the ESG products, and its underlying methodologies and data sources, is not only important in meeting regulatory obligations, it is also pertinent to ensuring that the ESG data and products are used appropriate and in a manner which supports an asset manager's investment strategy and delivers an outcome that is aligned with how the investment product was described and what its investors are looking for.

ESG Service Provider's adherence to VCoC - To facilitate asset managers in meeting its due diligence requirements, asset managers may take into account the principles and recommended actions of the VCoC during its initial due diligence and ongoing assessment of ESG Service Providers:

- where ESG Service Providers have signed up to the VCoC and completed the self-attestation document, asset managers may use such information for their due diligence and on-going assessment of its ESG Service Providers
- however, asset managers will still need to determine the level and extent of due diligence required in order to satisfactorily discharge its obligations
- the level of due diligence and ongoing assessments of the third-party ESG Service Providers and their products to be conducted should be proportionate to the impact that the products ultimately have on their investment and risk management processes.

Policy and procedures - Asset managers may leverage group resources and staff, and adopt group policies and procedures to satisfy SFC's regulatory expectations provided that such policies and procedures are subject to similar or higher than the SFC's expectations. Further, the local management will retain the responsibility to ensure the intermediaries comply with the SFC's requirements.

Last but not least, asset managers should have written policies and procedures as well as written records to the due diligence and ongoing assessment conducted in order to demonstrate how they have adequately satisfied the SFC's expectations.

The Fund Repository of the Integrated Fund Platform is online

Joyce Li

The first phase of the Integrated Fund Platform was launched on 13 December 2024 with the Fund Repository coming online : **[Explore the Fund Repository](#)**.

The Fund Repository will provide investors with a one-stop access to information on Hong Kong retail funds, streamlining access to essential information for investors. This is a key part of the new financial infrastructure in Hong Kong aiming to enhance product transparency as well as to facilitate the building of an electronic ecosystem for retail fund distribution.

As previously reported in our **[News & Insights](#)**, the next stage of the Integrated Fund Platform is to build a business platform and a communications network to facilitate dealing of funds on a business-to-business basis between fund managers and distributors.

Hong Kong SFC licensing and compliance hints – December 2024

Gabriel Shea

Use of artificial intelligence language models (AI LMs): Reminder of senior management responsibilities

Further to our recent article concerning the use of generative AI by licensed corporations (click **[here](#)**), we wish to highlight the following issues that senior management needs to consider concerning the use of AI LMs in the conduct of regulated activities:

1. Have you updated your internal policies, procedures and internal controls governing the use of AI LMs?
2. Have you identified suitably qualified key individuals within your organisation to assume / facilitate senior management oversight concerning the use of AI LMs?
3. How is senior management oversight being implemented in practice and how can this be demonstrated if challenged?
4. Have you identified high-risk use cases and notified the SFC of the intended use of AI LMs as per the Information Rules?
5. How are you keeping clients updated as to the use of AI LMs?

Recent publications

[New Developments in Cross-Border Data Transfers in the Greater Bay Area](#)

[Review of the Banking Ordinance](#)

[Policy Statement on Responsible Application of Artificial Intelligence in Financial Market](#)

[Supervisory Policy Manual: Revised module TM-E-1 on “Risk Management of E-banking”](#)

[Guideline on Authorization of Digital Banks](#)

[Sustainable Finance Action Agenda](#)

[Prudential Measures for Property Mortgage Loans](#)

[Unlocking the Patent Box: Exploring the value of your software, not just patents!](#)

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