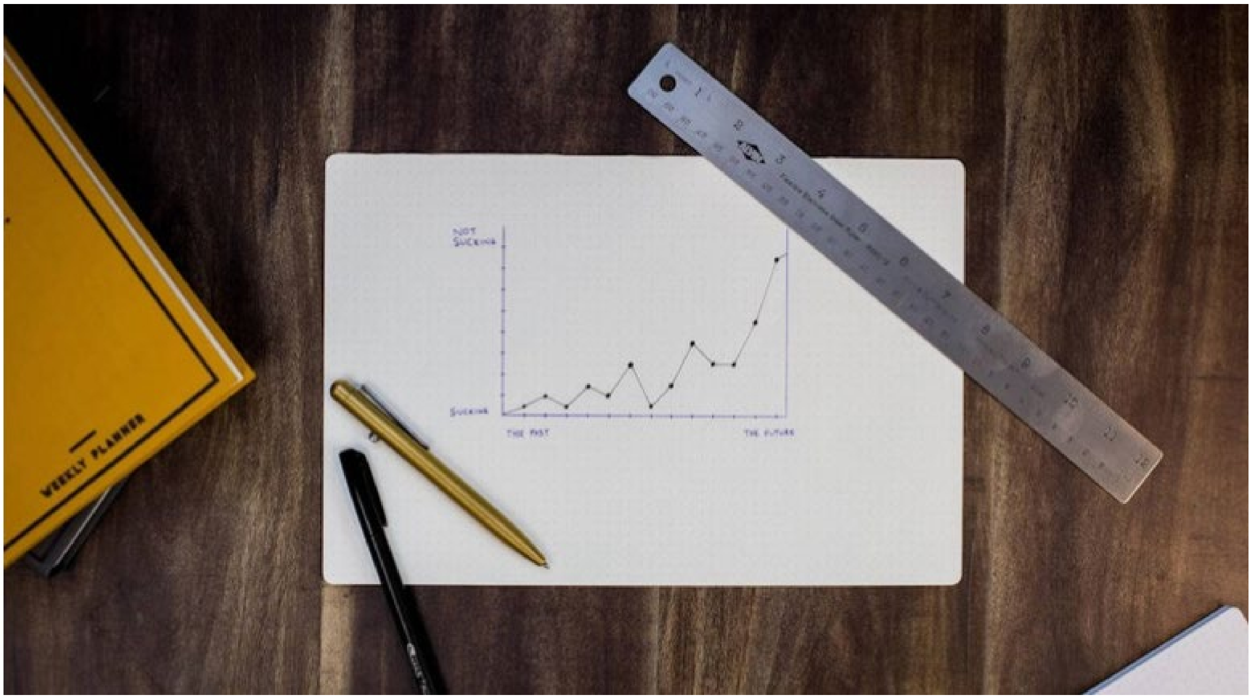
Establishing an Effective Regulatory Ecosystem for Fund Management

Funds Can Leverage Regulatory Insights to Bolster Compliance and Governance in Hong Kong's Asset Management Industry



As Hong Kong aims to become a regional hub for family offices and international wealth management, ensuring a robust and user-friendly regulatory framework for fund management companies (FMCs) is crucial. By comparing the regulatory approaches of the Monetary Authority of Singapore (MAS) and the Hong Kong regulators, including the Securities and Futures Commission (SFC), the Corporations Registry (CR), and the Hong Kong Monetary Authority (HKMA), we aim to offer insights to enhance the corporate governance and compliance practices of FMCs in Hong Kong.

Compliance Requirements

Both Singapore and Hong Kong have comprehensive compliance regulations for FMCs, though with some differences.

Singapore

MAS oversees licensing and regulations of FMCs in Singapore. FMCs in Singapore are regulated by the Securities and Futures Act (Cap. 289). In order to conduct the regulated activity of fund management, FMCs must obtain either registration or license from MAS as a:

- Registered Fund Management Company (RFMC);
- Capital Markets Services License (CMSL) as a Licensed Fund Management Company;
- Venture Capital Fund Manager (VCFM); or
- be expressly exempted from holding a license.

Prior approval is mandatory for FMCs in relation to significant changes, including the appointment of a Chief Executive Officer (CEO) or directors. MAS requires relevant persons in regulated activities such as directors and CEO to be fit and proper, including qualities like honesty, competence, and financial soundness. The responsibility lies with each relevant person to demonstrate their fitness, rather than placing the burden on MAS to prove otherwise.

This is particularly important for firms where ownership is separate from the CEO and/or the senior management team. Where appropriate, MAS may require the CEO and directors to be sufficiently anchored to the FMC, for example, by holding meaningful shareholding stakes in the FMC, in order to align the interests of the owners and the management team of the FMC in carrying out the fund management activity in a sound manner.

FMCs must also fulfil regular filing requirements, including the submission of audited financial statements and compliance reports. The compliance reports serve as a means to report any misconduct perpetrated by representatives of the FMCs. This includes instances of non-compliance with regulatory requirements pertaining to the provision of regulated activities under the Securities and Futures Act (Cap. 289), or any significant violation of the FMC's code of conduct.

Hong Kong

Hong Kong's regulatory landscape involves multiple bodies. SFC oversees licensing and conduct requirements for FMCs, while the CR handles corporate filings, and the HKMA focuses on banks and deposit-taking institutions that engage in fund management activities. FMCs in Hong Kong must navigate the respective guidelines and approval processes of these different regulators, which can be more complex than the centralized approach in Singapore.

Given the nature of FMCs, it is typical for FMCs that oversee assets such as securities or futures contracts to seek a Type 9 (Asset Management) license. Additionally, depending on the specific activities carried out by FMCs, they may also be required to obtain licenses for other regulated activities, such as engaging in activities related to dealing in securities (Type 1), dealing in futures contracts (Type 2), providing advice on securities (Type 4), and/or advising on futures contracts (Type 5). Unlike MAS, SFC does not differentiate between different classes of FMCs but rather distinguishes them based on various types of regulated activities.

Similar to MAS, SFC sets clear guidelines for the appointment criteria of certain individuals. According to the Securities and Futures Ordinance (Cap. 571) (SFO), it is a requirement that a licensed corporation engaging in regulated activities must have not less than two responsible officers (RO) to directly supervise the conduct of each regulated activity and for each regulated activity, it must have at least one RO available at all times to supervise its business operations. An RO is obligated to meet both general fit and proper requirements and specific competence criteria, which include academic and professional qualifications, relevant industry experience, recognized industry qualifications, and management expertise.

For authorized financial institutions that engage in fund management activities operating under the jurisdiction of HKMA, it is a legal requirement that every registered institution ensures its relevant individuals engaged in conducting regulated activities on behalf of the institution are fit and proper. This condition of registration is imposed by statute.

Common change events, such as changes in ROs, directors, share capital and business activities, require timely notification to SFC. In the case of registered institutions carrying on regulated activities that require registration with the SFC, the notification should be made to both the SFC and the HKMA. FMCs that engage in regulated activities have the obligation to submit regular financial resources returns to the SFC. Additionally, as the FMCs are registered under the CR, the corporate structure or details of a company, such as alterations in share capital, directors, or registered office address must also be reported to the CR as a requirement.

Apart from that, FMCs in Hong Kong have compliance reporting obligations for their intermediaries and substantial shareholders. These requirements extend beyond regulated activities in Hong Kong and cover information about directors, substantial shareholders, and related corporations or businesses owned or managed by them. The obligations include notifying SFC and, where applicable, HKMA in writing within seven business days of any change in "relevant information," whether in Hong Kong or elsewhere. Relevant information encompasses details such as disciplinary actions, investigations by regulatory or criminal bodies, affecting the intermediary or its group entities. The purpose of these notification requirements is to ensure that SFC and HKMA are continuously informed and satisfied that intermediaries and their representatives remain fit and proper, even in the face of changing circumstances.

Regulatory Guidance

To support FMCs, both Singapore and Hong Kong offer extensive guidance on various regulatory aspects. The MAS has published detailed notices and guidelines covering areas such as anti-money laundering and countering the financing of terrorism (AML/CFT), outsourcing, and technology risk management. Similarly, the SFC has issued comprehensive guidelines on internal control, anti-money laundering and countering the financing of terrorism (AML/CFT) compliance, corporate governance, and ethical practices.

The availability of such regulatory guidance is crucial in helping FMCs understand and implement best practices, ultimately contributing to a more robust and trustworthy industry ecosystem.

The following regulatory guides are provided to support FMCs in Hong Kong:

The Guideline on Anti-Money Laundering and Counter-Financing of Terrorism (AML/CFT) for Licensed Corporations and SFC-licensed Virtual Asset Service Providers provides comprehensive guidance on complying with AML and CFT regulations in Hong Kong. The guideline covers various aspects, including risk assessment to assess and mitigate money laundering and terrorist financing risks, customer due diligence especially for higher-risk customers, record-keeping, internal controls, suspicious transaction reporting, and ongoing monitoring. It emphasizes the importance of implementing robust AML/CFT policies, procedures, and systems to prevent money laundering and terrorist financing activities.

The Guideline relating to Technology Risk Management: The SFC has published guidelines requiring senior management and the respective MICs to revisit the “Management, Supervision and Internal Control Guidelines For Persons Licensed by or Registered with the Securities and Futures Commission” to examine whether they have in place adequate and effective internal control. Qualified and experienced staff should be assigned to manage information and it should be managed in a secure and controlled environment. Management should ensure the firm has in place (i) clearly defined information management reporting requirements; (ii) information management system design and implementation programmes; and (iii) appropriate and effective electronic data processing and data securities policies.

Guidelines on risk management of outsourcing arrangements: The SFC and the HKMA issue guidelines on the outsourcing of data used by financial institutions. The HKMA sets out requirements for authorized institutions regarding outsourcing in its Supervisory Policy Manual (Module SA-2) and provides guidance on technology risk management (Module TM-G-1) and operational risk management (Module OR-1 and OR-2). Additionally, the HKMA has issued a circular providing guidance on cloud computing. The SFC, on the other hand, endorses the International Organization of Securities Commissions Principles on Outsourcing of Financial Services and has specific requirements for the use of external electronic data storage providers, as outlined in its circulars and frequently asked questions on the use of external electronic data storage.

Independence and Operational Separation

Ensuring the independence of audit and other key functions is another important consideration. The MAS emphasizes the need for FMCs to avoid providing both external audit and internal audit services to the same firm, thereby maintaining the necessary checks and balances. This helps to mitigate conflicts of interest and strengthen the reliability of financial reporting and internal controls.

In Hong Kong, the Hong Kong Institute of Certified Public Accountants (HKICPA) provides guidelines and professional standards that emphasize the importance of maintaining the independence and objectivity of both internal and external audit functions. These guidelines discourage the same firm from providing both services simultaneously to the same FMC.

Financial Stability and Resilience

Promoting the financial stability and resilience of FMCs is a shared priority for both Singapore and Hong Kong. The MAS has implemented measures such as requiring FMCs to deduct charged assets that are not available for their use from their financial resources, effectively adjusting their liquidity position. Additionally, the MAS excludes redeemable preference shares with a redemption period of less than two years from the calculation of an FMC's financial resources, mitigating potential short-term funding risks.

Hong Kong's regulators have also introduced similar requirements to ensure the financial soundness of FMCs. For instance, the SFC's liquid capital rules and the HKMA's capital adequacy framework aim to safeguard the stability of FMCs and the broader financial system.

SFC's liquid capital rules

FMCs are required to maintain a minimum level of liquid capital, which serves as a buffer to cover potential losses and liabilities. The specific amount of liquid capital required depends on factors such as the nature and scale of the FMC's activities.

FMCs are required to monitor their liquid capital on an ongoing basis to ensure compliance with the SFC's requirements. They are obliged to report their liquid capital position to the SFC at regular intervals or as requested. SFC also conducts regular inspections and examinations to assess FMCs' compliance with the liquid capital rules. These oversight activities aim to verify that FMCs maintain the required level of liquid capital and have appropriate risk management and internal control systems in place.

HKMA's capital adequacy framework

HKMA is primarily responsible for regulating banks and maintaining the stability of the banking system in Hong Kong. While the HKMA does not specifically regulate FMCs, they have certain requirements related to capital adequacy for banks that provide fund management services.

Regulatory Reporting and Supervision

Both Singapore and Hong Kong have established robust regulatory reporting mechanisms to monitor the health and compliance of FMCs. The MAS requires FMCs to report on issues such as capital shortfalls, the resignation of key personnel, or the establishment of new subsidiaries or branches without prior approval.

Similarly, Hong Kong's regulators expect FMCs to report on various compliance and operational matters, with the SFC taking the lead on most aspects. FMCs are expected to have contingency plans to prepare for and respond to events or shocks that could undermine their financial stability or operational capability. According to the Securities and Futures (Licensing and Registration) (Information) Rules, corporate license applicants must provide information about their business plans, including contingency plans and related matters, to the SFC. The SFC also has the authority to request additional information or documents regarding an applicant's contingency plans.

Capital shortfall alert

Pursuant to sections 6(1) and 55(1)(a) of the Securities and Futures (Financial Resources) Rules (Cap. 571N) (FRR), FMCs must at all times maintain its required liquid capital and notify the SFC in writing within one business day when it becomes aware that its liquid capital falls below 120% of the required amount. Under sections 146(1) and (2) of the SFO, it shall notify the SFC in writing and immediately cease carrying on any regulated activity for which it is licensed if it becomes aware that it is unable to maintain, or to ascertain whether it maintains, the financial resources required of it, unless otherwise permitted by the SFC.

Reporting on unavailability of key personnel

When FMCs become aware that it will have less than two ROs or no Executive Director (ED) in respect of any regulated activity for which it is licensed, it should immediately activate its business continuity plan and notify the SFC of the situation. It should also provide information regarding its remedial actions to appoint additional ROs or EDs, with a concrete timeframe. Whilst FMCs should submit related RO applications to the SFC as a matter of urgency, the competence of the RO candidates should not be compromised and the quality of the application materials should comply with all the relevant application requirements.

Subsidiary or branch set up

FMCs will need to seek approval for the premises of each branch office in Hong Kong if regulatory records are being kept at, or can be accessed from, such premises according to section 130 of the SFO. FMCs cannot use premises for record-keeping without prior written approval. This is so even for those licensed corporations which transfer all of their records from branches to the head office because it is likely that at some point in time, there may be records kept by the branch but not by the head office.

The availability of these regulatory reporting frameworks allows the authorities to identify potential risks or compliance breaches in a timely manner, enabling proactive intervention and supervision. FMCs in both jurisdictions must ensure they have robust internal controls and reporting mechanisms to fulfil their regulatory obligations.

Conclusion

As Hong Kong continues to position itself as a leading international wealth management center, fostering a robust and transparent regulatory environment for FMCs will be crucial. By comparing the regulatory approaches of Singapore and Hong Kong, we can see the key areas of regulatory attention concerning FMCs in light of compliance practices for developing an effective and user-friendly ecosystem for fund management in Asia. Both jurisdictions have comprehensive regulatory framework and the availability of detailed regulatory guidance, emphasizing on governance measures to enhance financial stability, operational integrity and investment effectiveness of FMCs.

For inquiries about how JML can support your fund management compliance and governance strategies, including regulatory insights and best practices, please scan the QR code below for quick access to learn more about our services:

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