Growth of the family office industry in Hong Kong: licensing and regulatory considerations

April 2023

Executive summary

In efforts to solidify Hong Kong's position as an international financial centre, the Hong Kong SAR Government has consistently been working towards strengthening Hong Kong's position as a family office hub.

In mid-2020, the Hong Kong SAR Government introduced the family office tax concession regime (the '**Concession Regime**') to attract and support more family offices to set up in Hong Kong. The regime aims to provide tax concessions to eligible family offices on qualifying profits and salaries tax. A central part of the Concession Regime is the concept of investment vehicles which consolidate and hold all of the family office's investments (the family-owned investment holding vehicles ('**FIHVs**'), which are, in turn, managed by a single family office manager ('**SFO Manager**'). See our article summarising the Concession Regime here.

In this first of a three-part series on family offices, we consider the regulatory implications for family offices seeking to set up in Hong Kong to take advantage of the Concession Regime. For the purpose of this article, we will assume that a trustee is not involved in the structure.

SFC licences

It is an offence under the Securities and Futures Ordinance ('**SFO**') for a person to carry on a business, or hold itself out as carrying on a business, in Hong Kong in a regulated activity, except if the person holds a licence or falls within a carve-out from the definitions of the regulated activities.

Types of regulated activities

There are currently ten types of regulated activities ('**RA**') under the SFO. Type 9 RA, which covers the discretionary management of a portfolio of securities (defined widely to include shares, debentures, bonds, funds, and rights and options thereof) or futures contracts, is likely to be most applicable to family offices although Type 1 (dealing in securities), Type 2 (dealing in futures contracts), Type 4 (advising on securities) and/or Type 5 (advising on futures contracts) licences may also be relevant depending on the actual business(es) of the family office.[1]

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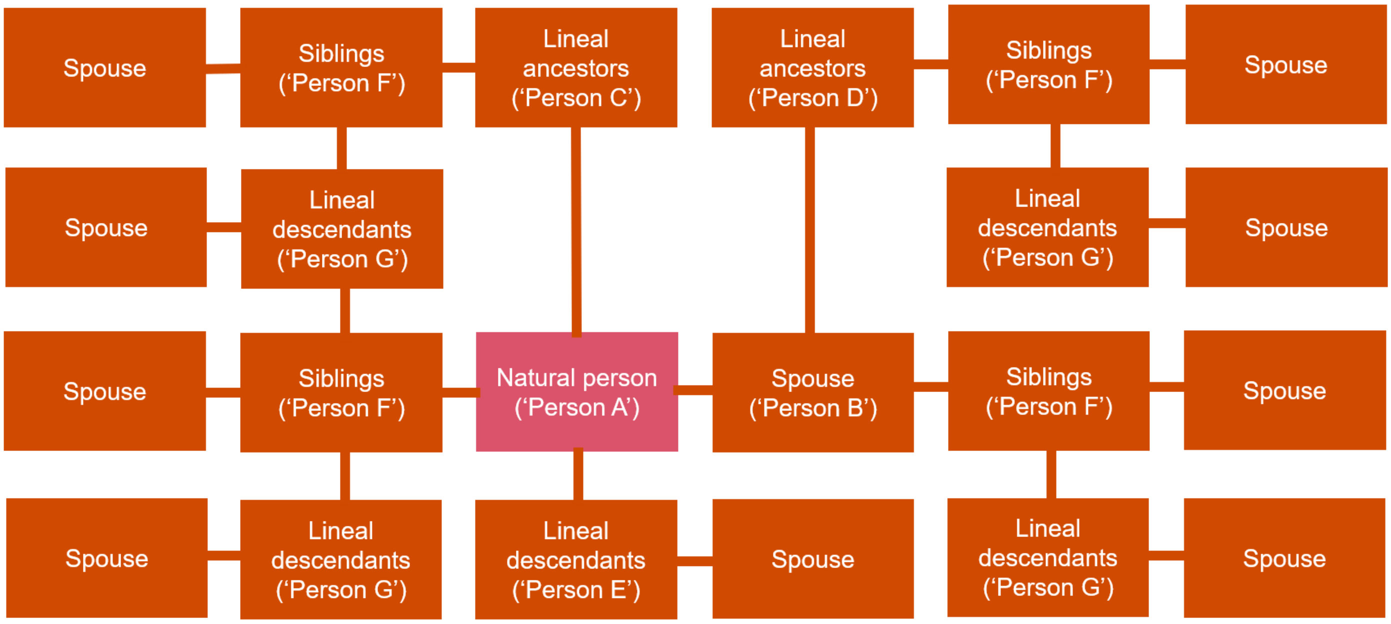
[1] Type 1 (dealing in securities) – this licence is required for the distribution, marketing and broking of securities as well as the introduction of parties for the purpose of a securities transaction; Type 2 (dealing in futures contracts) – same as Type 1 except that Type 2 is in respect of futures contracts, not securities; Type 4 (advising on securities) – this licence is required for the issuance of analysis/reports on securities with advice/recommendation on when and at what price to buy/sell a particular security; Type 5 (advising on futures contracts) – same as Type 4 except that Type 5 is in respect of futures contracts, not securities

The concept of a 'family'

Under the Concession Regime, certain conditions must be met in order to qualify for the tax concession, the key one being that at least 95% of the beneficial interest in the FIHV must be held, directly or indirectly, by one or more 'members of a family'. 'Members of a family' include:

- a natural person ('**Person A**');
- that person's spouse ('**Person B**');
- lineal ancestors of Person A ('**Person C**') and Person B ('**Person D**');
- lineal descendants of Person A ('**Person E**');
- siblings of Person A, Person B, Person C and Person D ('**Person F**');
- lineal descendants of Person F ('**Person G**'); and
- the spouse of Person E, Person F and Person G.



Under the SFO, however, neither the concept of a 'family office' nor 'family members' is defined. As a result of this mismatch between the regulatory and the tax regime, family office industry participants raised concerns regarding their licensing obligations in Hong Kong, in particular, whether an SFO Manager managing an FIHV would require a Type 9 RA licence from the Securities and Futures Commission ('**SFC**').

On 7 January 2020, SFC issued a circular to clarify the licensing obligations of family offices in Hong Kong. In the circular, the SFC confirmed that the Hong Kong licensing regime is activity based and that consistent with the assessment for any other type of business, a family office will not need to be licensed by the SFC if the services provided by, and the businesses of, the family office (1) do not constitute any regulated activity or (2) fall within a carve-out (from the definitions of the regulated activities) in the SFO.

Carve-outs for Type 9 RA

In relation to Type 9 RA, there is a carve-out for a person that provides asset management services solely to its 'related entities'. 'Related entities' is defined as (a) its wholly owned subsidiaries, (b) its holding company which holds all its issued shares, or (c) that holding company's other wholly owned subsidiaries (also known as the '**Intra Group Exemption**'). While it may be technically possible for asset managers to structure themselves such that they become a wholly-owned subsidiary of the investment fund which they are appointed to manage, the Intra Group Exemption would still not be available in situations where the fund takes in subscription moneys from 'third party' investors[2]. Although 'third parties' is not defined, it is quite clear from the Licensing Handbook

[2] https://www.sfc.hk/-/media/EN/assets/components/codes/files-current/web/guidelines/licensing-handbook/licensing-handbook.pdf?rev=b2109e7546cb4080a66f40e645fc65ac

that the Intra Group Exemption would **not** apply where moneys belonging to more than one ultimate individual beneficial owner are being managed.

Similarly, while it may be possible to structure the SFO Manager to be a wholly-owned subsidiary of the FIHV which it is managing, given the narrow application of the Intra Group Exemption, it is unlikely that the Intra Group Exemption will be applicable to an SFO Manager managing an FIHV that has, as its investors, different 'members of a family' as defined under the Concession Regime (since in our view, these 'members of a family' would still be regarded as 'third party' investors in accordance with the SFC's approach as set out in its Licensing Handbook).

Having said that, it is worth noting that on 21 March 2023, the SFC published a quick reference guide on licensing requirements of family offices[3] stating that '**a single-family office may serve non-family members without the need to be licensed**'. In that reference guide, the SFC also contemplates FIHV structures where the investors comprise family as well as non-family members.

It is unfortunate that the reference guide makes no mention of the Intra Group Exemption, or to the SFC's earlier position as set out in the Licensing Handbook (in relation to managing third party moneys), nor does it provide any authoritative definition of concepts such as 'family' or 'family members'.

In our view, it is highly unlikely that the SFC has revoked its position in relation to the non-applicability of the Intra Group Exemption to a Type 9 RA licence where third party moneys are being managed (as this will open the floodgate to asset managers structuring around the need for a Type 9 RA licence). However, even if this were to be the official position for single family office situations only, without a formal concept or definition of a 'family', or 'family members', we anticipate the SFC will have to devote a lot of time and resources looking into investor profiles, and determining when they are genuine 'family members' (for which a Type 9 RA licence will not be needed), and when they are 'third parties' (for which a Type 9 RA licence will be needed).

It is hoped that further clarity will be forthcoming from the SFC around this issue. Until such time, a more certain approach to justifying why a Type 9 RA licence is not needed may be to argue that one is not 'carrying on a business' of asset management.

Not carrying on a business

The SFO does not provide any definition of 'carrying on a business' so in relation to instances where the courts have had to determine this issue, they have had to resort to general taxation and commercial cases for guidance. Generally speaking, 'carrying on a business' refers to the regular and continuous activity of carrying out commercial or economic activities for the purpose of making a profit. In doing so, a court will have regard to factors such as the frequency of an activity, the level of organisation involved, the presence of a profit motive, and the amount of time and effort devoted to the activity.

Suffice it to say, this is a complex area of law, and where one is looking to mount an argument that one is not 'carrying on a business', (specifically in the circumstance of an SFO Manager and its relationship with the FIHV it is managing), a starting point may be to ensure no management or performance fees are being paid to the SFO Manager (or otherwise that the SFO Manager is not carrying on any activity with a 'profit motive').

However, regard would also need to be paid to the entire relationship between the FIHV and the SFO Manager, its relationship with the 'family', and the general matrix of factors/circumstances surrounding that relationship. Careful consideration would need to be given to the structure, documents, contracts and agreements in place to justify such a position.

To ensure that a single family office structure is able to qualify under the Concession Regime and also not in violation of the SFO, co-ordinated legal and tax advice would be needed to navigate both regimes effectively.

Multi-family offices

A multi-family office manager ('**MFO Manager**') serves more than one family and unless the families are 'related entities', a MFO Manager is unlikely to be able to take advantage of the Intra Group Exemption. As such, a MFO Manager looking to provide services, for fees, in regulated activities in Hong Kong will need to obtain the appropriate SFC licence(s). See the section above for the types of regulated activities and the related SFC licences.

While there would be no regulatory issue for a MFO Manager carrying on asset management activities in Hong Kong (and charging fees for doing so), these managers would need to consider how to structure their FIHVs to be tax efficient. Clearly, MFO Managers

[3] https://www.sfc.hk/en/Regulatory-functions/Intermediaries/Licensing/Quick-licensing-guide/Family-Offices

are excluded from being able to rely on the Concession Regime. However, if the FIHVs are structured as 'funds' that have a number of different investors (and in our view, different 'members of the family' as defined under the Concession Regime would still be viewed as third parties), the FIHV should qualify as a 'fund' and should fall within the tax exemption available under The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance 2019 (Ordinance No. 5 of 2019), commonly referred to as the unified tax exemption for funds, provided that its portfolio constitutes assets under Schedule 16C of the Inland Revenue Ordinance.

Conclusion

The Concession Regime represents an exciting opportunity for the asset and wealth management industry in Hong Kong to expand its offering to ultra-high-net-worth-individuals and their families. This would be a boon for the Hong Kong economy, which is also uniquely placed to service this strata of clients, given Hong Kong's depth and breadth of talent and resources in traditional asset management.

While the Concession Regime will make it quite simple for FIHVs to qualify for an exemption under the existing tax regime, building this on top of the existing regulatory regime (and in particular, the licensing regime and exemptions from licensing for Type 9 RA) is going to require a more nuanced approach. This is especially so, given that the concept of a 'member of the family' does not sit very well within the definition of 'related entities' under the Intra Group Exemption. As such, families that are considering coming to Hong Kong to set up an FIHV and related SFO Manager (or MFO Managers looking to service multiple families and their FIHVs) should obtain clear regulatory and taxation advice before setting up in Hong Kong.

Let's talk

For a deeper discussion of how this impacts your business, please contact us.

Tiang & Partners

Gaven Cheong
Partner
Tiang & Partners
+852 2833 4993
gaven.cheong@tiangandpartners.com

Esther Lee
Registered Foreign Lawyer (Counsel equivalent)
Tiang & Partners
+852 2833 4950
esther.yt.lee@tiangandpartners.com

PwC Hong Kong

John Wong
Family Business and Private Client Services Leader
PwC Hong Kong
+852 2289 1810
john.cw.wong@hk.pwc.com

Rex Ho
Asia Pacific Financial Services Tax Leader
PwC Hong Kong
+852 2289 3026
rex.ho@hk.pwc.com

www.pwc.com
www.tiangandpartners.com

Tiang & Partners
程偉賓律師事務所