

立法會
Legislative Council

LC Paper No. CB(1)697/14-15
(These minutes have been seen
by the Administration)

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Panel on Financial Affairs

Minutes of meeting
held on Monday, 5 January 2015 at 10:00 am
in Conference Room 1 of the Legislative Council Complex

Members present : Hon CHAN Kin-por, BBS, JP (Chairman)
Hon Christopher CHEUNG Wah-fung, SBS, JP (Deputy Chairman)
Hon Albert HO Chun-yan
Hon James TO Kun-sun
Hon CHAN Kam-lam, SBS, JP
Hon Abraham SHEK Lai-him, GBS, JP
Hon WONG Kwok-hing, BBS, MH
Hon Jeffrey LAM Kin-fung, GBS, JP
Hon Andrew LEUNG Kwan-yuen, GBS, JP
Hon WONG Ting-kwong, SBS, JP
Hon Starry LEE Wai-king, JP
Hon Mrs Regina IP LAU Suk-ye, GBS, JP
Hon James TIEN Pei-chun, GBS, JP
Hon NG Leung-sing, SBS, JP
Hon Kenneth LEUNG
Hon Dennis KWOK
Hon SIN Chung-kai, SBS, JP

Member absent : Hon Ronny TONG Ka-wah, SC

Public officers attending : Agenda items IV

Mr Billy AU
Acting Principal Assistant Secretary for Financial
Services and the Treasury (Financial Services)2

Mr Daryl HO
Head (Financial Stability Surveillance)
Hong Kong Monetary Authority

Ms Polly LEE
Senior Manager (Financial Stability Surveillance)⁴
Hong Kong Monetary Authority

Agenda item V

Mr Gary POON
Principal Assistant Secretary for Financial Services
and the Treasury (Treasury) (Revenue)

Mr David FONG, CMSM
Assistant Commissioner (Excise and Strategic Support)
Customs and Excise Department

Mr Fred CHAU
Senior Staff Officer (Dutiable Commodities Administration)
Customs and Excise Department

Agenda item VI

Miss Salina YAN, JP
Deputy Secretary for Financial Services and the
Treasury (Financial Services)¹

Ms Joyce HO
Principal Assistant Secretary for Financial Services
and the Treasury (Financial Services)¹

Mr CHIU Kwok-kit, JP
Deputy Commissioner of Inland Revenue (Technical)
Inland Revenue Department

Agenda item VII

Mr Eddie CHEUNG
Deputy Secretary for Financial Services and the
Treasury (Financial Services)²

Miss Nancy CHIEN

Acting Assistant Commissioner of Insurance
(Enforcement)

Attendance by invitation : Agenda item IV

Ms Daphne DOO
Senior Director (Supervision of Markets)
Securities and Futures Commission

Ms Thrity MUKADAM
Director (Supervision of Markets)
Securities and Futures Commission

Ms Eunice CHENG
Senior Manager (Supervision of Markets)
Securities and Futures Commission

Clerk in attendance: Ms Connie SZETO
Chief Council Secretary (1)4

Staff in attendance : Mr YICK Wing-kin
Assistant Legal Adviser 8

Ms Angel SHEK
Senior Council Secretary (1)4

Ms Sharon CHAN
Legislative Assistant (1)4

Action

I Confirmation of minutes of meetings and matters arising

(LC Paper No. CB(1)379/14-15 — Minutes of the meeting on
3 November 2014)

The minutes of the meeting held on 3 November 2014 were confirmed.

II Information papers issued since the last meeting

- (LC Paper No. CB(1)233/14-15(01) — Third Quarter Economic Report 2014 and the press release
- LC Paper No. CB(1)242/14-15(01) — Third quarterly report of 2014 on "Employees Compensation Insurance — Reinsurance Coverage for Terrorism"
- LC Paper No. CB(1)360/14-15 — Quarterly Report of the Securities and Futures Commission (July to September 2014)
- LC Paper No. CB(1)372/14-15(01) — Press release on accrual-based consolidated financial statements of the Government for the year ended 31 March 2014
- LC Paper No. CB(1)390/14-15(01) — Information paper on "Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions) Ordinance (Amendment of Schedule 2) Notice 2015")

2. Members noted the five information papers issued since the last regular meeting held on 3 November 2014.

III Date of next meeting and items for discussion

- (LC Paper No. CB(1)385/14-15(01) — List of outstanding items for discussion)

Follow-up on re-scheduling of the regular meeting on 1 December 2014

3. The Chairman informed members that following cancellation of the regular meeting on 1 December 2014, two of the four agenda items originally scheduled for discussion at that meeting had been deferred to the current

meeting. As regards the remaining two items for which the Financial Secretary ("FS") would attend, i.e. briefing on Hong Kong's latest overall economic situation and 2015-2016 Budget consultation, the Chairman said that he had instructed the Clerk to liaise with the FS Office for FS to attend another Panel meeting on the items. He then invited the Clerk to report on the follow-up actions on the matter.

4. The Clerk said that due to an overseas duty visit and other official commitments, FS was unable to attend another Panel meeting in December 2014. Upon instruction by the Chairman, the Secretariat had written to the FS Office for scheduling another meeting in January 2015. The FS Office advised in its reply letter dated 24 December 2014 that in order to disseminate the essential information on Hong Kong's latest economic outlook to the general public in a timely manner, FS had held a press conference on the subject on 1 December 2014. Members would also be briefed on the subject when the 2015 Policy Address and the 2015-2016 Budget were announced respectively in January and February 2015. Besides, the Budget consultation exercise was launched jointly with the consultation on the Policy Address in October 2014. Given that the relevant information had already been disseminated and the small window of time available before the Policy Address, the FS Office considered that a special meeting of the Panel on the economic situation and Budget consultation in the new year might not be fruitful. However, FS was prepared to brief members if necessary. The Clerk added that the FS Office had provided the transcript of FS' remarks at the press conference on 1 December 2014, the powerpoint slides on Hong Kong's recent economic situation and near-term outlook as well as the 2015-2016 Budget consultation of members' reference. The letter of 24 December 2014 from the FS Office and the above mentioned reference materials were issued to all Legislative Council ("LegCo") Members on 2 January 2015 vide LC Paper No. CB(1)399/14-15. The Chairman added that according to past practice, FS would brief Members on the Budget after the delivery at LegCo, and Members could exchange views with FS on that occasion.

5. Members noted the matters reported above and did not raise any views.

Regular meeting on 2 February 2015

6. The Chairman said that the Panel would receive a briefing by the Secretary for Financial Services and the Treasury on relevant policy initiatives in the Chief Executive's 2015 Policy Address at the next regular meeting on 2 February 2015. Members agreed to discuss the following items proposed by the Administration at the meeting:

- (a) Briefing on the work of Hong Kong Monetary Authority ("HKMA");
- (b) Budget of Securities and Futures Commission ("SFC") for the financial year of 2015-2016; and
- (c) Second stage of public consultation on establishing an effective resolution regime for financial institutions in Hong Kong.

7. Members further agreed that the next regular meeting on 2 February 2015 should start at 8:45 am so as to allow sufficient time for discussion of the agenda items.

(Post-meeting note: At the request of the Administration and with the concurrence of the Chairman, item (c) above was subsequently deferred to a future meeting of the Panel. Members were informed accordingly on 26 January 2015 vide LC Paper No. CB(1)478/14-15.)

IV Proposed implementation of the first phase of the over-the-counter derivatives regulatory regime in Hong Kong

(LC Paper No. CB(1)269/14-15(04) — Administration's paper on "First Phase of Implementation of the Over-the-counter Derivatives Regulatory Regime in Hong Kong"

LC Paper No. CB(1)269/14-15(05) — Background brief on the over-the-counter derivatives regulatory regime in Hong Kong prepared by the Legislative Council Secretariat)

Briefing by the Administration

8. With the aid of a powerpoint presentation, the Acting Principal Assistant Secretary for Financial Services and the Treasury (Financial Services)2 ("Atg PAS(FS)2") briefed members on the background of the over-the-counter derivatives regulatory regime in Hong Kong ("OTC derivatives regulatory regime"). The Head (Financial Stability Surveillance), HKMA ("H(FSS)/HKMA") highlighted on the major proposals in respect of

mandatory reporting and record keeping for the first phase implementation of the OTC derivatives regulatory regime, which would be covered in the proposed Securities and Futures (OTC Derivative Transactions – Reporting and Record Keeping Obligations) Rules ("Reporting Rules") to be made by SFC.

(Post-meeting note: The notes of the powerpoint presentation (LC Paper No. CB(1)410/14-15(01)) were issued to members vide Lotus Notes e-mail on 5 January 2015.)

Discussion

Mandatory reporting of OTC derivatives transactions

9. Noting that the reportable transactions to be included in the first phase implementation of the OTC derivatives regulatory regime would only cover certain types of interest rate swaps ("IRS") and non-deliverable forwards ("NDF"), Mr SIN Chung-kai was concerned that the mandatory reporting obligations might not address problems revealed by the global financial crisis of 2008, such as mis-selling of complex financial products like the Minibonds.

10. H(FSS)/HKMA responded that the 2008 financial crisis was triggered by a series of financial events and had multiple causes, including structural deficiencies in the OTC derivatives market. It was noted then that the absence of regulation and the bilateral nature of OTC derivatives transactions had caused great difficulties for regulators to assess OTC derivatives positions of market players in monitoring the build-up of exposures that might impose risks on the market or the wider economy. The global nature of OTC derivatives transactions also contributed to the interconnectedness of market players in various jurisdictions, thus giving rise to contagion risks. The Group of Twenty Leaders therefore joined efforts to mandate and coordinate the regulatory requirements in respect of OTC derivatives transactions in order to better assess and mitigate the contagion risks. As regards the scope of reportable OTC derivatives transactions, he explained that IRS and NDF would be covered in the first phase of implementation as they were the major types of such transactions conducted in Hong Kong. HKMA and SFC would consider extending the coverage to include other types of OTC derivatives transactions when appropriate.

11. Mr James TO enquired whether Renminbi ("RMB") and the Russian Rouble would be included in NDF currencies to be covered as reportable transactions under the OTC derivatives regulatory regime. H(FSS)/HKMA responded that it would depend on the product class and type in question. For IRS, the scope would initially cover globally traded currencies (e.g. the United

States ("US") Dollar, European Euro, Japanese Yen and United Kingdom Sterling) under the currency codes of International Organization for Standardization, whereas NDFs would also cover a range of currencies including RMB and Rouble.

12. Mr NG Leung-sing noted that under the OTC derivatives regulatory regime, authorized institutions ("AIs"), approved money brokers ("AMBs") and licensed corporations ("LCs") were required to report reportable transactions if they were a counterparty to such transactions; or they had conducted such transactions in Hong Kong on behalf of an affiliate. He enquired about the overseas jurisdictions with similar requirements in place.

13. H(FSS)/HKMA said that the first reporting limb (i.e. reporting obligation where AIs, AMBs and LCs were a counterparty) was a common requirement in nearly all overseas OTC derivatives regulatory regimes and reference had been made mainly to the frameworks in US, the European Union and major international financial markets in working out Hong Kong's regime. As regards reporting requirement of reportable transactions conducted in Hong Kong on behalf of an affiliate, it was also adopted by some jurisdictions including Singapore and Australia. H(FSS)/HKMA pointed out that, as OTC derivatives transactions might typically be booked with an overseas affiliate in the same group (i.e. overseas affiliate rather than the local entity was a counterparty to the transaction), it was necessary to capture these transactions as well in order to obtain a full picture of OTC derivatives activities in Hong Kong.

14. Mr WONG Kwok-hing expressed support for the proposals in the first phase implementation of the OTC derivatives regulatory regime to enhance regulation and stability of the local financial market. He enquired whether the Reporting Rules would specify the applicable period on historical transactions requiring mandatory reporting (i.e. backloading obligation). Mr NG Leung-sing noted that there would be a nine-month grace period to ensure reporting entities had enough time to set up the necessary system connection for reporting and complete backloading of relevant historical transactions, etc. He enquired about the industry's views on this proposal.

15. H(FSS)/HKMA said that under the current proposal, reporting entities should backload historical transactions as long as they were still outstanding when the Reporting Rules came into effect, regardless of the contract period of the transactions in question. Hence, it would not be necessary to specify a retrospective period for tracing such transactions. As regards the nine-month grace period, he said that the current proposal had taken into account industry's views and was supported by the market.

16. On the sharing of data collected by HKMA via the Hong Kong Trade Repository for regulatory and market surveillance purposes, Mr NG Leung-sing stressed the need to avoid disclosure of confidential and sensitive particulars. H(FSS)/HKMA advised that HKMA would adhere to international standards whereby public disclosure of the data collected via trade repositories would be made in summary form according to the OTC derivatives product/transaction types without showing the particulars of individual transactions. This would ensure that sensitive data, such as the OTC derivatives positions held by individual market player, could not be ascertained.

Exemptions and exclusions

17. Referring to the proposal to exempt AIs, AMBs and LCs which were small players and inactive in the OTC derivatives market from the reporting transactions where they were a counterparty to (except if they had conducted transactions in Hong Kong on behalf of an affiliate), Mr Christopher CHEUNG enquired about the definition of "small players". He cautioned that OTC derivatives transactions undertaken by small players could also give rise to systemic risks.

18. H(FSS)/HKMA said that under the current proposal, an AI, AMB or LC would be considered a small player if the aggregate gross notional value of its outstanding OTC derivatives transactions did not exceed US\$30 million. He pointed out that the systemic risks posed by the systemically important financial institutions or large market players were higher in view of the relatively larger positions of OTC derivatives in their portfolio and the interconnectedness of these players. Granting exemption for small players would strike a balance between ensuring regulatory oversight and smooth operation of the market; and avoiding unreasonable compliance costs on market participants if they only occasionally engaged in such transactions, or the impact of the transactions was relatively insignificant.

19. Mr James TO sought clarification about whether mandatory reporting obligation would apply to sovereign states for OTC derivatives transactions conducted directly among themselves in Hong Kong. The Senior Manager (Financial Stability Surveillance)⁴, HKMA said that the obligation would apply to prescribed persons which initially included AIs, AMBs, LCs and certain central counterparties ("CCPs"). Sovereign states were not covered under prescribed persons in any event. If an AI, AMB or LC was a counterparty to a reportable transaction conducted between two sovereign states, they being reporting entities would need to report the transaction. H(FSS)/HKMA pointed out that it was likely for sovereign states to conduct

OTC derivatives transactions through financial institutions as the latter were the major providers of market liquidity.

20. Mr James TO queried the justification for excluding sovereign states from the mandatory reporting obligation, given that systemic risks could arise from defaults of OTC derivatives transactions conducted directly among such states. He enquired about the reference drawn from international requirements/practices in this regard. H(FSS)/HKMA and the Senior Director (Supervision of Markets), SFC reiterated that mandatory reporting obligation initially applied only to AIs, AMBs, LCs and CCPs that provided clearing services to persons in Hong Kong, and in any event not applied to foreign entities with no Hong Kong nexus because they were not governed by Hong Kong legislation. At the request of Mr TO, the Administration agreed to provide written information to clarify –

- (a) whether mandatory reporting obligation applied to sovereign states for OTC derivatives transactions conducted directly among themselves in Hong Kong, and if not, provide justifications with reference to international practices;
- (b) how potential systemic risks arising from transactions in (a) above would be mitigated; and
- (c) whether mandatory reporting obligation applied to market intermediaries (i.e. AIs, AMBs, LCs and CCPs) engaged by the sovereign states for conducting OTC derivatives transactions in Hong Kong.

(Post-meeting note: The Administration's written response was circulated to members vide LC Paper No. CB(1)476/14-15(01) issued on 23 January 2015.)

Mandatory record keeping for OTC derivatives transactions

21. Mr WONG Kwok-hing noted that reporting entities would be required to keep sufficient records to demonstrate compliance with their reporting obligations, and the proposed record retention period was five years from the date the transaction matured or was terminated. He asked whether the Administration would align the record retention period with the usual requirement of seven years under other local legislation. H(FSS)/HKMA explained that Hong Kong was on a par with practices among other major financial markets to require keeping of OTC derivatives transaction records for five years. Given the global nature of OTC derivatives market, it was necessary

to align the record retention period with those of other major financial centres in order to facilitate compliance by market players.

Compliance costs on market participants and penalties for breaches of mandatory obligations

22. Mr NG Leung-sing emphasized the need to minimize compliance costs on market participants, such as by simplifying the mandatory reporting process with increased use of information technology and reducing manual input. Atg PAS(FS)2 said that when preparing the Reporting Rules, HKMA and SFC were mindful of the cost impact on the industry, and the need to strike a balance between enhancing regulation and keeping compliance costs at a reasonable level.

23. In response to Mr WONG Kwok-hing's enquiry on the penalties for breaches of mandatory obligations, Atg PAS(FS)2 said that civil fines would be imposed on any person who breached the mandatory obligations. For breaches by AIs, AMBs or LCs, HKMA and SFC would be empowered to take disciplinary actions against them, including imposing disciplinary fines, making public/private reprimand and prohibiting them from carrying on OTC derivatives business.

Conclusion

24. The Chairman concluded that members did not object to the Administration tabling the Reporting Rules before LegCo in the first quarter of 2015 for the first phase implementation of the OTC derivatives regulatory regime.

V Proposed revision of fees and charges for services under the Customs and Excise Department

(LC Paper No. CB(1)269/14-15(06) — Administration's paper on "Proposed Revision of Fees and Charges for Services under the Customs and Excise Department")

Briefing by the Administration

25. At the invitation of the Chairman, the Principal Assistant Secretary for Financial Services and the Treasury (Treasury) (Revenue) ("PAS(Tsy)(R)") briefed members on the Administration's plan to revise 20 fee items relating to

dutiable commodities and motor vehicles managed under the Customs and Excise Department ("C&ED") as set out in the Administration's paper (LC Paper No. CB(1)269/14-15(06)).

Discussion

26. Mr WONG Kwok-hing expressed support for the fee revision proposal as it was in line with the Government's policy to uphold the "user-pay" principle. He noted that among the 20 fee items covered in the current proposal, item 11, i.e. fee for every certificate of the Government Chemist that any spirits or methyl alcohol were denatured ("certificate fee"), in the Annex to the Administration's paper, had not been adjusted for 40 years since 1974; and the cost recovery level after the proposed increase of \$1 was merely 43%. He queried why the fee adjustment was not made earlier or more frequently to achieve a more gradual cost recovery ratio. He was concerned if this reflected negligence on the part of the Administration.

27. Mr SIN Chung-kai observed that notwithstanding improvement in the cost recovery ratios for the 20 fees items after the proposed revision, there was still a gap for the fees to reach the full cost recovery level. Noting that 19 fees items were last revised in 2010, Mr SIN enquired whether the Administration had worked out a timetable for conducting systematic fees reviews at regular intervals, with a view to achieving full cost recovery early. In the absence of timely adjustment in fees, he was concerned that the cost recovery ratios would deteriorate rendering it more difficult to achieve full cost recovery in the long run. The Chairman asked whether the Administration would consider conducting fee reviews at more frequent intervals.

28. PAS(Tsy)(R) advised that it was Government's policy that fees charged for public services should in general be set at levels sufficient to recover the full cost of providing the services. The Government would conduct regular costing reviews and make necessary adjustments to the fee levels, with a view to achieving full cost recovery. In accordance with the general fee revision guidelines, the magnitude of increase would depend on the cost recovery ratio of the fee item concerned (for example, a fee should be increased by 20% if the cost recovery ratio was below 40%). The arrangement aimed at avoiding drastic fee adjustment and undue impact on the relevant trades. Accordingly, the level of increase proposed under the current fee review exercise was in the range of 10% to 20%, which was comparable to the increase in the previous adjustment exercise. PAS(Tsy)(R) assured members that the Administration would continue to review the various fees and charges under C&ED on a regular basis and consider making adjustments when necessary and appropriate in accordance with the established principles for "cost recovery". As regards the certificate fee item, PAS(Tsy)(R) explained that it was covered in previous

reviews, but no adjustment was found required on those occasions because the fee item could achieve full cost recovery (or was at a level near to full cost recovery) or because of other reviews. However, the current costing review revealed that the fee was too low to achieve full cost recovery and hence a fee revision was proposed.

Conclusion

29. The Chairman concluded that members did not object to the Administration introducing the legislative amendments for the proposed fee revision into LegCo in early 2015.

VI Proposed extension of profits tax exemption for offshore funds to private equity funds

(LC Paper No. CB(1)385/14-15(02) — Administration's paper on "Legislative Proposal to Extend Profits Tax Exemption for Offshore Funds to Private Equity Funds")

Briefing by the Administration

30. With the aid of a powerpoint presentation, the Deputy Secretary for Financial Services and the Treasury (Financial Services)1 ("DS(FS)1") briefed members on the legislative proposal to extend profits tax exemption for offshore funds to private equity funds.

(Post-meeting note: The notes of the powerpoint presentation (LC Paper No. CB(1)410/14-15(02)) were issued to members vide Lotus Notes e-mail on 5 January 2015.)

[At about 11:05 am, the Chairman directed that the meeting be suspended to allow members to cast votes on a motion at the meeting of the Panel on Development held concurrently in another conference room. The meeting was resumed at about 11:16 am.]

Discussion

Qualifying conditions for offshore private equity funds and portfolio companies

31. Mr NG Leung-sing noted that, for an offshore private equity fund to be a "qualifying fund" and hence be eligible for tax exemption, one of the conditions was that at all times after the final close of sale of interests, there were five or more investors (who were not associates of the originator of the fund). He sought the reasons for setting the threshold at "five or more investors". DS(FS)1 explained that the proposed minimum number of investors had taken into account the typical characteristics of private equity funds including the number of investors on average. The purpose was to ensure that only bona fide private equity funds would be eligible for tax exemption and to prevent abuse or round-tripping by onshore private equity funds and other entities disguised as offshore funds.

32. As the Administration's proposal was meant to extend profits tax exemption for offshore funds to private equity funds in respect of transactions in securities in eligible overseas portfolio companies, and the exemption relief must not benefit the portfolio companies directly, Mr Kenneth LEUNG questioned the policy considerations for imposing the proposed restrictive qualifying conditions on the portfolio companies as set out in paragraph 11 of the Administration's paper. Mr LEUNG pointed out that portfolio companies in question were already subject to profits tax and their dividends would only be distributed after payment of the profits tax. From a wider economic perspective, he urged that the Administration should consider relaxing the conditions and/or waiving the conditions for certain types of portfolio company (e.g. high-technology and innovative companies), so as to attract these companies in using Hong Kong as a platform for corporate financing and asset management through private equity funds. Mr LEUNG also suggested relaxing the requirement if the portfolio company's income derived from Hong Kong did not exceed a specified threshold (say 5% to 10%) of its total income.

33. The Deputy Commissioner of Inland Revenue (Technical) ("DCIR(T)") explained that, as announced by FS in his 2013-2014 Budget, the current proposal was meant to extend profits tax exemption for offshore funds to include transactions in private companies which were incorporated or registered outside Hong Kong and did not hold any Hong Kong properties nor carry out any business in Hong Kong. The proposed qualifying conditions in paragraphs 11(b) and 11(c) of the Administration's paper would serve as safe harbour within which the portfolio companies in question could be accepted as having met the policy objective.

34. As regards Mr Kenneth LEUNG's suggestion of adopting an income threshold for portfolio companies, DCIR(T) responded that the proposed asset threshold (whereby the portfolio company should not directly or indirectly hold share capital in one or more private companies carrying on any business through or from any permanent establishment in Hong Kong, with the aggregate value of which capital exceeding 10% of the value of its own assets) reflected the views gathered from the fund industry during consultation. For the term "permanent establishment", reference had been made to a relatively less stringent definition adopted by the Organization for Economic Cooperation and Development. While there was a suggestion from the fund industry that the income threshold might be adopted, they ultimately agreed to use the asset threshold. DS(FS)1 supplemented that the asset threshold in question had taken into account the operational needs of such companies (e.g. setting up offices in Hong Kong for exhibition of business). At the request of Mr LEUNG, the Administration agreed to provide a written response to his enquiries above.

(Post-meeting note: The Administration's written response was circulated to members vide LC Paper No. CB(1)476/14-15(02) issued on 23 January 2015.)

35. Mr Kenneth LEUNG enquired whether and how the Inland Revenue Department would take into account the nature of income (i.e. whether it was profits or capital income) derived from transactions conducted by onshore private equity funds in respect of portfolio companies before levying taxes.

36. DCIR(T) said that based on the territorial source principle of taxation adopted by Hong Kong, profits tax was only charged on profits which arose in or were derived from a business carried on in Hong Kong. Specifically, the operations test was to ascertain whether the activities of an onshore private equity fund (e.g. investment, financing, management and divestment of the portfolio companies concerned) were carried on in Hong Kong, and each case should be determined on its own merits. If the activities were carried on in Hong Kong, it was likely that the profits so derived would be taxable whereas income accrued from passive holding of the portfolio companies' equities in absence of active business and management activities would likely be regarded as capital income not subject to profits tax.

37. DS(FS)1 added that as extending profits tax exemption to onshore funds would involve much broader considerations having regard to the diverse types of investment activities, fair arrangement for different sectors and issues of tax avoidance, it would take longer time to consider the suggestion in detail. The fund industry appreciated the issues involved and welcomed the current

proposal to extend profits tax exemption for offshore funds to private equity funds as a first step.

Benefits of extending tax exemption to offshore private equity funds

38. Mr SIN Chung-kai enquired about the quantifiable targets to be met by the current proposal, such as the estimated growth in the total capital under management in private equity funds in Hong Kong, or the estimated number and major markets of private equity funds to be attracted to operate business in Hong Kong.

39. Mr WONG Kwok-hing questioned the need to extend the profits tax exemption for offshore funds to private equity funds, as he noted that even without the proposed tax exemption, the total capital under management in private equity funds in Hong Kong had achieved a substantial year-on-year increase of 16% in 2013. Mr James TIEN enquired whether the current proposal served to put Hong Kong on equal footing with Singapore in similar tax initiatives for offshore funds.

40. Mr NG Leung-sing expressed support for the proposal as it was conducive to attracting more funds to operate business in Hong Kong, and hence would benefit the local economy at large. Referring to the taxation arrangements in respect of "leverage leasing", Mr NG said that the Administration should carefully assess the benefits and cost implications on related trades before implementation or withdrawal of any tax proposal.

41. DS(FS)1 said that, as reflected by the fund industry, a number of private equity fund managers had indicated interest to set up or expand their fund business in Hong Kong and use Hong Kong as a platform for managing assets. In particular, there was keen interest from the Mainland market players in raising private equity funds in Hong Kong for making investment in the Mainland. All along, there were calls from the fund industry for providing clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas portfolio companies, taking into account similar measures/proposals by other competitors (e.g. Singapore) in the region. The Administration therefore considered it both necessary and worthwhile to strengthen the measures in Hong Kong with a view to expanding its fund market and enhancing competitiveness amidst regional competition. As observed, there was still considerable room for further growth in Hong Kong's share in Asia's total capital under management in private equity. DS(FS)1 added that, while it would be difficult to quantify the targets or benefits, the current proposal was expected to attract more private equity fund managers to hire local asset management, investment and advisory services which would be conducive to further development of Hong Kong's asset

management industry. This would in turn drive demand for other relevant professional services, such as accounting and legal services. As regards the major markets of private equity funds likely attracted to operate in Hong Kong, DS(FS)1 said that the objective of the proposal was to develop Hong Kong as an asset management hub which was not confined to a particular market or specific location of investment by the private equity funds.

42. Mr WONG Kwok-hing enquired about the estimated revenue forgone as a result of the proposal. DS(FS)1 and DCIR(T) said that while the Administration did not have the information at hand, reduction in tax revenue arising from the proposal was expected to be minimal since profits tax exemption was already applicable to offshore funds at present. DCIR(T) added that as the current proposal would attract more private equity fund managers to operate business in Hong Kong by providing clear tax exemption to transactions conducted by offshore private equity funds in respect of eligible overseas portfolio companies, the potential increase in tax revenue and other economic benefits brought by the associated business activities would far outweigh the reduction in profits tax arising from the proposal.

43. Given that offshore funds had already been exempted from profits tax since 2006, Mr James TIEN opined that the proposed extension of the tax exemption to private equity funds only served to facilitate the originators or managers of such funds rather than bringing benefits to investors concerned.

44. DS(FS)1 said that, while profits tax exemption was currently applicable to offshore funds, the existing definition of "securities" did not include securities of a private company. Besides, private equity business might not necessarily be managed by corporations licensed by SFC as required by the current exemption provisions. It was therefore necessary to provide clear tax exemption to transactions in securities conducted by offshore private equity funds through the proposed legislative amendments. Referring to the increasing trend of professional or high-end investors allocating their assets in private equity funds, DS(FS)1 said that investors of private equity funds might benefit directly or indirectly from the proposal in terms of potential increase in investment returns from the funds as a result of profits tax exemption.

45. Mr James TIEN enquired whether the proposal would help attract more investment through private equity funds operating in Hong Kong and trading in the Shanghai-Hong Kong Stock Connect ("S-HK SC"). DS(FS)1 pointed out that S-HK SC established mutual stock market access between Shanghai and Hong Kong for trading of securities of public companies whereas the current proposal was meant to extend profits tax exemption for offshore funds to include transactions in private companies which were incorporated outside Hong Kong. If the private companies in question could meet the relevant

requirements for listing in Hong Kong or Shanghai, they would also benefit from S-HK SC in the long run. DCIR(T) supplemented that, although private equity funds invested mainly in private companies, the fund managers might make use of surplus cash (if any) of the funds to invest in the securities of listed companies including eligible shares under S-HK SC.

Conclusion

46. The Chairman concluded that members did not object to the Administration introducing the relevant legislative amendments into LegCo in the first half of 2015 for extending the profits tax exemption for offshore funds to private equity funds.

VII Proposal for staffing support to implement regulatory reforms for the insurance industry

(LC Paper No. CB(1)385/14-15(03) — Administration's paper on "Creation/extension of Supernumerary Directorate Posts in the Financial Services and the Treasury Bureau (Financial Services Branch) for establishing an independent Insurance Authority"

LC Paper No. CB(1)385/14-15(04) — Background brief on proposal for staffing support to implement regulatory reforms for the insurance industry prepared by the Legislative Council Secretariat)

Briefing by the Administration

47. At the invitation of the Chairman, the Deputy Secretary for Financial Services and the Treasury (Financial Services)² ("DS(FS)2") briefed members on the proposal to create/extend three supernumerary directorate posts in the Financial Services Branch under the Financial Services and the Treasury Bureau to implement reforms for the insurance industry, as set out in the Administration's paper (LC Paper No. CB(1)385/14-15(03)).

Discussion

48. Mr WONG Kwok-hing and Mr SIN Chung-kai expressed support for the proposed creation/extension of the supernumerary directorate posts for establishing the independent Insurance Authority ("IIA") which aimed to, among other things, enhance protection of policyholders' interest. Mr WONG stressed that the Administration should ensure smooth transfer of regulatory powers and expertise from the Office of the Commissioner of Insurance ("OCI") to IIA.

49. DS(FS)2 advised that IIA would recruit staff through open recruitment. There were some 150 staff in OCI, of which 22 were general grade staff and others were professional officers in insurance, accounting or actuarial fields. It was likely that OCI staff would apply for openings in IIA and they had a competitive edge due to their regulatory experience. Therefore, regulatory expertise was unlikely to be lost due to the institutional changes.

50. On the creation of a supernumerary post of Principal Executive Officer ("PEO") to head a Preparatory Team to help set up IIA, Mr SIN Chung-kai enquired if the relevant duties could be absorbed by the existing staff members of OCI.

51. DS(FS)2 responded that in formulating the current proposal, reference had been made to other statutory bodies (e.g. the Competition Commission and the West Kowloon Cultural District Authority) on additional manpower required for undertaking the preparatory work where new posts were created for over 12 months in the relevant preparatory teams to support initial operations of the new bodies. The feasibility of internal redeployment of resources had been explored but was considered not viable as the existing staff of OCI were fully engaged by the ongoing regulatory duties and initiatives. Besides, the Preparatory Team headed by the new PEO would be involved in preparing for open recruitment of staff for IIA and assisting IIA to determine the remuneration packages for its employees. It would be more appropriate for a separate team to handle such work given that OCI officers were likely to apply for openings in IIA.

Conclusion

52. The Chairman concluded that members supported the Administration submitting the staffing proposal for consideration of the Establishment Subcommittee.

VIII Any other business

53. There being no other business, the meeting ended at 12:05 pm.

Council Business Division 1
Legislative Council Secretariat
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