KPMG

香港信託人公會
Hong Kong Trustees' Association

Hong Kong Trust Industry Spotlight:

Enhancing its competitive edge

October 2017

Contents

Vivian Chui

Partner, KPMG China

Foreword (KPMG China)

KPMG China, together with the Hong Kong Trustees' Association, is pleased to present the second edition of the Hong Kong Trust Industry Report, a follow-up to our highly successful inaugural publication in June 2013.

A pivotal part of the Hong Kong financial services sector, the trust industry has undergone numerous changes since our previous report. The Hong Kong Trustee Ordinance, which is the underlying statutory foundation of the industry, has been modernised to facilitate more effective trust set-up and administration.

There have also been several landmark initiatives within the broader financial sector that have impacted the trust industry, such as the launch of Mutual Recognition of Funds, Shanghai-Hong Kong Stock Connect, Shenzhen Connect and Bond Connect.

The main objective of this report is to highlight the key developments concerning the trust industry and understand the challenges as well as opportunities such changes have brought about. In addition, the report presents various suggestions gathered from market practitioners on the areas Hong Kong should look at addressing in order to enhance the trust industry's competitiveness.

We would like to express our utmost gratitude to the Hong Kong Trustees' Association for their input, and to all the senior executives we interviewed for providing their valuable insights. We would also like to thank the many institutions and market practitioners who took the time out to participate in our independent Hong Kong Trust survey.

Last but not least, we are grateful for the feedback from the various government bodies and regulators for providing their views and outlook of the Hong Kong trust industry. All your comments, suggestions and views were essential in helping to put this report together.

Vivian Chui

Partner, KPMG China

Foreword (HKTA)

Michael Shue

Chairman, HKTA

Hong Kong is a major international financial centre and the Hong Kong Trustees' Association (HKTA) represents the trust and fiduciary services industry in Hong Kong. I am delighted that KPMG has joined with the HKTA again to produce the second report on the Hong Kong trust industry. The objective of this report, which follows on from the inaugural report in 2013, is to provide an update on the overview of Hong Kong's diverse trust market. This includes taking key snapshots of its characteristics, wide range of participants, latest developments, challenges and issues, and offering insights into the trends and developments in the coming years.

The HKTA's collaboration with KPMG on this second project reflects our continued commitment to facilitating the growth and development of the trust industry. Our active participation in various initiatives as below has reinforced our position as an important representative body that works with the government and regulators to steer the direction of the trust and fiduciary services industry. These initiatives include:

- The HKTA's consultation with Hong Kong Government bodies (such as the Financial Services and the Treasury Bureau, the Security Bureau, Inland Revenue Department and Companies Registry) on:
  - The licencing and regulation of trust and company service providers by enhancing the Anti-Money Laundering and Counter-Terrorist Financing Ordinance,
  - The introduction of a register of beneficial owners for Hong Kong companies by amending the Companies Ordinance,
  - The amendment of the Inland Revenue Ordinance to mandate financial institutions to identify and collect information in relation to accounts held by tax residents of Automatic Exchange Of Information Partners of Hong Kong to comply with the Common Reporting Standards of the Organisation for Economic Co-operation and Development;

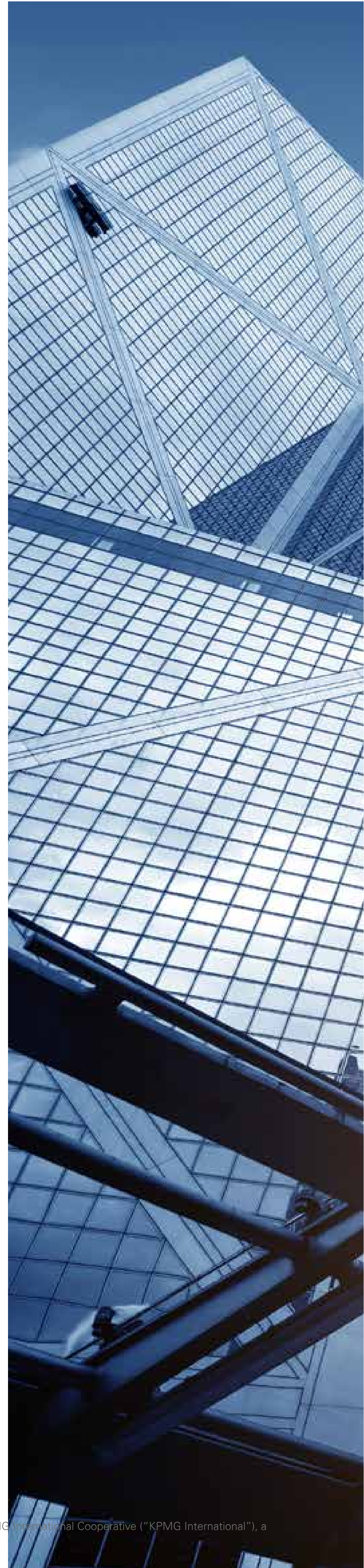
- The continuing review of the MPF system;
- The issuance of Best Practice Guides/Practice Guidelines to raise the standards and credibility of Hong Kong trust practitioners; and
- The preparation of a formal accreditation and training program for trust practitioners.

I am grateful for the support of the Executive Committee, and would like to express our sincere appreciation to the excellent team of professionals at KPMG whose expertise and dedication were invaluable in putting this second report together. My gratitude also goes to the many groups and individuals who have contributed to this report - members of the HKTA taskforce responsible for collaborating with KPMG on this initiative, the association's members, the HKSAR government and regulators, as well as trust practitioners, professional groups and companies for providing useful information to the survey and for sharing their candid views in interviews with the KPMG team.

We hope that you will find this report interesting and useful for understanding how the diverse trust industry in Hong Kong has evolved and developed since our 2013 report, and that you will continue to support us in promoting this important sector of the Hong Kong economy. The trust and fiduciary services industry is entering an increasingly challenging phase with so many new regulatory developments and market opportunities. If we face it with commitment, integrity, professionalism and excellence, we can further strengthen Hong Kong's role as a modern trust jurisdiction and reinforce the HKSAR's position as a major financial and trust centre.

Michael Shue

Chairman, HKTA



About HKTA

The Hong Kong Trustees' Association Limited was established in 1991 by members of the trust and fiduciary services sectors to represent the trust industry in Hong Kong, particularly in the areas of legislation and education. It is a not-for-profit company limited by guarantee and incorporated in Hong Kong. The Trustees' Association currently has more than 110 corporate members, and represents thousands of people working in the trust, pension, private banking, asset servicing, legal, accounting, and other professional services fields.

Our mission:

- Represent the trust industry in promoting high standards of professionalism, corporate governance and regulatory compliance;
- Contribute towards advancing the status of Hong Kong trust professionals and that of the industry internationally;
- Represent the industry to the government, the media, local and international professional bodies and the public in promoting Hong Kong as an international trust and fiduciary services centre; and
- Promote quality standards for the industry by the issuance of Best Practice Guides applicable to corporate trusts, pension schemes, private trusts and charitable trusts;
- Contribute towards enhancing the education and knowledge of practitioners in the trust industry through a relevant accreditation and training programme for trust practitioners.

Acknowledgements

We would like to thank the following individuals for participating in the interviews and providing us with their invaluable insights:

Arthur Bacci	Chairman, Hong Kong Investment Funds Association
Phillip Andrew Bretnall	Chief Executive Officer, HSBC Provident Fund Trustee (Hong Kong) Limited
Seth Bohart	Managing Director, Plan Managers (Asia), Computershare Hong Kong
Carolyn Butler	Executive Director and CEO, The Hong Kong Trust Company Limited
Eddie Cheung	Deputy Secretary, Financial Services and the Treasury Bureau
Christina Choi	Executive Director (Investment Products), Securities and Futures Commission
Rebecca Chow	Director, Trident Trust Co HK Limited
Alex Chu	Chief Executive Officer, BOCI Prudential Trustee Limited
Andrew Fung	Director and General Manager, Hang Seng Investment Management Limited
Stephen Fung	Chief Executive Officer, AIA Company (Trustee) Limited and AIA Pension and Trustee Co. Limited
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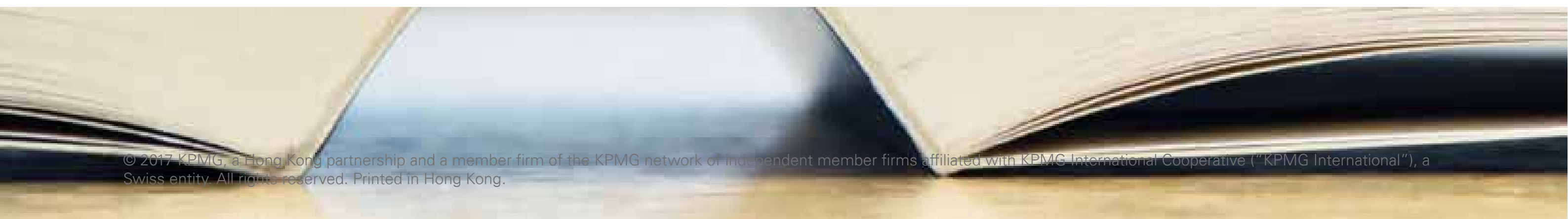
Ruth Kung	Chief Executive, Hong Kong Securities and Investment Institute
Loretta Lam	Executive Committee Member, Hong Kong Trustees' Association
Saren Lam	Hang Seng Investment Management Limited
Ka Shi Lau	Managing Director & Chief Executive Officer, BCT Group (BCT Financial Ltd / Bank Consortium Trust Co. Ltd)
Alice Law	Chief Operating Officer and Executive Director, Mandatory Provident Fund Schemes Authority
Eva Law	Founder and Chairman, Association of Family Offices in Asia
Phyllis Lee	Chief Operating Officer, Computershare Hong Kong
Ellis Liu	Deputy Chief Investment Officer, Hang Seng Investment Management Limited
John Maguire	Chairman, Hong Kong Securities and Investment Institute
Philip Marcovici	Offices of Philip Marcovici, Hong Kong
Stefano Mariani	Counsel and Head of Tax and Trusts, Deacons
Jimmie Ng	Head of Fiduciary and Fund Services, Greater China and North Asia Region, Standard Chartered Trust (Hong Kong) Limited
Nigel Rivers	Chief Executive Officer, Capital Solutions Limited
Mark Shipman	Partner, Clifford Chance
Michael Shue	Executive Director, Trust Services, Vistra
Richard Weisman	Senior Tax Partner, Baker McKenzie
Brent York	Managing Director, Global Head of Solutions Development, Private Wealth Solutions, HSBC

Note: All titles as at the date of interviews, which were conducted in mid-2017

Glossary

AEOI	Automatic Exchange of Financial Account Information
AM	Administration Master
AMF	Autorité des Marchés Financiers
AML	Anti-Money Laundering
AUM	Assets Under Management
BVI	British Virgin Islands
C&SD	Census and Statistics Department
CFA	Chartered Financial Analyst
CO	Companies Ordinance
CPWP	Certified Private Wealth Professional
CRS	Common Reporting Standard
CTF	Counter-Terrorist Financing
DIS	Default Investment Strategy
EBT	Employee Benefit Trust
ECF	Enhanced Competency Framework
ESP	Employee Share Plan
ESOP	Employee Share Ownership Plan
ESPP	Employee Share Purchase Plan
ETF	Exchange-Traded Fund
FATCA	Foreign Account Tax Compliance Act
FATF	Financial Action Task Force
FER	Fund Expense Ratio
FSTB	Financial Services and the Treasury Bureau
HKEx	Hong Kong Stock Exchange
HKMA	Hong Kong Monetary Authority
HKMC	Hong Kong Mortgage Corporation
HKTA	Hong Kong Trustees' Association
HKTO	Hong Kong Trustees Ordinance
IA	The Insurance Authority
IRD	Inland Revenue Department
IRO	Inland Revenue Ordinance

LegCo	Legislative Council
LSP	Long Service Payment
MPF	Mandatory Provident Fund
MPFA	Mandatory Provident Fund Schemes Authority
MPFSO	Mandatory Provident Fund Schemes Ordinance
MRF	Mutual Recognition of Funds
MSME	Micro, Small and Medium-Sized Enterprise
OCI	Office of the Commissioner of Insurance
OECD	Organisation for Economic Co-operation and Development
OFC	Open-Ended Fund Company
ORSO	Occupational Retirement Schemes Ordinance
PTC	Private Trust Company
REIT	Real Estate Investment Trust
RS/U	Restricted Share Unit Plan
SFC	Securities and Futures Commission of Hong Kong
SP	Severance Payment
SRO	Self-Regulatory Organisation
STAR	Special Trusts Alternative Regime
STEP	Society of Trust and Estate Practitioners
S-VACC	Singapore Variable Capital Company
TCSP	Trust or Company Service Provider
UGC	University Grants Committee
UHNWI	Ultra High Net Worth Individual
UCITS	Undertakings for the Collective Investment of Transferable Securities
VISTA	British Virgin Islands Special Trusts Act
WAM Pilot Programme	Pilot Programme to Enhance Talent Training for the Asset and Wealth Management Sector



Executive summary

The future of the Hong Kong trust industry looks both promising and challenging as the competition continues to intensify regionally and globally. The main objective of this report is to outline the latest industry trends in Hong Kong and provide insights on how the HKSAR can enhance its competitive edge. This includes suggestions to expand the size of the industry and the range of services that will reinforce Hong Kong's position as a premier trust jurisdiction in the long term.

In this report, we have identified a number of key challenges and areas that the HKSAR should look at addressing:

1) The compliance conundrum

Trust companies are spending an increasing amount of time and effort on compliance and regulatory matters, which has led to a surge in operating costs. The higher cost either undermines profitability or is passed on to clients, neither of which is positive for the industry. Some companies are turning to technology-based solutions, while others are calling for the government to develop simplified policies for global compliance.

2) Improving the talent pool

A common theme expressed by interviewees is the shortage of talent across many aspects of the industry such as trust administration, legal and compliance, and client management. A lack of formal training and qualifications for trust professionals was widely cited as an issue. However, the HKTA is working with the Hong Kong Securities and Investment Institute (HKSI) on providing a solution.

3) Streamlining of the regulatory framework

The diverse nature of the Hong Kong trust industry means the regulatory regime is highly fragmented. While the areas under

governance are defined, there are overlaps in the reporting, licencing and approval processes. The regulation of trust companies was the industry's top pick as the most effective method to drive further development, while some respondents have called for a single regulator model, which could streamline disclosures and boost efficiencies.

4) Clarity on tax

The application of current tax legislation to trusts and, in particular, trusts carrying on a trade or business in Hong Kong, is considered somewhat opaque by many practitioners. Greater clarity and certainty is therefore regarded as desirable and can enhance Hong Kong's competitiveness as a trust jurisdiction. Hong Kong should look at establishing a comprehensive tax code for the taxation of trusts, similar to other comparable jurisdictions like Singapore and the United Kingdom.

There are also more sector-specific improvements that can be made such as further enhancements to the MPF system (including developing the eMPF, availability of more retirement income stream products and increasing contribution rates over time), introducing purpose trust legislation and establishing a charities commission.

In order to build on Hong Kong's strong foundations and leverage its advantages as a location for financial services, the government, regulators and the industry will need to increase their collaboration.

Greater coordination among stakeholders is required to position Hong Kong as the destination of choice for trust services amidst stiff competition from Singapore as well as traditional jurisdictions such as BVI, Cayman Islands and Channel Islands.

State of the Hong Kong trust industry

It has been four years since the Hong Kong Trustee Ordinance (HKTO) was amended to improve Hong Kong's attractiveness and standing as a trust jurisdiction. There have been a number of developments following the legislative amendments, such as a marked increase of interest in Hong Kong trusts, tightened compliance regulatory requirements, and the growth of private wealth in China.

The trust industry is an important component of the Hong Kong financial services sector. The primary objective of the report is to understand the market's development following the 2013 amendment[1] of the HKTO. It also identifies the key challenges and opportunities surrounding trusts in Hong Kong in light of the views of market practitioners on how the industry can be further improved.

In order to fully understand the intricacies of the Hong Kong trust and related industries, it is important to recognise this is a diverse market that provides a wide variety of services, including succession and estate planning, conventional retail products, as well as sophisticated bespoke trust structures.

The Hong Kong trust industry

- Corporate trusts, pension schemes, private trusts, charitable trust
- Custodian, fund and pension administration, professional trustee, wealth management, wealth & estate planning, family office services, trust corporate structure
- Retail and universal banks, independent trust companies, insurers, private banks, legal, tax, accounting and professional services providers, company services providers

Source: KPMG research

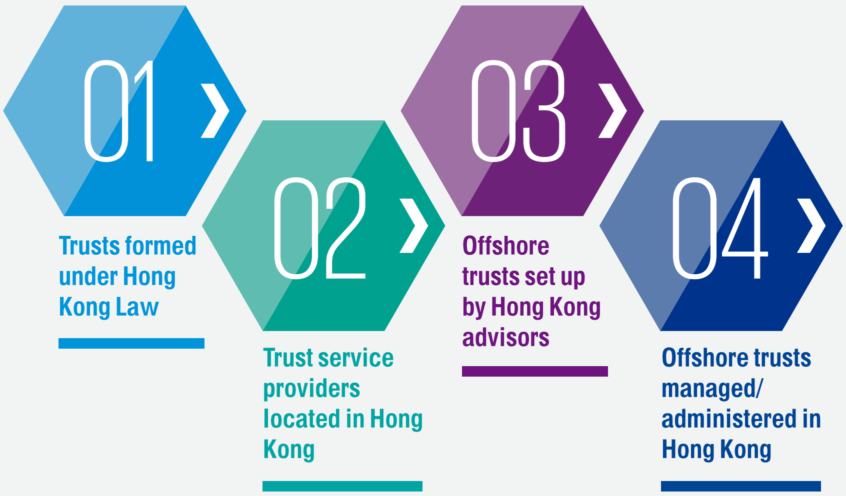
1 'Trust Law (Amendment) Ordinance 2013 gazetted today', Financial Services and the Treasury Bureau, 26 July 2013, http://www.fstb.gov.hk/fsb/ppr/press/doc/pr260713_e.pdf

In addition, Hong Kong is a hub for an expanding array of trust-related businesses such as legal, tax, accounting and professional services.

This list of services and products is being marketed and consumed by customers spanning from charities and those on modest salaries to ultra high net worth individuals (UHNWIs) and wealthy global families, thereby impacting a broad segment of residents in Hong Kong and abroad. A wide range of corporates and institutions also use trust structures and are consumers of trust-related services.

The Hong Kong trust and related businesses serve local, regional and international clients, with a variety of services, including wealth and estate planning, trust administration, and fund services.

The variety of the market



Source: KPMG research

Size of the Hong Kong trust market

The Hong Kong trust market is very broad with stakeholders from different segments of the financial services industry.

This diversity makes it challenging to gauge the actual size of the market although the Census and Statistics Department (C&SD) does publish some statistical data on the number of trustees and custodians in Hong Kong.

However, C&SD statistics do not separately identify market players not working as trustees or custodians – such as those in law firms, insurance companies, pension funds, private banking as well as investment advisory and fund services – but who are extended members of the trust family.

Nevertheless, this report does attempt to provide some, but by no means a full, indication of the size of the Hong Kong trust industry based on a number of sources.

According to the Securities and Futures Commission of Hong Kong (SFC) data[2], the number of SFC-authorised, Hong Kong-domiciled funds grew by

2 'Fund Management Activities Survey 2016,' Securities and Futures Commission, July 2017, http://www.sfc.hk/web/EN/published-resources/surveys/periodic-surveys/

12 percent to reach 735 as at 31 March 2017. The net asset value of these unit trusts and mutual funds totalled US$ 132 billion, or a year-on-year increase of 11.9 percent.

Data from the Mandatory Provident Fund Schemes Authority (MPFA) is also helpful. The aggregate net asset value of all MPF schemes stood at HK$ 774 billion as at 31 July 2017 [3], while the asset size of Occupational Retirement Schemes Ordinance (ORSO) schemes was HK$ 306.03 billion.

Statistics are available for Exchange-Traded Funds (ETFs) - one of the most popular products within the corporate trust space – listed on the Hong Kong Stock Exchange (HKEx). As at the end of August 2017, the market capitalisation of all ETFs trading on the HKEx was HK$ 353 billion. [4]

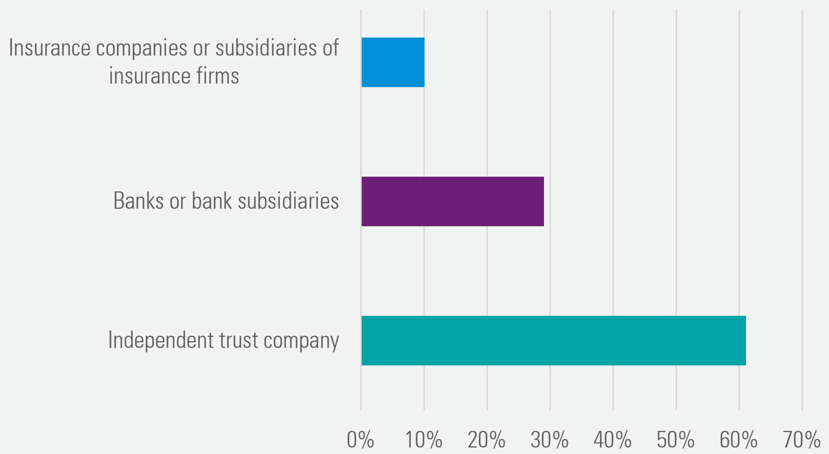
This report is also supported by an independent survey conducted by KPMG and HKTA as well as 30 interviews with senior industry practitioners, government officials and regulators. The survey was conducted from October 2016 to January 2017, while the interviews were conducted in the middle of 2017.

About the survey

KPMG and HKTA jointly conducted a quantitative survey of 48 respondents from a broad spectrum of institutions in Hong Kong, with the majority engaging in multiple trust segments.

The survey respondents are mostly independent trust companies (61 percent), banks or bank subsidiaries (29 percent), and a small number of insurance companies or subsidiaries of insurance companies (10 percent).

Survey respondents: Organisation type



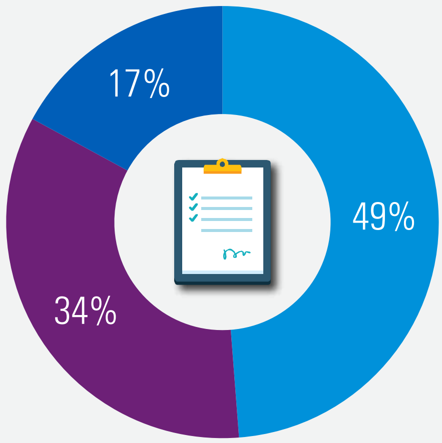
Source: Joint KPMG and HKTA survey

Around 49 percent of respondents indicated that their companies had assets under management (AUM) below US$ 1 billion and about 34 percent between US$ 1 billion to US$ 10 billion. There were quite a number of large players with 17 percent managing trust assets over US$ 10 billion. The findings were similar to the inaugural joint KPMG and HKTA Hong Kong Trust Survey in 2013, which had 53 percent of respondents with AUM bellow US$

3 'Statistical analysis of accrued benefits held by MPF scheme members', Mandatory Provident Fund Schemes Authority, http://www.mpfa.org.hk/tch/main/speeches/files/2017-09-27-speakingnotes-c-Chairman.pdf
4 'ETF and L&I Product Market Perspective,' Hong Kong Stock Exchange, August 2017, https://www.hkex.com.hk/eng/prod/secprod/etf/etfmain.htm

1 billion, 27 percent US$ 1 billion to US$ 10 billion, and 20 percent over US$ 1 billion. [4]

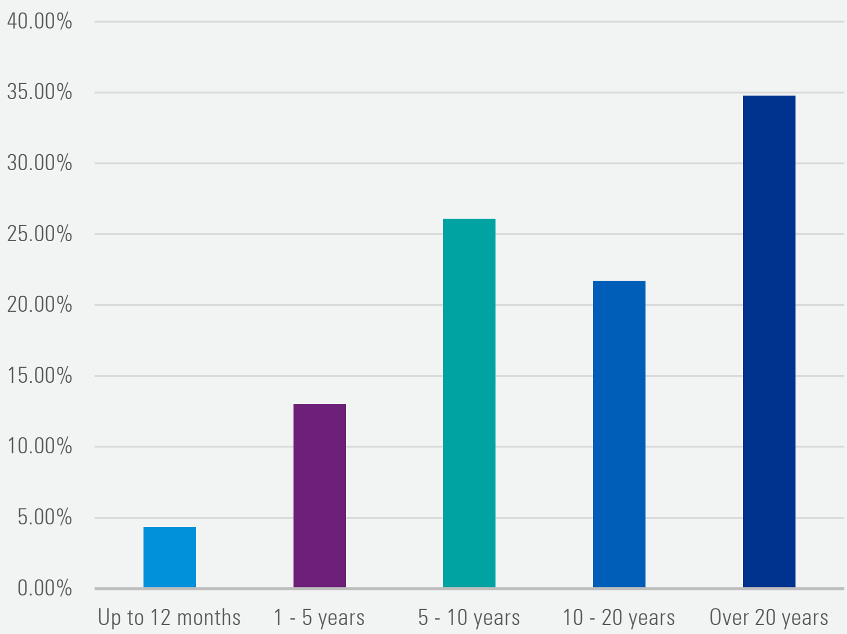
Survey respondents: AUM



Source: Joint KPMG and HKTA survey

Also similar was the dominance of well-established firms. Close to 35 percent of respondents indicated that their companies had been operating in the industry for over 20 years, roughly 22 percent 10 to 20 years, approximately 26 percent five to 10 years, and the remaining below five years. In our previous survey, 43 percent had operated in the industry for more than 20 years, 24 percent 10 to 20 years, 13 percent five to 10 years, and 20 percent below five years.

Survey respondents: Years of establishment



Source: Joint KPMG and HKTA survey

Hong Kong as a trust jurisdiction

The legal system in Hong Kong is based on the common law, and Hong Kong trusts have been operating under this legal system effectively for many years.

There is a conscious effort from the government to continuously improve not only the regulation, but also the business environment and overall infrastructure for trusts to thrive as a business solution.

The introduction of Mutual Recognition of Funds (MRF), for example, allows fund sponsors to distribute existing and, in the future, new funds to mainland China. This has significantly boosted the viability of trusts as structuring solutions for collective investment vehicles.

Consequently, a number of international fund managers have set up new Hong Kong funds or have moved to re-domicile their funds from offshore or Undertakings for the Collective Investment of Transferable Securities (UCITS) jurisdictions to Hong Kong. It is envisaged that additional fund managers may follow suit.

In addition, the Financial Services and the Treasury Bureau (FSTB), SFC and the HKEx have been active in promoting ETFs. The Hong Kong ETF market is very diverse and is comprised of single-country, regional, global, precious metals, futures, leveraged and inverse products.

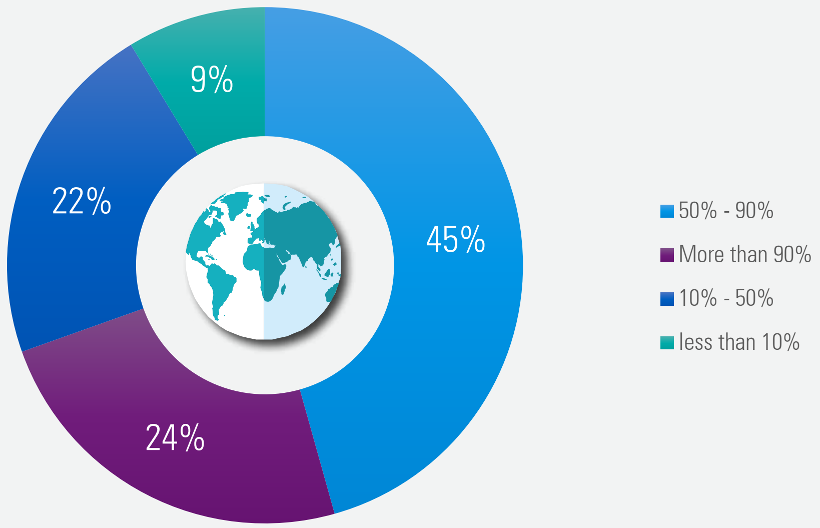
In the pension segment, both the MPF and ORSO schemes are structured by way of trusts. While the regulations were created in mid and late 1990s, this segment has grown exponentially and has reached HK$ 1,052 billion AUM as at 30 June 2017. Within the MPF ecosystem, approved pooled investment funds (APIFs) are utilised as retail funds.

Recent cross-border initiatives such as the Shanghai-Hong Kong Stock Connect, Shenzhen-Hong Kong Stock Connect, and Bond Connect have boosted the industry, opening up previously inaccessible markets. The enhancement of the overall financial market infrastructure has made the Hong Kong trust industry more competitive regionally and globally.

According to our survey results, the industry's biggest customer group comprises of Hong Kong-based companies, individuals and families.

Close to 70 percent of respondents indicated that more than half of their customers are based in Hong Kong with almost 24 percent saying that their business is derived almost exclusively from local clients.

Customer base: contribution of Hong Kong-based clients to a firm's business



Source: Joint KPMG and HKTA survey

Hong Kong-based customers are expected to retain their status as a core clientele, although the majority of respondents (with the exception of those operating in the pension scheme sector) also believed that one of the biggest drivers of the industry is wealth flowing out of China.

As China continues to open up, the need for its population to diversify wealth overseas will increase. This geographic diversification is generally associated with UHNWIs or HNWIs, many of whom already have plenty of experience in holding assets and managing their wealth globally.

But several interviewees have highlighted the Chinese middle class population as a key segment for future development, as this growing segment has begun seeking to diversify their assets, investments and wealth. In this regard, Hong Kong's all-rounded financial services capabilities make it an attractive destination for Chinese clients.

Language is also a major advantage as Hong Kong is one of a restricted number of jurisdictions in which untranslated Chinese documents are admissible in court. While many respondents noted that the majority of cases involving trusts do not go to court, simply having the option to use Chinese documentation appeals to Chinese clients.

However, Hong Kong as a trust jurisdiction is facing a great deal of competition; many of the HKSAR's service providers also offer foreign trust structures. Popular offshore trusts administered in Hong Kong include those organised under the laws of British Virgin Islands (BVI), Cayman Islands, Guernsey, Jersey and Singapore.

> ***"The growth potential of the Hong Kong trust industry is huge due to the massive growth in wealth in Asia and, in particular, China.[5]"***

5 Nigel Rivers, Capital Solutions Limited

Key industry developments

This report covers the key developments and topics surrounding the trust industry. It builds upon the 2013 report [6] and analyses the impact of the HKTO amendment, the challenges brought about by increasing compliance costs, and methods to enhance Hong Kong's competitive edge as a trust jurisdiction.

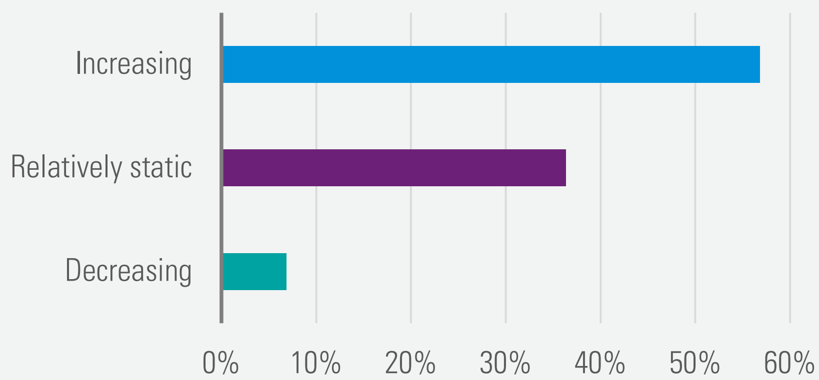
Impact of the 2013 amendments to the HKTO

The amendment to the HKTO and related legislation in 2013 was a milestone for the industry, since trust legislations in Hong Kong had not been updated for almost 80 years.

Many respondents and interviewees agree that those statutory enactments have modernised Hong Kong's trust regime and put the city back on the map as a key trust jurisdiction.

The amendment has prompted increased interest in Hong Kong-domiciled trusts – a sentiment that was supported by our survey results, which found approximately 57 percent of respondents said their proportion of assets held by trusts governed by Hong Kong law had increased in the past three years.

Proportion of assets held by Hong Kong-domiciled trusts

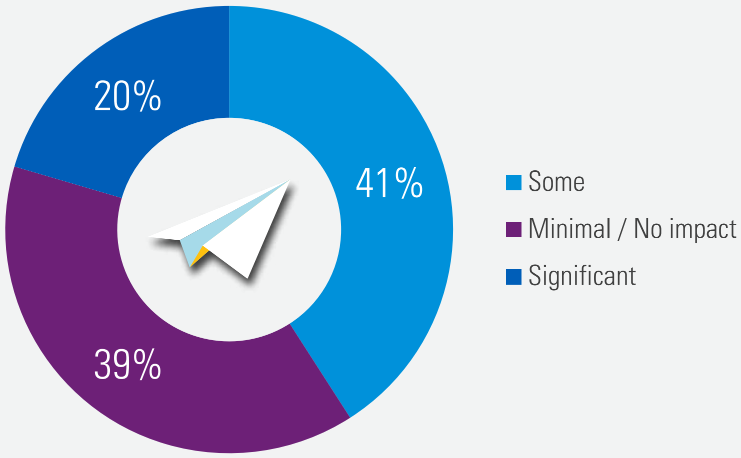


Source: Joint KPMG and HKTA survey

6 'Hong Kong Trust Industry: A Cross-Sector Perspective', KPMG and the Hong Kong Trustees' Association, June 2013, https://home.kpmg.com/cn/en/home/insights/2013/06/hong-kong-trust-industry-201306.html

In addition, 61 percent of respondents believed that the 2013 amendment has made a significant or some contribution to the growth of their trust-related business.

The impact of 2013 HKTO amendments on the growth of trust-related business



Source: Joint KPMG and HKTA survey

In the past, our clients do not generally see Hong Kong as a destination to set up their trusts. However, we have seen greater interest in Hong Kong as a trust jurisdiction since the 2013 amendments. Inputs from the government and industry practitioners are still much needed to make the city an ideal trust location.[7]

Before the 2013 amendment, the only type of Hong Kong trusts service providers could provide were pure discretionary trusts in which a trustee was effectively required to make all the investment decisions for which he was liable as a fiduciary.

Following the amendments, reserved powers trusts are now available, such that the power of investment may be reserved or retained by the settlor without compromising the validity of the trust. This effectively mitigates the trustee's liability for losses occasioned by investment decisions.

Clients who are not comfortable handing over full control of their investment or asset management decisions to trustees are able to use reserved power trusts, which enable them to retain some formal control over assets settled on trust.

While quite a large number of interviewees felt the 2013 amendments could have gone further in terms of providing more reserved powers and introducing a licencing regime for trustees, many agreed it was a positive first step.

7 Rebecca Chow, Trident Trust Co HK Limited

Highlights of the amended HKTO

Clarification of trustees' duties and power

- Impose a statutory duty of care on trustees
- Improve and clarify the law relating to short-term delegation by a single trustee
- Provide trustees with general power to appoint agents, nominees and custodians
- Give trustees wider powers to insure any trust property against risks of loss by any event
- Allow professional trustees to receive remuneration for rendering services to charitable and charitable trusts

Better protection of beneficiaries' interests

- Regulate the exemption clauses of professional trustees who receive remuneration for their services
- Provide a mechanism for beneficiaries to remove a trustee on fulfilling certain conditions

Modernisation of trust law

- Clarify that a trust is not invalid only by reason of a limited reservation of the settlor's power
- Abolish the rule against perpetuities with respect to new trusts
- Abolish the rule against excessive accumulations of income with respect to new non-charitable trusts

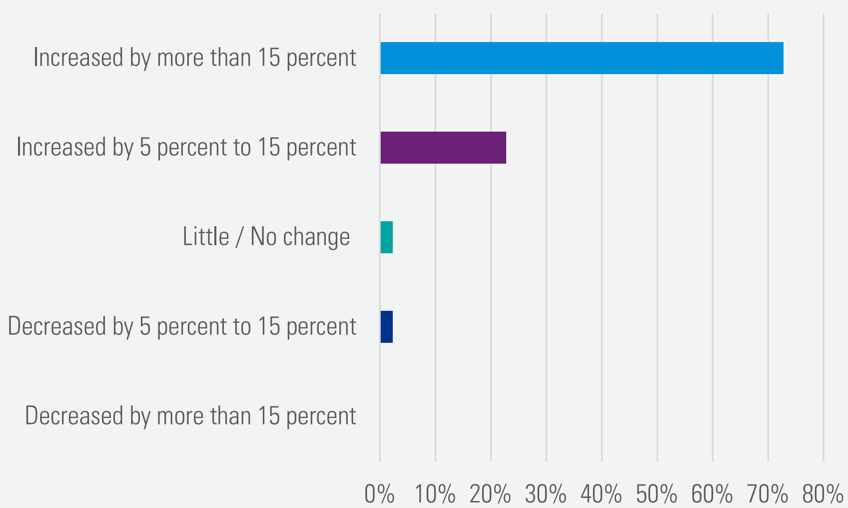
Source: KPMG research

The compliance conundrum

Another key topic that most survey respondents highlighted is the burden of increasing compliance costs.

More than 72 percent of respondents indicated that the time and effort spent on compliance and regulatory matters over the past 12 months had increased by more than 15 percent, while around 22 percent said it had gone up by 5 percent to 15 percent.

Time and effort spent on compliance and regulatory matters over the past 12 months



Source: Joint KPMG and HKTA survey

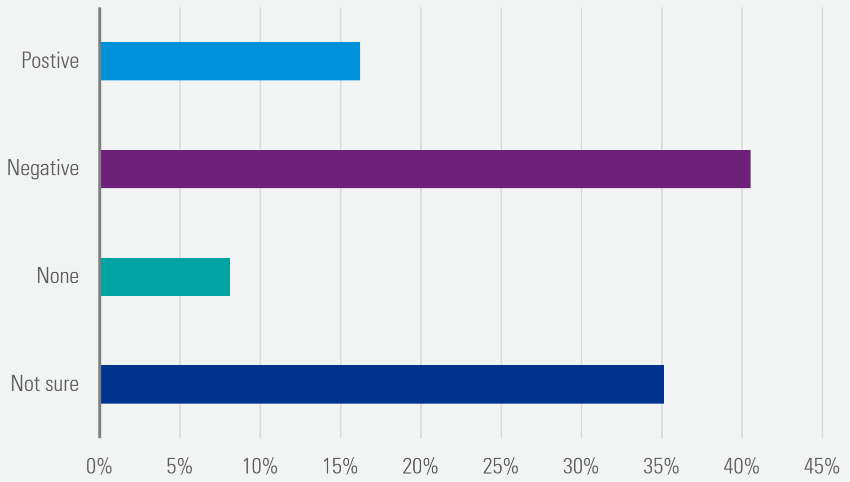
A main contributor of the increase is attributable to the expansion of compliance teams, and many respondents said this trend is likely to escalate as a result of stricter Anti-Money Laundering (AML) regulations and the Organisation for Economic Co-operation and Development's (OECD) Common Reporting Standard[8] (CRS).

CRS is a global regulatory framework aimed at attaining greater transparency across jurisdictions with a view to detect and deter money laundering, tax evasion and tax non-compliance. The framework generally operates on the basis of the multilateral disclosure of information on financial accounts held by individuals and organisations outside their jurisdiction of tax residence.

This is similar to the reporting regime introduced by the US Foreign Account Tax Compliance Act (FATCA). But unlike FATCA, whereby information need to be disclosed to competent authorities in the US, the disclosure of information under CRS will be made to all participating jurisdictions. As at August 2017, 102 jurisdictions have committed to CRS.

The trust industry is being impacted by the additional reporting requirements, which include accounts maintained or held by trusts. Institutions responsible for reporting on such accounts are required to look through passive entities to report on individuals that ultimately control these entities. This sends out a clear signal that trusts cannot be used to shield against reporting requirements.

Impact of Hong Kong's adoption of the Automatic Exchange of Information (AEOI)



Source: Joint KPMG and HKTA survey

More time is being spent by trust companies to ensure regulatory requirements are met in areas such as operational and system enhancements, training, and customer communication. This leads to higher operational cost, which either cuts into profitability or is passed on to clients.

8 'Automatic Exchange Portal, Common Reporting Standard', The Organisation for Economic Co-operation and Development, http://www.oecd.org/tax/automatic-exchange/common-reporting-standard/

Enhancing Hong Kong's AML and Counter-Terrorist Financing (CTF) regime

With Hong Kong's AML and CTF regime scheduled for evaluation by Financial Action Task Force (FATF) members in 2018, Hong Kong has been actively refining its regulatory system. Two key legislative changes were introduced in June this year with view to take effect from 1 March 2018.

In line with international developments, Hong Kong-incorporated companies will soon be required to maintain beneficial ownership information by keeping an up-to-date 'register of people with significant control'. However, the registers will not be made public and only competent authorities will be granted access due to compliance, privacy and security considerations. These changes will be introduced by amendments to the Companies Ordinance (CO).

Further, under the AML and CTF (Financial Institution) (Amendment) Bill 2017 [9], customer due diligence and record-keeping requirements will apply to trust and company service providers in the same manner as they have been applicable to financial institutions.

A licencing regime for trust or company service providers (TCSPs) will also be introduced. According to the government proposals, TCSPs will be required to apply for a licence from the Registrar of Companies (The Registrar) before they can provide trust or company service as a business for the public. The Registrar will be empowered to carry out inspection, investigations, and impose disciplinary sanctions for any non-compliance by a TCSP.

Rising compliance costs are not a Hong Kong-specific issue, but a global trend. That being said, trust companies operating in Hong Kong face more pressure than their peers in, for example, Singapore due to higher operating costs in terms of salaries and rent.

One way the government can relieve some of the pressure is to help develop simplified policies for global compliance. This should help the trust industry to manage compliance and regulatory costs by reducing the duplication of work. Such a move would require more constructive dialogue between the government and industry players, several interviewees noted.

In the face of higher regulatory reporting requirements, many industry participants are turning to technology to meet compliance obligations.

The benefits that technology offers include the automation of processes and alerts, exception reporting, and complex, real-time data analysis.

Organisations with fit-for-purpose systems are in a position to gain a significant competitive advantage through comparatively reduced costs, improved compliance efficiency and performance enhancements at the point of delivery, which may likewise result in better customer experience.

Several interviewees pointed out that vast amounts of money have been spent on IT systems that enable them to conduct automated client vetting on a daily basis as part of their AML and Know Your Customer (KYC) policies.

While the initial investment on such technologies tends to be high, they can reduce administrative and compliance costs over the longer term.

"Enhancing regulatory controls and compliance standards is not necessarily a bad thing. The key is to strive for a right balance between promoting market growth and raising regulatory standards. Whenever new compliance requirements are introduced, there should also be a holistic review of existing regulations to remove any redundant controls. [10]***"***

9 'Gazettal of the Anti-Money Laundering and Counter-Terrorist Financing (Financial Institutions)(Amendment) Bill 2017', Securities and Futures Commission, http://www.sfc.hk/edistributionWeb/gateway/EN/circular/anti-money-laundering/doc?refNo=17EC38
10 Alex Chu, BOCI Prudential Trustee Limited

Improving the talent pool

A common concern expressed by interviewees is that attracting and retaining talent has become a significant challenge. This has been felt across the full spectrum of roles, from back-office trust administration to front-office advisors involved in sales and marketing management.

There is generally a shortage of personnel in the trust administration, legal and compliance, and client management areas of the trustee industry. This shortage of trust specialists is the result of a lack of formal training or qualifications for trust professionals in Hong Kong.

The lack of a systemic training process means some trust professionals might not have a thorough understanding of the end-to-end operating model of their respective organisation as a trustee. Moreover, the standards among market practitioners can vary greatly.

In order to address the shortage of talent, the government rolled out a three-year Pilot Programme to Enhance Talent for the Asset and Wealth Management Sector[11] (WAM Pilot Programme) in August 2016 with approved funding of around HK$ 43 million.

Key areas of WAM Pilot Programme

1) Enhancement of public education

To promote the ins and outs of asset and wealth management, going beyond front office and into middle as well as back office operations.

Several interviewees suggested educating students at the university level, reaching out to the eight University Grants Committee (UGC) funded universities.

2) Summer internship opportunities for undergraduate students

Encourage more trust companies and employers to offer internships to university students to expose them to the trust industry.

3) Financial incentive scheme for professional training for in-service practitioners

In-service practitioners would be entitled to up to HK$ 7,000 of reimbursement over a three-year period if they sign up for eligible programmes.

Source: KPMG research

HKTA Accreditation/Training Programme

The HKTA and the Hong Kong Securities and Investment Institute (HKSI) have been working together on an accreditation and training programme that caters specifically for the trust industry. The training programme will cover basics such as trust structuring, AML and compliance requirements.

11 'Pilot Programme to Enhance Talent for the Asset and Wealth Management Sector', https://www.wamtalent.org.hk/eng/

It will also cover broader and more complex areas, including types and uses of trust compared with other wealth and succession planning vehicles.

Upon the successful completion of the programme, successful candidates will be awarded the designation of Certified Trust Practitioner.

This is a similar approach as the Enhanced Competency Framework [12] (ECF), which is responsible for the Certified Private Wealth Professional (CPWP) certification. The ECF started two years ago and has become a benchmark for private bankers in Hong Kong. AML officers also have a similar accreditation programme derived from ECF.

Some interviewees have called for the government to expand the scope of its subsidies beyond the HK$ 7,000 reimbursement eligible to individual participants to also encompass training providers and organisers.

But as with most similar accreditation and training programmes, the main challenge will be on building up the programme's reputation and recognition. The general sentiment among the interviewees is the ultimate objective of the programme should not simply be about setting a standard. Instead, it should be to attract university graduates or individuals who are in the financial services industry, not only in the trust segment, to take the qualification.

One successful example would be the Chartered Financial Analyst (CFA) Programme, which is widely recognised by students and the working population alike as the course to take if they are interested in entering the financial services market.

There are additional options for students and professionals to undergo trust-related training such as courses from the Society of Trust and Estate Practitioners [13] (STEP). STEP courses are international programmes rather than Hong Kong-specific courses.

Individuals with no or limited experience and trust-related qualifications in the private trust sector can take the STEP Certificate in International Trust Management or the STEP Diploma in International Trust Management.

The courses, however, are not eligible for the government's WAM Pilot Programme, which makes it expensive for individuals and for trust companies to send their employees to take the course.

Technology can also play a part in alleviating the shortage of talent in the Hong Kong trust industry. For example, technology-enabled remote working can be a possible solution as it would reduce the need to hire staff. In addition, advances in artificial intelligence, automation, and robotics can help to reduce human costs and errors in particular when it comes to administrative work.

“*Given the fact that there is no existing qualification or qualifying regime in the Hong Kong trust industry, it really is a sector that is crying out for something.*[14]”

12 ‘Enhanced Competency Framework for Private Wealth Management Practitioners,’ Hong Kong Monetary Authority, http://www.hkma.gov.hk/eng/key-information/press-releases/2014/20140624-3.shtml
13 ‘STEP Qualifications & Membership Framework’, http://www.step.org/qualifications/qualifications-membership-framework
14 John Maguire, Hong Kong Securities and Investment Institute

Streamlining of the regulatory framework

Whether Hong Kong should consider establishing a single regulator to oversee the trust industry continues to be a hot topic of discussion among market participants.

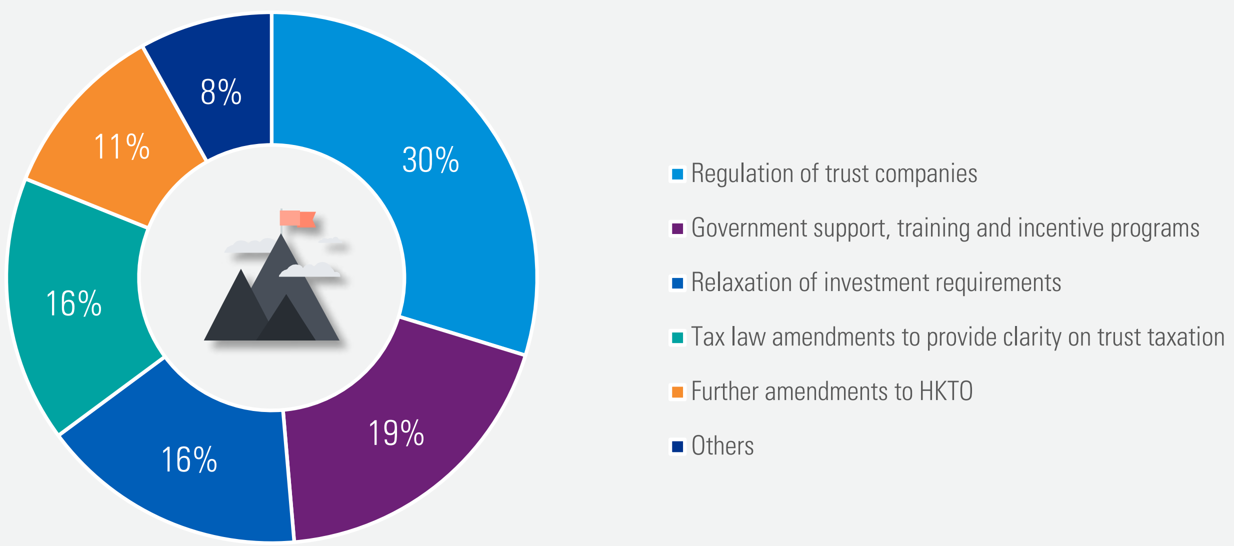
Four regulators currently have oversight over the Hong Kong financial market – the Hong Kong Monetary Authority (HKMA), the Mandatory Provident Fund Schemes Authority (MPFA), the SFC and the Insurance Authority (IA). The areas under governance are clearly defined although there are still overlaps in the reporting, licencing and approval processes.

For example, all MPF schemes and pooled investment funds established for the purpose of the MPF system have to be authorised by the SFC. MPF schemes are also required to be registered, and constituent funds and pooled products investment funds approved, by the MPFA. Applications of MPF schemes and pooled investment funds therefore have to be made to both authorities under separate covers.

At the same time, many trust companies are not regulated if they are not involved with either the MPF schemes or SFC-authorised retail funds although the proposed licencing regime for TCSPs would change that.

Market participants generally welcome the introduction of a licencing regime. This model could potentially streamline disclosures and avoid supervisory overlap, improve industry practices and boost the credibility of the Hong Kong trust industry.

Most effective method to grow the Hong Kong trust industry



Source: Joint KPMG and HKTA survey

This was reflected in our survey results, which revealed the regulation of trust companies was the industry's top pick as the most effective method to grow the Hong Kong trust industry.

The fragmented nature of the Hong Kong trust industry

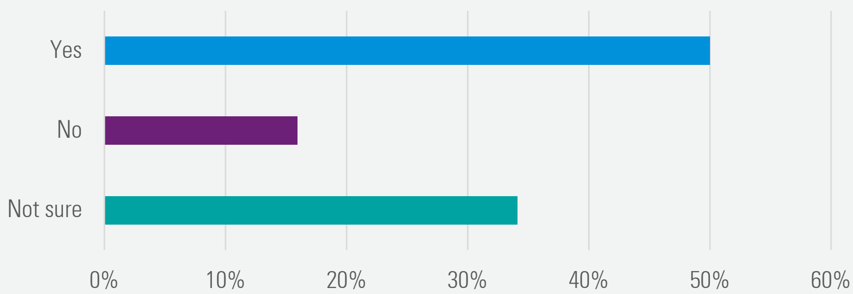
At the moment, there is no single, specialised regulator in the Hong Kong trust industry. A number of regulators have jurisdiction over the portfolio of products and services being offered and managed in the market, often by virtue of regulating the wider banking and financial services industry. The regulators and the areas they cover are:

Mandatory Provident Fund Schemes Authority (MPFA)	Regulates and supervises the operations of MPF and ORSO schemes in accordance with the Mandatory Provident Fund Schemes Ordinance (MPFSO). It registers provident fund schemes, approves trustees of registered schemes, regulates the affairs and activates of approved trustees and formulates relevant rules or guidelines.
Securities and Futures Commission of Hong Kong (SFC)	Regulates the securities and futures markets in accordance with the Securities and Futures Ordinance and subsidiary legislation. Its responsibilities include setting and enforcing market regulations, licencing and supervising intermediaries seeking to conduct regulated activities for which the SFC has regulatory responsibility, supervising market operators, authorising investment products and/or offering documents prior to their distribution.
Hong Kong Monetary Authority (HKMA)	Regulates financial institutions (including banks, deposit-taking companies and money lenders) and aims to keep the Hong Kong dollar stable through the management of the Exchange Fund and monetary policy operations in accordance with the Exchange Fund Ordinance and the Banking Ordinance.
The Insurance Authority (IA)	The IA is a new insurance regulator that came into operation on 26 June 2017, replacing the Office of the Commissioner of Insurance (OCI). While the OCI was a government department that regulated insurance companies and the three self-regulatory organisations (SROs) overseeing insurance intermediaries, the IA is a statutory body that is independent of the government. At the moment, the IA oversees insurance companies and will eventually take over the regulation of insurance intermediaries from the SROs within the next two years.

Streamlining of the regulatory framework would also make it easier for Hong Kong to create a roadmap or vision for the trust industry, which would in turn contribute to the long term development of the market and enhance its international competitiveness.

Clarity on tax

Does tax legislation needs to be amended to provide more certainty to taxation of trusts in Hong Kong?



Source: Joint KPMG and HKTA survey

Similar to calls for the streamlining of regulations, the question of the taxation of trusts continues to generate discussions within the industry. Half of the survey respondents believed tax legislation needs to be amended to provide more tax certainty.

Hong Kong does not have a general charging provision on income. Instead, business and trading profits sourced in Hong Kong are charged to profits tax. The charging provision for profits tax is found in section 14 of the Inland Revenue Ordinance (IRO) and can be broken down into three cumulative requirements:

1. There must be a person as defined in the IRO;
2. That person must carry on a trade, profession or business in Hong Kong, whether as a principal or through a dependent or independent agent; and
3. That person must derive profits arising in or derived from Hong Kong, which are his 'assessable profits', from that trade, profession or business

A trust has no separate legal personality and is not deemed a person under section 2 of the IRO. A trustee, however, is expressly defined as a taxable person in the IRO. It should follow that a trustee carrying on a trade, profession or business in Hong Kong as trustee of a trust would be the person taxable in Hong Kong on the profits of that trade, profession or business to the extent such profits were Hong Kong source. The general scholarly consensus is that trust profits falling within section 14 of the IRO are chargeable to profits tax in the hands of the trustee.

That being said, practitioners have noted that greater clarity is desirable; as currently drafted, the application of section 14 of the IRO to trading trusts is perceived in some quarters as opaque. It may therefore promote Hong Kong's competitiveness as a trusts jurisdiction if amendments were enacted to the IRO, with a view to establishing a comprehensive tax code for the taxation of trusts, as is currently the case in jurisdictions like Singapore and the United Kingdom.

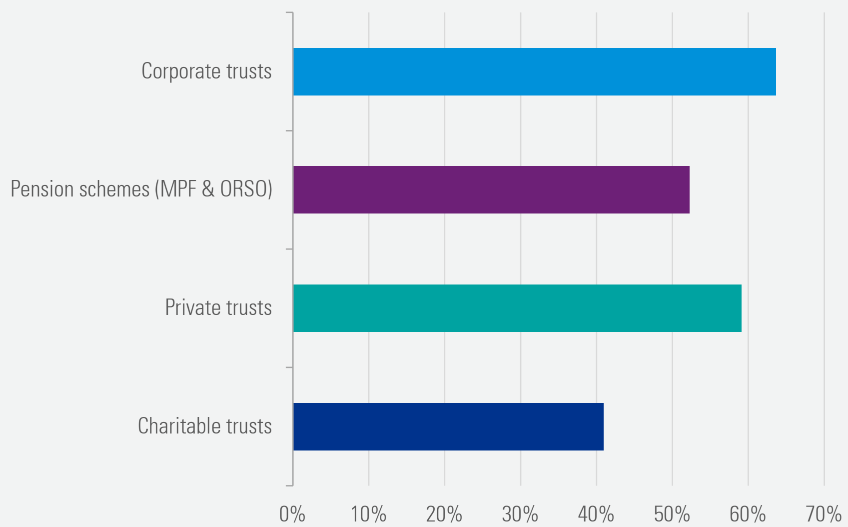

TAX

Sector analysis

In this section, the focus is on sector-specific developments, opportunities and challenges. Based on the same categorisation of our 2013 report, the Hong Kong trust industry can be divided into four main sectors - corporate trusts, pension schemes, private trusts and charitable trusts.

Within the four categories, the corporate trusts sector is the most popular with more than 63 percent of respondents offering corporate trusts services to clients. That is followed closely by private trusts (59 percent), pension schemes (52 percent) and charitable trusts (41 percent).

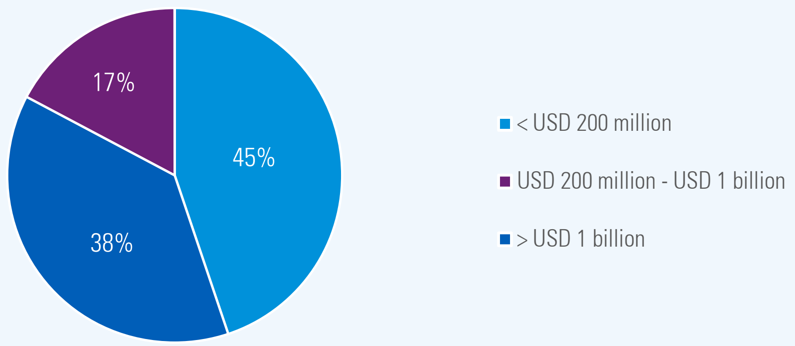
Type of trust administration services provided



Source: Joint KPMG and HKTA survey

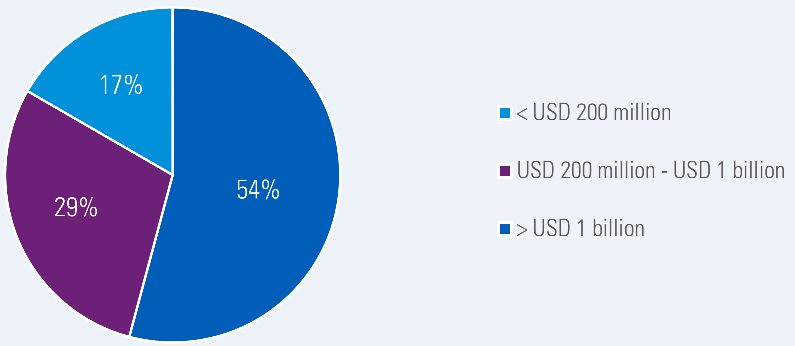
Corporate trusts	• Corporate trust providers offer core trustee services and important associated activities, such as setting up trusts, administering trusts, and acting as custodians. These service providers are vital to Hong Kong's fund management industry. • Trustees provide professional services and play a fiduciary role for wholesale and retail investment products, which offer investors the opportunity to invest in stocks or assets that they might not normally have access to in the open market.
Pension schemes	• Prior to the implementation of the MPF system, a number of Hong Kong employers had voluntarily been operating retirement schemes to provide retirement benefits for their employees. In many cases, these voluntary schemes, regulated under ORSO, have continued to operate. • Approximately 85 percent of the Hong Kong working population have some form of retirement protection (MPF and ORSO)
Private trusts	• The primary use of private trusts within wealth management relates to wealth and estate planning. There is a growing demand for these services from UHNWIs seeking to manage the inter-generational transmission of wealth and implement succession plans for family-owned businesses. • As the pool of wealthy individuals increases, wealth and estate planners in Hong Kong are seeing increasing demand from second and third generation wealthy individuals.
Charitable trusts	• Represent a small proportion of the wider Hong Kong trust industry. • Unlike other areas of the Hong Kong trust industry where offshore trusts dominate, charitable trusts are usually formed under the Hong Kong trust ordinance. It is one of four structures that can be used to set up a charity.

Corporate trust respondents: breakdown by AUM



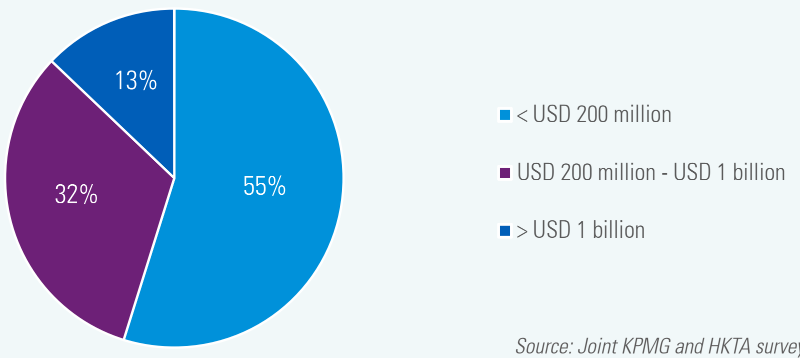
Source: Joint KPMG and HKTA survey

MPF and ORSO respondents: breakdown by AUM



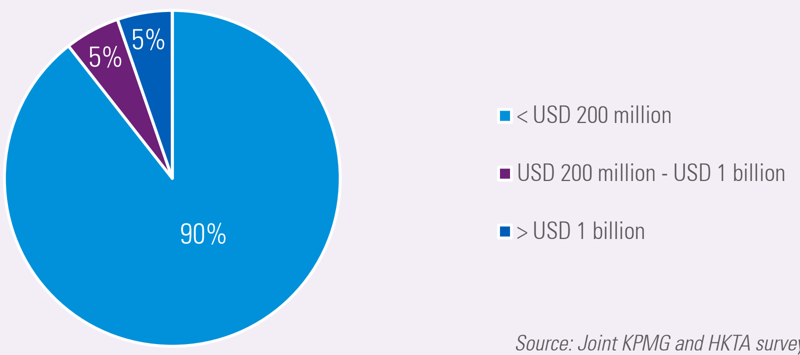
Source: Joint KPMG and HKTA survey

Private trust respondents: breakdown by AUM



Source: Joint KPMG and HKTA survey

Charitable trust respondents: breakdown by AUM



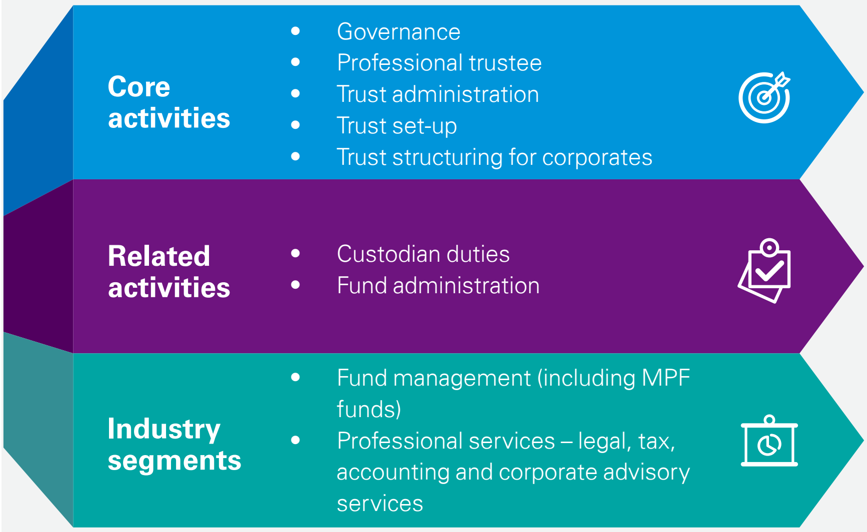
Source: Joint KPMG and HKTA survey

Corporate trusts

Corporate trust providers play an important role in the Hong Kong financial services sector, providing core trustee services and important associated activities such as acting as custodians.

Some of the most notable products in this segment include unit trusts, ETFs and real estate investment trusts (REITs), many of which cater to the retail investor base.

These products offer individual investors the opportunity to invest in stocks or assets that they might not normally have access to in the open market, combined with the added benefit of risk diversification.



Source: KPMG research

Unit trusts

A principal element of the corporate trust sector, a unit trust is a form of collective investment scheme constituted under a trust deed, which enables a number of investors to pool their assets and have those assets professionally managed by an independent manager.

The most common form of unit trust structure in Hong Kong is the two-party trust deed. Essentially, the trust vehicle pools the money of investors and invests in assets with a specific goal such as investing in emerging markets. The fund manager purchases a basket of stocks (or other assets) and pools these in a fund, while investors are in turn issued with units of the fund and become the beneficiaries.

This allows the professional fund manager to retain sole investment power over the underlying assets held in trust by the trustee for the unit holders to obtain a beneficial interest in the fund. A number of retail funds and ETFs have taken the form of unit trusts.

The SFC has indicated in the past that it would be conducting a holistic review of the Code on Unit Trusts and Mutual Funds. It has started a soft consultation with the industry in 2017 and plans to launch a public consultation on proposed enhancements by the end of the year.

Exchange-Traded Funds (ETFs)

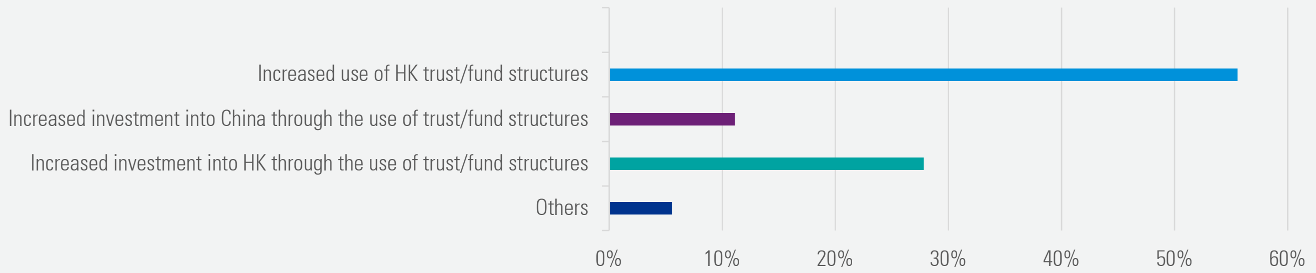
ETFs are based on the conventional unit trust, with the key difference being that units in the fund are tradable on stock exchanges. Hong Kong has been quite innovative in the way it created investment solutions since it launched the first ETFs in 1999. Hong Kong, as at April 2017, has over 150 domestic ETFs with assets of US$ 38 billion; six of the top 10 ETFs in Asia are in Hong Kong with the remaining three in China and one in Korea.

As with other retail products, one attraction of ETFs is the opportunity to indirectly access a broad range of markets. China A-share ETFs, for example, provide the opportunity to invest in China. The rise of the China economy has benefitted the ETF market immensely, with the success of A-share funds driving significant growth.

China's economic growth has prompted an increasing number of Chinese fund managers to enter the Hong Kong market – a trend that is likely to continue. The ETF market has proven to be very diverse with a number of products such as Hang Seng Index, Sensex India Index, MSCI Asia, precious metals, oil, futures, and recently leveraged and inverse.

In the longer term, it is expected that the future of the Hong Kong corporate trust industry will be closely related to inclusion of China investments in global markets such as inclusion of MSCI indices and the policies of the Chinese government (MRF [15] and ETF Connect). MRF, in particular, has the potential to grow beyond connecting the mutual fund markets of China and Hong Kong.

The impact of MRF on the Hong Kong trust industry



Source: Joint KPMG and HKTA survey

The SFC concluded an MRF arrangement in December 2016 with the Swiss Financial Market Supervisory Authority, allowing eligible Swiss and Hong Kong public funds to be distributed in each other's market through a streamlined vetting process. It followed that up by signing a Memorandum of Understanding with the Autorité des Marchés Financiers (AMF) on 10

15 'Mainland-Hong Kong Mutual Recognition of Funds', Securities and Futures Commission, http://www.sfc.hk/web/EN/faqs/mainland-hong-kong-mutual-recognition-of-funds.html
16 'Mutual Recognition of Funds (MRF) between France and Hong Kong', Securities and Futures Commission, http://www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=17EC43

July 2017 on France-Hong Kong MRF [16], laying the groundwork for the initiative to be further expanded to other countries.

In this aspect, Hong Kong's role as a centre for ETFs and China's asset management centre for overseas investments will continue to drive the growth of its trust industry.

Open-Ended Fund Companies (OFCs)

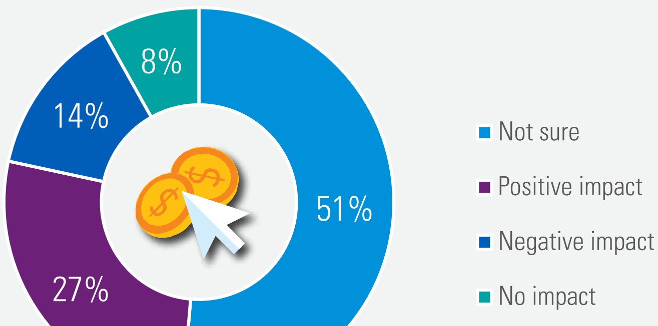
Efforts are being made to enhance the fund market infrastructure such as the introduction of open-ended fund companies (OFCs), which aims to position Hong Kong as an international funds hub.

OFCs are open-ended collective investment schemes set up in the form of a company. As a result, an OFC has a board of directors responsible for its governance instead of a trustee. Unlike conventional companies, however, an OFC has the flexibility to create and cancel shares in order to meet shareholder subscription and redemption requests, which is not currently possible for conventional companies incorporated under the CO. An OFC could be a publicly or privately offered fund.

However, many respondents are uncertain of the impact of OFCs with 51 percent saying they are not sure just what impact it could have on the Hong Kong trust industry. Around 14 percent said OFCs will have a negative impact, 8 percent no impact, and 27 percent positive impact.

Concerted efforts are nonetheless being made to develop OFCs in Hong Kong. An amended Securities and Futures Ordinance [17], which provides a legal framework for OFCs, was enacted by the Legislative Council (LegCo) in June 2016. The SFC and other relevant government departments, have since been working on the subsidiary legislation and code in order to set out the operational details of the OFC regime. Subject to the LegCo's assessment of the subsidiary legislation, OFCs could make an appearance in Hong Kong in 2018.

The impact of OFCs on the Hong Kong trust industry



Source: Joint KPMG and HKTA survey

17 'Securities and Futures (Amendment) Ordinance 2016 gazetted', Companies Registry, The Government of the Hong Kong Special Administrative Region, http://www.cr.gov.hk/en/publications/press20160610.htm

Aside from the legal regime, the government has proposed to extend profits tax exemption to onshore privately offered OFCs in the 2017-18 Budget to promote fund creation and management in Hong Kong. The bill is expected to be introduced into LegCo later this year in order to be implemented at the same time as the OFC regime.

The rationale behind the introduction of OFC as another form of investment fund vehicle is to help diversify Hong Kong's asset management industry and drive demand for professional services along the whole fund service chain. Such services include fund management and investment advice, legal, accounting, fund administration, custodian and other ancillary services as well as sales and marketing.

It would also strengthen Hong Kong's competitive edge as regional competitors are also making inroads in this area. Singapore, for example, announced the public consultation of the Singapore Variable Capital Company (S-VACC) legislation on 23 March 2017, which is a similar investment fund structure to OFC.

Employee Share Plan (ESP)

Employee share plans (ESP), also known as employee stock ownership plans (ESOP), are another important segment of the corporate as well as private trust sectors.

This usually involves the establishment of a special purpose trust and set up by way of a two-way party trust deed executed by the employer and the trustee. The trustee receives contributions and purchases shares in the employer company to meet new share awards granted to plan participants and hold the shares on trust for the benefit of the participating employees. In the case of Hong Kong-listed companies, the trusts tend to be Hong Kong-domiciled.

While it is not compulsory for employee share plans to be administered through trusts, many companies choose to adopt this approach due to amount of work and complexities involved with share plan administration.

Participation in employee share plans is an established part of the remuneration package offered to employees in Hong Kong and other overseas jurisdictions.

Several industry participants have noted the segment's growth over the past few years, which was driven by the increasing number of H-share companies offering employee share plans. The trend is likely to continue as the proportion of H-share companies with ESPs is relatively small.

To further the growth of the segment, a number of interviewees highlighted the need to modernise the regulatory regime concerning employee share plans. Chapter 17 of the HKEx's Listing Rules and Guidance, for example, is only applicable to share option schemes. Other popular forms of employee

> ***"Some international fund managers do not fully apprehend the responsibilities and obligations of the trustees under a unit trust structure. OFCs would be a viable alternative for them since OFCs are governed by a board of directors, which can retain more discretion in the management of the fund. The introduction of OFCs could attract more international managers to set up funds in Hong Kong.[18]"***

18 Ka Shi Lau, BCT Group

share plans such as employee share purchase plan (ESPP) and restricted share unit plan (RS/U) should also be regulated.

In spite of the segment's positive outlook, several interviewees pointed out that there has been a marked reduction in the number of companies providing employee share scheme services in recent years.

This can be attributable to rising compliance, staffing and operational costs. In addition, the need to provide a full-suite of services such as stock registration and transfer, investor services, and employee share plan management has led to many smaller players to leave the sector. Consequently, only a handful of companies, most of which are global, have the resources and capabilities to compete in this sector.

Pension schemes

The Hong Kong MPF system was established in December 2000 and is a mandatory, privately managed, fully funded contribution scheme.

Since its inception, the MPF has become the mainstay of Hong Kong's retirement protection regime with the total net asset value of all schemes hitting HK$ 774 billion [19] as at 31 July 2017. Approximately 85 percent of the Hong Kong working population have some form of retirement protection (MPF and ORSO), according to MPFA statistics.

ORSO

Before the implementation of the MPF, many Hong Kong employers had been voluntarily operating retirement schemes to provide retirement benefits for their employees. In many cases, these voluntary schemes, regulated under ORSO, have continued to operate. The features of the schemes, including the contribution level, choice of investment options, and vesting scale of accrued benefits, are governed by the individual scheme's rules.

Given the short history of the MPF system (relative to other developed economies), the regime is constantly being refined by new enhancements and proposed changes.

Default Investment Strategy (DIS)

One of the most recent developments in the MPF system is the introduction of DIS [20] in April 2017.

If a scheme member has never given investment instructions to their MPF accounts, their MPF contributions will be invested automatically according to DIS. A key characteristic of the DIS lies in its fee caps on management fees (0.75 percent maximum) and recurrent out-of-pocket expenses (0.2 percent maximum).

19 'Statistical analysis of accrued benefits held by MPF scheme members', Mandatory Provident Fund Schemes Authority, http://www.mpfa.org.hk/tch/main/speeches/files/2017-09-27-speakingnotes-c-Chairman.pdf
20 'Default Investment Strategy', Mandatory Provident Fund Schemes Authority, http://minisite.mpfa.org.hk/DIS/en/index.html

That is significantly lower than the fees of existing schemes with the average fund expense ratio (FER) of MPF funds about 1.56 percent, according to MPFA data. Other features of the DIS include the automatic reduction of investment risk according to a member's age and adopting a diversified investment approach by investing in different asset classes in global markets.

Many industry players are supportive of DIS as it provides a lower cost option and increases the availability of market-tracking as well as passively managed funds. A few respondents also commented that DIS could potentially lead to a more consistent investment outcome for its members given its standardised investment strategy.

Offsetting mechanism

In the 2017 Policy Address at the start of the year, the government under former Chief Executive Leung Chun-ying proposed[21] progressively ending a mechanism that allows employers to offset severance payments (SP) and long service payments (LSP) against employers' MPF contributions.

It suggests subsidising a portion of the money employers spend on SP and LSP for 10 years in a grandfathering arrangement that will see the subsidy level gradually decrease after the second year of abolishment. The abolition of the offsetting mechanism remains at the top of the new government's agenda. It is understood that the government is in active dialogue with relevant stakeholders to come up with a revised proposal before the end of 2017.

eMPF

Another strategic focus of the MPF regime is to develop eMPF – an electronic platform to facilitate the standardisation, streamlining and automation of scheme administration processes.

Over 90 percent of the companies in Hong Kong are micro, small and medium enterprises (MSMEs) and their administration process in relation to MPF is highly paper-based, which can bring about operational inefficiencies to trustees / administrators. A back-of-the-envelope calculation done by the MPFA found that there are 100,000 transactions executed within the MPF ecosystem every day, which involves some form of manual intervention or paper processing.

In the industry, different systems are being used by different trustees / administrators. Having a more centralised administrative platform would contribute to greater efficiency and ultimately lower costs of administering MPF schemes.

If eMPF is able to transform from concept to reality, this could lower the operating costs of MPF providers and help both employers and scheme members manage their accounts more efficiently and effectively.

21 '2017 Policy Address, Enhancing the Mandatory Provident Fund System', The Government of the Hong Kong Special Administrative Region, https://www.policyaddress.gov.hk/2017/eng/p188.html
22 '2017 Policy Address, Enhancing the Mandatory Provident Fund System', The Government of the Hong Kong Special Administrative Region, https://www.policyaddress.gov.hk/2017/eng/p191.html

The government has expressed its support and included eMPF in the 2017 Policy Address [22]. An eMPF working group has been set-up, which includes representatives of the government, the MPFA and the industry to explore viable solutions to enable eMPF to be run commercially by an Administration Master (AM).

The work group is supported by two task forces with specific objectives. One task force, led by the MPFA, is for building of the AM and other streamlining, standardisation and automation initiatives. The second task force, led by the FSTB, will work out strategies and actions required to encourage employers / scheme members to switch from paper-based to electronic processing and transactions.

While it is expected that the government will fund the development of the underlying systems for the AM, the private sector has expressed interest on possible options for the ownership and operation of the AM.

Focusing on 'De-cumulation'

In view of Hong Kong's ageing workforce, the MPF system should place more on the 'De-cumulation phase'. There are calls for the government and the private sector to promote and develop more income stream products to meet the needs of retirees.

An example of this is a life annuity scheme by the Hong Kong Mortgage Corporation (HKMC), which is expected to launch in mid-2018. The scheme will provide lifetime-guaranteed pay-outs to annuitants who are Hong Kong permanent residents aged 65 or above. The pay-outs will occur following a lump-sum premium payment, which has a tentative cap and floor of HK$ 1 million and HK$ 50,000, respectively. The internal rate of return is estimated to be 4 percent, while the scheme also comes with a death benefit provision – which guarantees annuitants monthly payments that total 105 percent of the premium paid. If the annuitant passes away before receiving the full 105 percent, his or her beneficiary will receive the remaining amount. The scheme is still subject to the support of the HKMA and the IA.

Investment restrictions

A key performance indicator of the MPF system is the return of its funds, which has been mixed in recent years. The annualised internal rate of return of the MPF since its inception was 4.3 percent, while the average inflation rate over the same period of time was 1.8 percent.

Recent geo-political events have had a negative impact on business sentiment and financial markets in general. In addition, a low interest rate environment in most developed economies, has made it difficult for funds to generate higher investment returns. Many respondents noted that even if rates were to normalise, the pace is likely to be slow.

One option raised by some interviewees is to lift the investment restrictions on MPF schemes.

The existing list of permissible investments has undergone several changes since the launch of MPF. However, several interviewees and respondents indicated that the alterations are still not sufficient to keep up with the developments of the financial markets. Such concerns had led to calls to broaden the investment universe of MPF funds.

A key development in recent years has been mainland China's attempts to open up its domestic bond market to more foreign investor participation.

Yet MPF funds are unable to take advantage of this development and invest in mainland China's domestic bond market as existing regulations require them to invest in debt rated by international rating agencies. Local debt in mainland China, however, are predominately rated by domestic Chinese rating agencies. While there is no guarantee that buying local debt in mainland China could provide better retirement outcome for MPF scheme members, several market participants noted that having the option and flexibility to do so would be a positive move for the sector.

In addition, there have been calls for alternate investments such as infrastructures, hedge funds, commodities, as well as the integration of environmental, social and governance (ESG) factors in the investment process of fund managers, to be considered for inclusion in the MPF investment space over time.

It is noted that the market is somewhat split on this subject. On one side of the argument, the inclusion of alternate investments could help to broaden and diversify the investment universe of MPF funds.

Those against the inclusion, however, point out that the various asset classes within alternate investments have different risk profiles and not all of them might be suitable for inclusion as pension assets.

Strengthening governance standards

The MPF was set up based on a trust structure, in which trustees assume significant fiduciary responsibility in relation to the MPF schemes and are entrusted with the overall administration and management.

While investment decisions are made by the fund managers, the trustees have a high degree of responsibility to ensure that investment decisions are in accordance with the trust deeds and applicable laws and regulations. Approved MPF trustees have a duty to supervise and exercise proper control over persons acting as service providers of MPF schemes (mainly funds managers, administrators and custodians).

However, the MPFA recently conducted a review of MPF trustees and came to the conclusion there is a need to improve the overall governance of MPF schemes, including the diversity of the industry's board composition.

Current regulations require a trustee board to have one independent director, however the MPFA has stated that it is important for a board to include individuals with different skillsets and expertise. It suggested that a board should include a non-executive director, an independent executive director and an independent non-executive director.

23 Alice Law, Mandatory Provident Fund Schemes Authority

"The responsibilities and expectations of trustees of a mandatory social programme is naturally higher than those of an optional programme. A MPF trustee should always put their members' interest as their fiduciary duty and the key challenge is how the trustees can also make service providers work towards the same goal. [23]***"***

Private trusts

Hong Kong is positioned close to the centre of the world's largest and fastest growing markets of private wealth. The growth across the region and in China especially has seen a surge in the demand for wealth and estate planning services, which are supported by advisors who specialise in private trusts.

The primary use of private trusts within wealth management relates to wealth and estate planning. There is a growing demand for these services from UHNWIs who are seeking to manage the intergenerational transmission of wealth, implement succession plans for family-owned businesses and pursue long-term philanthropic goals. As the pool of wealthy individuals expands, wealth and estate planners in Hong Kong are seeing increasing demand from second and third-generation wealthy individuals.

Private trusts are also increasingly being used for Employee Benefit Trusts (EBTs) that can be in the form of ESOPs or other forms of employee incentive schemes, designed to retain or incentivise key employees. The usage of EBTs tend to increase sharply before and after a listing, and is considered a hybrid between a private family trust and an investment fund.

While the private trust industry is successful in Hong Kong and has huge potential for growth, many of the trusts used are trusts governed by offshore laws administered in the HKSAR, rather than trusts governed by the laws of Hong Kong.

Top reasons for establishing trusts using jurisdictions outside of Hong Kong

1	Customer demand/preference
2	Tax effectiveness
3	Legacy reasons
4	Flexibility
5	Company expertise

Source: Joint KPMG and HKTA survey

These are interesting times for the Hong Kong private trust sector, which faces a number of opportunities and challenges. For example, mainland China is a great source of wealth and is viewed as a key growth area for the Hong Kong trust industry. Key characteristics of the China market includes:

- Capital controls
- Concept of succession not well understood
- Trust concept not well understood; Chinese clients do not like to cede control of their assets to a trustee

- Focus remains on growing assets
- Families tend to be smaller due to the now abolished one-child policy, which means that the intergenerational transmission of wealth and succession planning is less complicated

There are also a number of jurisdictions that are eager to capture the wealth flowing out of China. Singapore, for example, has been actively building its wealth management industry and is a key competitor to Hong Kong in terms of attracting Chinese wealth.

There are also risks associated with the opportunity. Market participants in Hong Kong need to actively discuss the legal and tax implications of Chinese nationals using trusts. Additionally, the concept of trust is very different between China and common law jurisdictions with the former based on civil law. This difference, together with its implications, will need to be properly communicated with clients. China, for example, is not a signatory to the Hague Convention on the Law Applicable to Trusts and on their Recognition.

The rationale behind the usage of trusts can also differ. In Hong Kong, the bulk of the wealth tends to rest with the first and second generation of wealth generators. As a result, their focus is naturally on wealth management and intergenerational wealth transfer.

The demographics are different in China as the country's wealth lies predominantly in the younger generation. This means that their rationale for establishing trusts is usually borne out of business needs, such as pre-IPO or tax planning.

In addition, there is a huge volume of wealth in Asia that will be transferred to the next generation within the coming two decades. This presents a material risk for wealthy families if the process is not managed effectively, as the wealth tends to be tied up in large, complex family businesses. It is particularly important for Hong Kong to manage this transfer smoothly, as a significant proportion of the economy is privately owned. This development is a great opportunity for the trust industry.

Meanwhile, the geographic spread of families (settlors and beneficiaries) and trust assets creates challenges for advisors. Not only do the legal, tax and political regimes of a number of jurisdictions need to be factored into the structures at the planning and implementation stages, but changes in law and practice also need to be monitored in the course of administering trusts. Market participants with the benefit of a global network of legal and compliance teams will have a competitive advantage over local and regional players.

Expanding the product mix

Legislation clarifying the status of reserved powers trusts has helped expand the repertoire of domestic structures service providers are able to offer. Nevertheless, Hong Kong still faces intense competition.

The growth of family offices

Family offices – where a UHNWI sets up his/her own company to manage their private financial and legal affairs – have become increasingly popular and sophisticated. Private banks are looking to take advantage of this opportunity by setting up dedicated teams to provide family office services. These may be attractive to those super rich clients who do not want to run their own full-time family office.

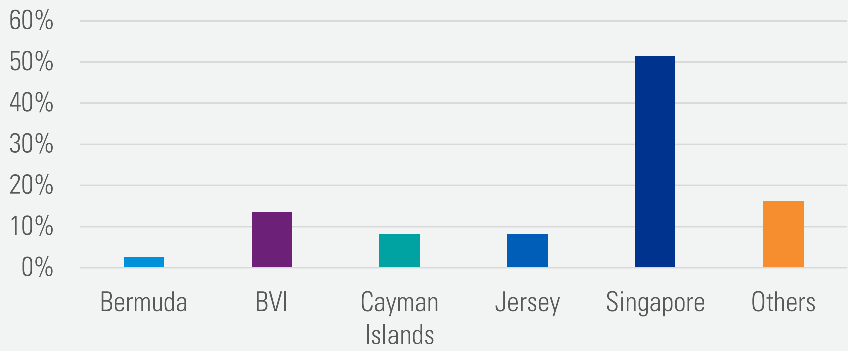
Wealth and estate planning advisors need to work to build relationships with family offices as well as with the ultimate client in order to win business; they should also ensure family offices understand the role and services trustees provide.

Family offices tend to use multiple providers and the super-rich will typically have a number of accounts with different private banks – tension therefore exists between this model and the wealth planning advisors' need for a more exclusive relationship with their clients.

For wealth and estate planning, face-to-face contact with the settlor is vital. Trustees need to learn how to work effectively with the family office, which may act as a 'gatekeeper' for the settlor.

Regionally, Singapore's emergence as a private banking and wealth management hub means that the Lion City is also focusing on the trust industry. Singapore's maturing asset management and private trust sectors puts the southeast Asian country in direct competition with Hong Kong. Marketing Hong Kong law governed trusts, which are relatively new in the industry, as estate planning and wealth management solutions has proved challenging. Clients typically still prefer trusts from traditional offshore jurisdictions such as BVI, Cayman Islands and Jersey.

Biggest competitors to the Hong Kong trust industry



Source: Joint KPMG and HKTA survey

One way to improve the Hong Kong's attractiveness as a trust jurisdiction would be to expand its product mix. Several respondents recommended the introduction of legislative changes to create trust structures similar to the BVI VISTA (British Virgin Islands Special Trusts Act[24]) trust or the Cayman Islands' Special Trusts Alternative Regime (STAR[25]) trust.

A traditional trust imparts the fiduciary duty on the trustee to ensure that assets are protected during the life of the trust. Trust assets are generally invested through a holding company, which is controlled by the trustee. This allows the trustee to oversee the management of the assets and ensure it adheres to the 'prudent investor rule'.

As a result, trustees tend to act conservatively during their stewardship of the trust assets. The high level of scrutiny and risk-aversion of professional trustees can lead to additional costs in both time and money.

Unlike conventional trusts, a VISTA trust removes the trustee's obligation to act based on the prudent investor rule, meaning it has no obligation to oversee the management of the underlying company. On the other hand, the STAR regime permits a trust to be set up for purpose of holding a specific asset, regardless of the investment performance of that asset. Under these regimes, the settlor then has the power to outline in the trust deed how and in what circumstances the trustee should use its voting powers to interfere with the management of a company.

24 'Virgin Islands Special Trusts (Amendment) Act, 2013', British Virgin Islands Financial Services Commission, http://www.bvifsc.vg/Home/LegislationResources/tabid/358/ctl/ArticleView/mid/1079/articleId/1355/categoryId/64/language/en-GB/Virgin-Islands-Special-Trust-Amendment-Act-2013.aspx
25 'Trusts Law (2011 Revision)', Cayman Islands Monetary Authority, http://www.gov.ky/portal/pls/portal/docs/1/11524845.PDF

The result is a trust structure that allows clients who are unfamiliar with the concept of trusts more comfort when transferring assets to a third party since they can continue to manage the underlying assets. Moreover, the greater control allows them to invest beyond what a trustee would traditionally deem as medium to low risk diversified investments.

Enacting legislation to provide for a VISTA or STAR-analogue would increase Hong Kong's ability to compete with other jurisdictions such as BVI, Labuan, and Samoa. It would also cater well to Chinese clients, many of whom are relatively new to the concept of trusts and would generally prefer to have greater control over their assets.

The introduction of VISTA, STAR trusts or other similar structures would help reduce the overreliance on private trust companies (PTCs) – an alternative many wealthy Chinese and Hong Kong clients choose to adopt with a view to retaining control over their assets.

PTCs are established with the purpose of acting as a corporate trustee to a trust or a number of trusts, provided they are 'connected'. A member of the family setting up the underlying trust, would then sit on the board of the PTC, which effectively allows the trust to be run by the family itself.

While PTCs allow families greater control over their assets, several interviewees noted that there is a chance that wealthy families or individuals are adopting PTCs without fully understanding the implications of doing so. One concern industry practitioners have is that many wealthy families or individuals may not actually possess the necessary administrative knowledge to run a trust. In some cases, these trusts are simply being managed like companies.

A complication in using PTCs lies with ownership of the trustee company, particularly in the event of a death within a family. If the owner of shares in a PTC dies, the shares will pass according to succession laws, which can lead to estate disputes and litigation.

Some advisors recommend establishing an offshore purpose trust, to hold the shares in the PTC. A professional trustee would, however, have to be appointed to administer the purpose trust, which adds another layer of administration and cost to what is already a complicated structure.

There are no regulations governing PTCs in Hong Kong at the moment and several interviewees indicated this is one area the government should seek to address. One solution would be to follow the lead of Singapore[25], which requires the appointment of licenced trustees to provide trust administration services for PTCs. However, this is not an option that is available to Hong Kong unless Hong Kong introduces licencing and regulation of trustees.

"There are some concerns that the introduction of VISTA or STAR trusts or other similar structures would turn Hong Kong into an offshore jurisdiction. That view is misguided because it is a jurisdiction's tax laws that determines whether or not it is a tax haven. While Hong Kong is a relatively low tax city, its tax regime is fundamentally different from that of offshore jurisdictions that charge no tax or a nil tax rate, and should not be considered an offshore jurisdiction or tax haven.[27]"

26 'Notices on the Prevention of Money-Laundering and Countering the Financing of Terrorism', Monetary Authority of Singapore, http://www.mas.gov.sg/Regulations-and-Financial-Stability/Anti-Money-Laundering-Countering-The-Financing-Of-Terrorism-And-Targeted-Financial-Sanctions/Anti-Money-Laundering-and-Countering-the-Financing-of-Terrorism.aspx
27 Michael Shue, Vistra

"Hong Kong charities are defined by the Common Law. While this bare bones system has met with some modest success, the regime doesn't fully reflect the 21st century marketplace, which is needed if Hong Kong is serious about developing the sector and securing high levels of governance and public trust. Other common law jurisdictions such as Singapore and the UK have their own charities act or legislation and Hong Kong should consider following suit.[28]*"*

Charitable trusts

Charitable trusts represent a small proportion of the wider Hong Kong trust industry, but have a profound influence on the city's social, cultural, and economic fabric. They are, together with statutory bodies, companies limited by guarantee, and societies, one of four broad structures that can be used to establish a charity in Hong Kong.

There are opportunities for industry development in this sector, and several interviewees have noted that high net worth families are looking to set up trusts for philanthropic purposes, as are overseas educational institutions with large contingents of Hong Kong alumni. There is also a growing number of Chinese clients interested in setting up charitable trusts in Hong Kong, which certain wealth managers have identified as a key growth area.

Obstacles to overcome

Limitations on the development of the charitable trusts sector in Hong Kong are largely due to the absence of a comprehensive statutory and regulatory framework for charities:

- No statute governing the establishment and governance of charities – charities law is still largely based on Victorian and early 20th century United Kingdom case law
- No industry regulator and therefore relative lack of transparency on the operations of charities
- Limited system of oversight of charitable fundraising activities
- Inconsistent standards and requirements on governance, accounting and reporting by charities resulting from the different types of legal structures
- Regulatory and reputational challenges arising from the misuse of charities to pursue commercial objectives

A number of interviewees have called for the establishment of a charities commission based on the United Kingdom model to operate as a registrar and regulator of charities. In principle, a charities commission would be the sole regulator for charitable bodies in Hong Kong, controlling, among other things, the establishment and recognition of charities for tax purposes, their governance, and further be responsible for ongoing monitoring of their operational and charitable activities. Industry participants have also called for a clear and broader statutory definition of charitable objects, again with a view to modernising the charities regime in Hong Kong and to reflect the jurisdiction's distinct social and cultural context. A credible, independent regulator should further serve to secure public confidence in charities.

Whilst the Secretary of Justice is the Protector of all charities in Hong Kong, he is not a regulator as such. His role is to represent the beneficiaries or the

28 Stefano Mariani, Deacons

objects of a charity. Consequently, apart from joining in legal proceedings involving Hong Kong charities, the Secretary of Justice generally leaves charities to operate autonomously under their own governing bodies and in accordance with their own rules. As a result, charities have no obligation to inform the public of their operations.

On the other hand, the IRD maintains a list[29] of charities exempted from tax under section 88 of the IRO. However, it is not compulsory for charities to have their names on that list, which is for tax-exempted status rather than regulatory purposes. In other words, merely because an organisation is on the list maintained by the IRD does not necessarily signify that it is a well-maintained charitable trust. Similarly, simply because an organisation is not exempted from tax under section 88 of the IRO does not mean that it is not a charity with proper governance. Plainly, the lack of objective certification of standards is an issue for charitable institutions and donors.

In practice, neither the Department of Justice nor the IRD actively review or otherwise oversee the operations of charities in Hong Kong. Whereas the IRD does conduct certain monitoring activities, these are intermittent and largely limited to random spot checks on registered charities' financial affairs, instead of systematically overseeing their governance. As a result, the standards of governance in Hong Kong charities can vary considerably.

29 'Charitable Donations and Tax-Exempt Charities', Inland Revenue Department, The Government of the Hong Kong Special Administration Region, http://www.ird.gov.hk/eng/tax/ach_index.htm

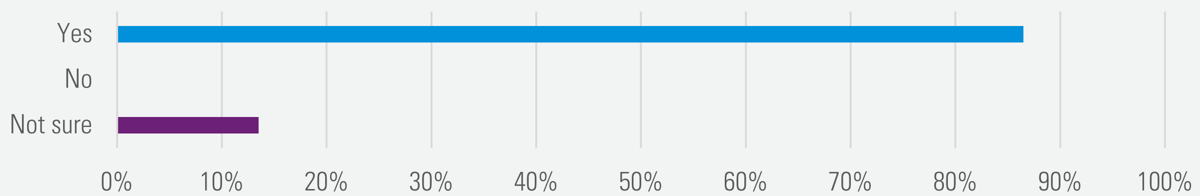
Looking ahead: Enhancing Hong Kong's competitive edge

The operating environment of the Hong Kong trust industry will be characterised by emerging opportunities, intensifying competition and increasing expectations from customers and regulators.

Industry players are under considerable pressure to grow their business under increasingly stringent compliance, reporting and regulatory requirements. On the other hand, they are also looking forward to the benefits that could arise from upcoming initiatives such as the expansion of the MRF scheme, ETF Connect, the proposed licencing regime for TCSPs, and the launch of OFCs.

More than 86 percent of respondents think the Hong Kong government ought to do more to encourage the growth of the trust industry.

Should the government do more to encourage the growth of the Hong Kong trust industry?



Source: Joint KPMG and HKTA survey

Some of the key areas that need addressing include reducing the burden brought about by regulatory compliance, the shortage of talent, the fragmented nature of the regulatory framework, and the perceived ambiguity of the tax treatment of trusts carrying on a trade or business in Hong Kong.

There are also more sector-specific improvements that can be made such as further enhancements to the MPF system (including the development of eMPF, availability of more retirement income stream products, review of investment restrictions), introduction of purpose trust and VISTA / STAR-type trusts, guidelines for PTCs, and establishing a charities commission.

In order to build on Hong Kong's strong foundations and leverage its advantages as a location for financial services, the government, regulators and the industry will need to increase their collaboration.

Greater coordination among stakeholders is required to position Hong Kong as the destination of choice for trust services amidst stiff competition from Singapore as well as traditional jurisdictions such as BVI, Cayman Islands and the Channel Islands.

This publication hopefully serves as a guide to the issues and opportunities surrounding the Hong Kong trust industry. If Hong Kong is able to take advantage of its inherent geographical strengths, mature physical and informational infrastructure, and respond to these challenges, it will help shape its position as a premier trust jurisdiction in the long term.

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In 1992, KPMG became the first international accounting network to be granted a joint venture licence in mainland China. KPMG China was also the first among the Big Four in mainland China to convert from a joint venture to a special general partnership, as of 1 August 2012. Additionally, the Hong Kong office can trace its origins to 1945. This early commitment to the China market, together with an unwavering focus on quality, has been the foundation for accumulated industry experience, and is reflected in the Chinese member firm's appointment by some of China's most prestigious companies.

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Publication number: CN-MS17-0005

Publication date: October 2017