A new limited partnership regime for private equity/venture capital funds in Hong Kong

By James Griffiths and Paul Lau

The Hong Kong Government is moving forward rapidly towards setting up a new limited partnership regime for onshore private equity and venture capital (**PE/VC**) funds with the publication of the Limited Partnership Fund Bill on March 20, 2020. The publication of the Bill was expected later this year and so its early release is a welcome surprise.

The introduction of the new regime is timely given that the PE/VC industry is currently dealing with new laws in the Cayman Islands (to date the most favoured jurisdiction for offshore PE/VC funds). In response to the Base Erosion and Profit Shifting package of the Organization for Economic Co-Operation and Development, which requires taxation to be levied where asset management activities take place, the Cayman Islands has introduced requirements for local "economic substance" that will affect many Cayman Islands incorporated investment managers of PE/VC funds. In addition, the Cayman Islands has brought in a new Private Funds Law in 2020, requiring PE/VC funds to register with and become subject to regulation by the Cayman Islands Monetary Authority.

The new regime should be of interest to Hong Kong and Mainland PRC sponsors of funds, as well as to U.S. and other international fund managers who have offices in Hong Kong.

What should PE/VC groups do now?

The Government is targeting a commencement date for the new regime of August 31, 2020. The PE/VC industry and professionals now have a relatively short window in which to study the bill in detail and to offer suggestions for improvement as the Bill goes through its committee and second reading stages, while recognizing that the Bill is already the result of months of discussions between Government, industry, and regulators.

PE/VC professionals in Asia considering raising new funds in the future will want to assess the benefits of the new Hong Kong regime in light of existing offshore alternatives.

As the regime requires an investment manager to be based in Hong Kong, PE/VC firms who wish to take advantage of the new regime may need to review their licence status under the Securities

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and Futures Ordinance (Cap. 571) (**SFO**) and where applicable consider obtaining a licence at least for Type 9 regulated activities (asset management).

Background

The creation of an onshore regime for limited partnership funds is part of the Government's effort to develop Hong Kong as a competitive hub for asset and wealth management in Asia and to position Hong Kong as the principal financial centre in the Greater Bay Area of southern China. The Government describes its approach as "multi-pronged" and has included:

- the introduction of a new domestic regime for Open-ended Fund Companies in July 2018 (currently subject to proposals for improvement);
- the expansion of a profits tax exemption for funds from one giving relief to certain open ended funds (introduced in 2006) to a "unified scheme" that was extended to cover offshore and onshore PE/VC funds (including the now proposed LPFs) in April 2019;
- the Hong Kong Financial Secretary's announcement in the 2020–21 budget heralding a potential tax concession for carried interest paid by private equity funds.

Features of the new regime

Key features of the Bill are as follows:

Constitution of an LPF

To be treated as an LPF under the new regime, a fund will need to register with the Registrar of Companies (**RC**) and to qualify for registration the fund must:

- have one general partner (**GP**) and at least one limited partner (**LP**);
- be constituted by a written limited partnership agreement;
- have a registered office in Hong Kong;
- have an investment manager (**IM**) appointed by the GP to carry out the day-to-day investment management function (the GP can also be the IM);
- have an independent Hong Kong auditor appointed by the GP to carry out annual audits of the LPF's financial statements;
- appoint a "responsible person", being a bank or other authorized institution, a corporation licensed by the Securities and Futures Commission, an accounting firm or professional or a law firm or professional, to carry out statutory anti-money laundering/counter-terrorist financing checks;
- if the general partner has no legal personality itself (e.g., if it is a limited partnership without a legal personality), have an authorized representative with legal personality to be responsible for the management and control of the LPF and liable with the general partner for all the debts and liabilities of the LPF; and
- have an English name, a Chinese name, or a name that includes both an English and a Chinese name.

Registration

The details to be registered are restricted to fairly basic items. The application must be submitted by a Hong Kong law firm or practising lawyer on behalf of the proposed GP and must contain the:

- name of the LPF;
- identification details of the GP and if relevant the authorized representative;
- registered office of the LPF in Hong Kong;
- investment scope and principal place of business of the LPF;
- identification details of the IM;
- identification details of the responsible person; and
- identification details of the law firm or lawyer submitting the application.

and a declaration and undertaking from the GP that the fund is intended to be set up as an LPF and meets the eligibility requirements. A certificate of registration will be issued by the RC on completion of the registration process and is conclusive evidence that the fund is registered as an LPF. The RC will maintain a public register of LPFs containing the above information and any changes required to be notified to the RC.

Importantly, no details need be notified to the RC regarding the limited partners (either on registration or by later notification), recognizing that institutional LPs typically insist on confidentiality.

Registration and annual fees are levied but these are modest.

Statutory obligations

Some offshore jurisdictions do not require an audit for a private fund. In contrast, an LPF must obtain an audit of its annual financial statements. Such financial statements are available to all partners in the LPF, but may not be made available for public inspection.

In addition, the GP/IM must maintain in Hong Kong a register of partners (including LPs), AML/CFT records obtained, records relating to transactions of the LPF, and information on the controller of each partner in the LPF. These items may not be made available for public inspection but may be accessed by regulators and law enforcement officers.

The GP must ensure that there are proper custody arrangements for the assets of the LPF. Without further definition, and without any requirement in the LPF regime for an independent custodian, it will be up to the GP and LPs to agree in the limited partnership agreement as to what arrangements constitute proper custody, taking account of the circumstances of the particular fund.

Contractual freedom

The LPF regime accepts that there should be broad freedom of contract as to the operation of an LPF, leaving the GP and LPs wide scope to agree in the limited partnership agreement on the admission and withdrawal of partners, the transfer of LP interests in the fund, the organization and governance of the LPF, the fund's investment scope and strategy, the rights and obligations of the partners, the scope of the fiduciary duties of the GP and the remedies for breach or default, the financial arrangements among the partners (including as to capital contributions, withdrawals, distribution waterfalls, and clawback obligations), the life of the fund (and extensions to any agreed term), the frequency of financial reporting and verification of net asset value, the custodial arrangements, and the dissolution procedures. Withdrawals and distributions can be made subject to the LPF remaining solvent.

Safe harbor for limited partners

The Bill provides reassurance that an LP's liability will generally be limited to the amount of the LP's "agreed contribution" (i.e., capital commitment), subject to the limited partner not taking part in the management of the LPF. As in the case of comparable offshore legislation, the Bill contains a fairly comprehensive list of actions that would not amount to taking part in the management of the LPF, including (among others) serving on or appointing any person to serve on a board or committee of the LPF or GP; acting as an agent, member, contractor, officer, or employee of the LPF or GP or as a director of the GP; acting or appointing a person to serve on the board of an investee of or service provider to the LPF; advising the GP/IM on or approving actions relating to the business, prospects, affairs, or transactions of the LPF; or taking part in certain decisions relating to the LPF, such as the admission or removal of partners, the extension of the term of the LPF, the incurrence of indebtedness by the LPF, a change in investment scope, or the dissolution of the LPF. An LP should not, however, participate in investment decisions of the LPF.

Dissolution and liquidation

Given that PE/VC funds typically have a limited life (often 7–10 years with the ability to extend for one or two additional years), it is important that the fund can be dissolved quickly and easily. The Bill provides a mechanism for an LPF to be dissolved in accordance with the terms of the limited partnership agreement, leaving it to the partners to agree to the detailed mechanism. Notice of dissolution must be given to the RC.

An LPF may also be dissolved by order of the Hong Kong High Court where needed to protect investors or on just and equitable grounds.

In addition, power is given to the Hong Kong High Court to wind up an LPF in certain circumstances, including the inability of the LPF to pay its debts.

The Bill also contains provisions for:

- a voluntary deregistration by the GP in certain circumstances similar to deregistration of companies (including where the LPF has no liabilities); and
- the "striking off" of the LPF by the RC in certain cases of default, including the fund not meeting the eligibility requirements for an LPF, the fund not having an investment manager or responsible person, or in certain circumstances the fund not being in operation or carrying on business, or where all the partners are corporations in the same group.

Enforcement powers

The RC is given various enforcement powers and the Financial Secretary may make regulations for the purposes of the Bill.

Tax and stamp duty treatment

Following the creation of a unified tax exemption for offshore and onshore funds in 2019, all privately offered onshore and offshore funds operating in Hong Kong, regardless of their structure, their size, or the purpose that they serve, can agree to meeting certain conditions to enjoy profits tax exemption for their transactions in qualifying assets (set out in Schedule 16C of the Inland Revenue Ordinance (Cap. 112) (**IRO**) and transactions incidental to the carrying out of qualifying transactions. An eligible fund can also enjoy profits tax exemption from its investment in both overseas and local private companies.

To be eligible for exemption, an LPF must fall within the definition of a "fund" under section 20AM of the IRO. Most typical PE/VC funds should not find this difficult as the definition of "fund" is based on the definition of a fund in the IRO and of a collective investment scheme under the SFO. However, it should be noted that if a business is structured as a fund but is operated for "general commercial or industrial purposes" as more specifically defined in the IRO, it will not be eligible for exemption from profits tax.

Transactions must be carried out in Hong Kong by or through, or arranged in Hong Kong through, a specified person, which in the case of an LPF is likely to be an investment manager licensed with the Securities and Futures Commission.

Since an interest in an LPF is not "stock" as defined in the Stamp Duty Ordinance (Cap. 117), no stamp duty should generally be payable on instruments under which an interest in an LPF is contributed, transferred, or withdrawn, at least where the contribution, transfer, or withdrawal is in cash or for a cash consideration. However, stamp duty would be payable on transfers of dutiable assets, including for example in-kind capital contributions of Hong Kong stock or immovable property, and in-kind distributions of such assets.

Conclusion

The Bill is a welcome development for Hong Kong as it seeks to expand its fund and asset management industry and to take advantage of the opportunities presented by closer cooperation with the Greater Bay Area in Southern China. It contains many features that will be attractive to GPs and LPs alike and will encourage the establishment of PE/VC funds in Hong Kong. Key features such as freedom to contract and the safe harbor activities for LPs are specifically designed to meet the operational needs of PC/VC funds and their investors.

The Bill could be expanded to allow for statutory migration of offshore PE/VC funds to Hong Kong. Indeed, as similar proposals are already under consultation for the OFC regime, it would be logical for equivalent arrangements to be included for LPFs in the Bill.

Adoption of the LPF regime may also help remove some of the regulatory uncertainties over the operation of PE/VC fund managers and advisers in HK.

Participants in the PE/VC industry should consult their legal and tax advisors to understand how the new LPF regime could help them develop their business in Hong Kong.

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