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Oversight

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Proposed Hong Kong Limited Partnership Regime for Funds

Background

By dint of its entrepreneurial culture and free markets as well as its proximity to the Mainland, Hong Kong has a strong PE industry. The Asian Venture Capital Journal estimated that at the end of 2018, the total capital under management of some 520 PE firms operating in Hong Kong exceeded HK$1.21 trillion.

In December 2015 the Hong Kong Financial Services Development Council (FSDC) issued "A Paper on Limited Partnerships for Private Equity Funds" – FSDC Paper No. 17 (FSDC Paper). The FSDC Paper highlighted Hong Kong's lack of suitable vehicles domiciled in jurisdiction for use as private equity (PE) funds. It followed the FSDC's initiative of November 2013 to encourage the creation of Hong Kong incorporated mutual funds which has ultimately resulted in the establishment of the open-ended fund company (OFC) regime. The OFC regime finally came into effect in July 2018 (see *Oversight* of August 2018) although as at the date of this publication none has yet been incorporated.

The FSDC Paper identified a number of benefits for Hong Kong if a suitable limited partnership regime were to be created: (i) the substantial community of PE firms already based in Hong Kong which will otherwise be motivated to establish onshore entities in other jurisdictions (such as the Cayman Islands or those with a good double tax agreement (DTA) network) will be able to use Hong Kong DTAs, (ii) foreign PE firms that wish to benefit from Asian investment returns will be motivated to set up in Hong Kong, (iii) the number of Mainland PE investors (encompassing State Owned Enterprises, pension and insurance funds and domestic PE funds) using Hong Kong that are expanding their outbound investment activities may be increased, and (iv) the Hong Kong based advisory firms which provide services to PE firms in fund administration, accounting, legal and tax advice will benefit from more business.

Hong Kong has long had in place the Limited Partnership Ordinance of 1912 (LPO) which is based on the United Kingdom's Limited Partnership Act of 1907 – although unlike the latter, the LPO has not been materially modified or updated during the over a century of its existence. The difficulty of utilising a limited partnership established under the LPO to date has been for a variety of reasons:

- the LPO does not cover issues relating to the distribution of capital;
- the general partner (GP) of a Hong Kong limited partnership would possibly be subject to licensing requirements under the Securities and Futures Ordinance (SFO); and
- a Hong Kong limited partnership and its general partner would likely be subject to Hong Kong profits tax.

In the 2019-20 budget speech at the end of February 2019, the Hong Kong Financial Secretary stated that the Government had been studying the establishment of a limited partnership regime for PE funds. The Government has now set out further its proposals (Proposal) after discussions with the Securities and Futures Commission (SFC), the Hong Kong Monetary Authority (HKMA), the Hong Kong Treasury and the Hong Kong Inland Revenue Department (IRD). This Oversight summarises and comments on the Proposals as well as the related issues identified previously by the FSDC of (i) taxation, and (ii) SFC licensing.

Legal Structure

The limited partnership fund (LPF) regime, as outlined in the Proposal, is to be a registration regime which, unlike the OFC regime, will not directly involve the SFC.

Notwithstanding the FSDC Paper's recommendation, the Government does not intend to modify or revise the LPO. The Proposal states that the Government is not intending to do so in order not to inadvertently affect non-fund limited partnerships already formed (which include game centres, restaurants and consulting firms) or future non-fund limited partnerships to be formed under the LPO. Whilst the Proposal concludes that a standalone, self-contained piece of legislation catering for the needs of funds would also be more "user-friendly", this approach differs from many jurisdictions and risks confusion. It should be noted that there are, at present, only 210 limited partnerships registered under the LPO.

The outlined LPF vehicle will, like a limited partnership under the LPO and in England and Wales, have no legal personality. It will need to be a "fund", which is likely to be further defined but similar to that of a "fund" under the newly revised Inland Revenue Ordinance (IRO) and that of a collective investment scheme under the SFO. Like most limited partnerships, for example those established in the Cayman Islands or under the LPO, an LPF will have to have at least one partner that is a GP with unlimited liability as regards the debts and liabilities of the LPF. Other partners will have limited liability provided they do not have day-to-day management rights or control over the assets of the LPF.

An LPF will be constituted by a written agreement, i.e. a form of limited partnership agreement (LPA) and the limited partners (LPs) who invest in the LPF will be able to agree the following terms of the LPA with the GP as the parties wish:

- admission and withdrawal of LPs, as well as transfer of partnership interests by LPs;
- organisation, management structure, governance and decision-making procedures of the LPF;
- investment scope and strategy of the LPF;
- powers, rights and obligations of the partners (subject to other applicable statutory obligations of GP under the LPF regime);
- scope of GP's fiduciary duties, and remedies for breach of default; and
- financial arrangements among the partners, such as capital contribution, distribution of proceeds, and clawback obligations of partners.

There is no indication in the Proposal that there will be any prescribed contents. The LPF will need to maintain a registered office in Hong Kong (in practice most likely the same office as that of the GP which will often be the office of the LPF's investment manager (Manager) or its lawyers).

Investment Scope

There will be no minimum capital requirement or restriction on the investment scope for a LPF.

The Proposal sets out requirements for the eligibility of the GP. The GP must be a Hong Kong private company incorporated under the Companies Ordinance but must also appoint a Manager. The Manager must be any of (i) a bank regulated by the HKMA, (ii) a licensed corporation under the SFO, (iii) an accounting professional or (iv) a legal professional. If the Manager carries on any business of regulated activity under the SFO for the LPF then the Manager would have to hold at least a Type 9 (asset management) license granted by the SFC.

The fact that non-SFC licensed entities may perform the role of the Manager in respect of a LPF suggests that LPFs will not primarily be restricted (as is the case with OFCs) to investment in "securities" as defined in the SFO.

In addition to appointing a Hong Kong auditor in respect of the LPF, a GP will need to ensure that there are proper custody arrangements for the assets of the LPF. Where the LPF will invest in securities this requirement, in effect, repeats the obligation binding on the Manager (which in that circumstance would have to be SFC licensed) under the SFC's Fund Manager Code of Conduct (FMCC).

Limited Partners

The Proposal does not indicate that LPs must be Hong Kong resident or meet any other eligibility requirement. Because the LPF will be, by its nature, a fund it will fall within the definition of a collective investment scheme under the SFO and thus be subject to the prohibitions on the marketing of its interests under the SFO to the public unless within an exemption. Accordingly most

LPs in LPFs will likely be professional investors as defined by the SFO (although the Proposal does not suggest that this will be a requirement).

A key feature of any limited partnership regime is the limitation of liability attaching to LPs. The Proposal says that LPs will enjoy such statutory limitation up to the amount of their respective commitment to the LPF. However, as with successful limited partnership legislation elsewhere (such as the Exempted Limited Partnership Law of the Cayman Islands), the LPF legislation will set out express safe harbours from what constitutes any LP as participating in the management of the LPF (which would otherwise cause such LP to lose its limited liability). The Proposal details these safe harbours as follows where a LP is:

- acting, or authorising a person to act, as an agent, director, shareholder, member, contractor, officer or employee of the LPF or the GP. Serving or appointing a person to serve, on a board or committee of the LPF or the GP, or revoking such appointment. Exercising any powers or authorities or performing any obligations in the capacity of the above positions;
- entering into, or acting under, a contract with the GP or any LP(s) of the LPF, provided that the contract does not require, or the action under the contract does not involve, a LP taking part in the day-to-day management of the LPF business;
- serving, or appointing a person to serve, on the board of directors, or a committee of any corporation in which the LPF has an interest, or any corporation providing management, consultation, custody or other services to the LPF or having a business relationship with the LPF, or revoking such appointment;
- discussing, advising, approving or authorising the GP, any LPs or the Manager on the business, prospects or affairs or transactions of the LPF;
- calling, requesting, attending or participating in a meeting of the LPs;
- exercising any right or power conferred under the LPA, other than any power to carry out management functions, but including the right to vote on or signify the approval or disapproval to any proposed transaction of the LPF;
- consulting, investigating, reviewing, approving or advising on the accounts, the valuation or the assets of the LPF or affairs of the LPF;
- acting as a guarantor for the LPF or the GP;
- approving or disapproving any amendment to the LPA or taking part in a decision about the variation of, or waiver of a term of, the LPA or associated documents;
- commencing or instructing someone to commence, continue or defend legal proceedings on behalf of the LPF where the GP has refused to do so without good reason; and
- taking part in a decision about: (i) whether a person should become or cease to be a GP or LP; (ii) whether the LPF should end or the term of the LPF should be extended; (iii) changes in the persons responsible for the day-to-day management of the LPF; (iv) the incurrence or renewal of indebtedness by the LPF; (v) a change in the investment scope of the LPF; (vi) entering into contract with other parties in relation to the business of the LPF; (vii) enforcing an entitlement under the LPA, provided that the entitlement does not involve a LP taking part in the day-to-day management of the partnership business; (viii) the exercise of the LPF's rights in respect of an investment; (ix) the participation by a LP in a particular investment by the LPF; and (x) the creation, extension, variation or discharge of any other obligation owed by the LPF.

Tax

The launch of OFCs was initially thought to be hindered, with regard to private funds, by the lack of any helpful tax exemption similar to the old offshore fund profits tax exemption under the IRO. However, as reported in the *Oversight* of March 2019, the Government amended the IRO as from 1 April 2019 by way of the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Ordinance. The effect of this legislation was to exempt all funds, no matter where established or domiciled, from Hong Kong profits tax arising from qualifying transactions provided that the relevant funds are managed by specified persons (essentially SFC licensed corporations). This has given OFCs equality of treatment with Cayman Islands mutual funds and LPFs should also be able to rely on this tax exemption in the same way as offshore funds can in respect of qualifying transactions.

In the FSDC Paper, the FSDC proposed not only tax neutrality as outlined above, but also that no stamp duty should be payable on assignment of interests in limited partnerships under the new regime. The Proposal states with regard to interests in LPFs that these are not "Hong Kong stock" as defined in the Stamp Duty Ordinance and so, on assignment, should not be chargeable to Hong Kong stamp duty. However, it is noted that in-kind capital contributions to a LPF or distributions by a LPF of Hong Kong stock would be dutiable in the normal way.

Hong Kong resident LPs and the GP of a LPF will be subject to profits tax, as applicable.

Licensing

It is clear from the Proposal with regard to Managers that (unlike OFCs) Managers will not necessarily always be regulated by the SFC (for example if the underlying investments of the PE fund structured as a LPF are shares in private companies under the Companies Ordinance and are therefore not "securities" under the SFO). However the requirement that a GP must appoint a Manager which is licensed by the SFC where appropriate to the investments of the LPF suggests that, given full delegation, the GP itself will not need to be licensed by the SFC (or fulfil any other regulatory eligibility requirement) to merely act as GP of the LPF.

The Proposal also states clearly that a LPF would only need to be authorised by the SFC as a collective investment scheme under the SFO if it is offered on a retail basis, i.e. to the Hong Kong public other than within an exemption.

With regard to the licensing of managers or advisers of PE funds in general it should be noted that there have recently been discussions with the PE industry to clarify the applicability of the regulated activities under the SFO to PE fund managers and advisers based out of Hong Kong. The SFO was enacted in 2003 and replaced, amongst other legislation, the Securities Ordinance. The old Securities Ordinance allowed an express exemption for investment advisers servicing only professional investors and investors outside Hong Kong. In addition, as mentioned above, the definition of securities under the SFO excludes shares in Hong Kong private companies which has often been misinterpreted to mean unlisted or non-public securities. These factors, taken together with the intra-group exemptions in the SFO under both Types 4 (advising on securities) and 9 (asset management) regulated activities, means that a significant proportion of PE fund managers and advisers in Hong Kong are unlicensed, often when they should be. There are only about 100 licensed PE firms in Hong Kong which represent approximately 3% of all licensed corporations.

The LPF regime, as proposed, is not ambiguous in this regard – an LPF investing in securities must have a SFC licensed Manager (and by extension the Manager will need to comply with the FMCC in respect of the LPF).

Formation

Under the LPO the establishment of a limited partnership is simple. A Form 1 must be delivered to the Companies Registry (CR) together with the relevant fees. On registration (which gives a partnership its limited liability status subject to compliance with the LPO) a Certificate of Registration of a Limited Partnership is issued within 5 working days.

The Proposal indicates a similarly straightforward registration process for a LPF and, unlike OFCs, the body which will handle LPFs is the CR not the SFC. However an application to register an LPF will differ from that of a LRO limited partnership in that it will have to be presented via a Hong Kong solicitor and include the following:

- the name of the LPF (which, it is proposed, will have to end with the words "Limited Partnership Fund" or the equivalent in Chinese);
- the name, address and signature of the GP;
- the Certificate of Incorporation and Business Registration Certificate of the GP;
- the registered office address of the LPF;
- the investment scope and principal place of business of the LPF;
- the name of the Manager (and if SFC licensed, its central entity number);
- a declaration and undertaking by the GP that the LPF will operate as a fund; and
- the contact information of the Hong Kong solicitor presenting the application.

Interestingly it is intended that an existing limited partnership under the LPO can, if it wishes, migrate or transfer by way of continuation as a LPF if it re-registers (presenting the same information as above). It is intended the new legislation will allow for the automatic survival of all legal rights and obligations. This is similar in concept to mergers of Hong Kong companies as provided under the Companies Ordinance (although Hong Kong statute will only automatically apply to Hong Kong law governed contracts, foreign courts should recognise the change of status).

Conclusion

Whilst it would arguably be better if the Government followed the FSDC's original proposal of amending the LPO, the LPF legislation, as put forward in the Proposal, will nonetheless be a significant and welcome change to the PE funds regime in Hong Kong. As explained briefly in this *Oversight*, greater clarity with regard to the licensing and taxation of PE managers and their funds respectively will bolster the further development of PE fund industry in Hong Kong. The availability of LPFs will complete the picture by offering a lightly regulated, tax neutral, tailored Hong Kong vehicle with the capacity to utilise DTAs. The anticipated quick establishment process through the CR and lowering of costs by removing the need for offshore counsel should make LPFs a popular choice. It is only to be regretted that the legislation will likely take time and it has taken almost 4 years since the FSDC Paper was published.

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