Limited Partnership Fund Ordinance: A new fund vehicle for private equity in Hong Kong

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On 17 July 2020, the Limited Partnership Fund Ordinance (Cap. 637) (**LPFO**) was gazetted, marking the latest milestone in Hong Kong's drive to establish itself as a competitive full-service asset and wealth management centre and a preferred place of fund domicile. The new limited partnership fund (**LPF**) regime will take effect on 31 August 2020.

Background

The introduction of the LPF framework follows the introduction on 30 July 2018 of the open-ended fund companies (**OFC**) framework in Hong Kong, as well as the unification with effect from 1 April 2019 of the profits tax exemptions for privately offered funds so that they apply (for transactions in specified assets and subject to meeting certain conditions) equally to onshore and offshore funds and to investments in both local and overseas private companies.

Whilst the purpose of the OFC regime is to provide a corporate vehicle for use by open-ended funds (including hedge funds), the limited partnership fund regime is aimed primarily at the private equity industry.

Traditionally popular offshore fund domicile jurisdictions such as the Cayman Islands are facing increasingly burdensome regulatory requirements driven by pressure from the OECD, including economic substance requirements and more stringent reporting obligations. Hong Kong asset managers should therefore consider whether or not to use Hong Kong fund vehicles for future funds.

Key features and requirements of an LPF

1. No separate legal personality

An LPF has no separate legal personality.

2. Eligibility requirements

In addition to being constituted under a limited partnership agreement, an LPF must have:

(a) a general partner[1], with ultimate management responsibility and unlimited liability in respect of all debts and obligations of the LPF;

(b) at least one limited partner, with no liability in respect of the debts or obligations of the LPF (provided it does not participate in the management of the LPF – Schedule 2 to the LPFO sets out a non-exhaustive list of permitted activities for this purpose);

(c) an investment manager[2] (appointed by the general partner) to carry out day-to-day

[1] The general partner must be a Hong Kong private company, an overseas company registered with the Hong Kong Companies Registry, a limited partnership, an LPF or an individual.

[2] The investment manager must be a Hong Kong private company, an overseas company registered with the Hong Kong Companies Registry or a Hong Kong resident.

investment management functions of the LPF (the general partner may appoint itself for this purpose);

(d) a "responsible person"[3] (appointed by the general partner) to carry out anti-money laundering and counter-terrorist financing functions;

(e) an independent auditor (appointed by the general partner); and

(f) a registered office in Hong Kong.

If the general partner has no separate legal personality, the LPF must also have an "authorised representative" (appointed by the general partner), which shall be responsible for the management and control of the LPF and jointly and severally liable with the general partner for the debts and obligations of the LPF.[4]

3. Registration with Companies Registry & Register of LPFs

The general partner applies for the registration of the fund as an LPF with the Companies Registry.

The Companies Registry maintains a publicly available index of the names of each registered LPF, as well as a publicly available register containing the information submitted by the general partner during the registration process and any subsequent information required to be submitted by the general partner from time to time (see 8 below). This information includes the name, registered office address, principal place of business and investment scope of the LPF, as well as the name and address of the general partner, investment manager and/or authorised representative (as applicable).

However, the register will not contain the details of the limited partners.

4. Contractual freedom among partners

The partners of an LPF have freedom of contract with respect to the operation of the fund. This includes: (i) admission and withdrawal of partners; (ii) transfer of interests by limited partners; (iii) management structure and governance; (iv) investment scope and strategy; (v) financial arrangements between partners (such as capital contributions and withdrawals, and distribution of proceeds); (vi) custodial arrangements (see 6 below); and (vii) life of the fund, possibility of extension and dissolution procedures.

5. Distributions to partners

Withdrawal of capital contributions and the distribution of profits and assets are permitted, provided the LPF remains solvent following such withdrawal or distribution.

6. Custody of assets

There is no requirement under the LPFO to appoint a third party custodian to hold the assets of the LPF, but the general partner must ensure that there are proper custody arrangements for the assets of the LPF as specified in the limited partnership agreement.

Separately, if the LPF investment manager is licensed by the Securities and Futures Commission (**SFC**) to carry on Type 9 regulated activity (asset management) (see 8 below) and is responsible for

[3] The "responsible person" must be a Hong Kong authorised institution, a corporation licensed by the Hong Kong Securities and Futures Commission, a Hong Kong accountant or a Hong Kong lawyer.

[4] The "authorised representative" must be a Hong Kong private company, an overseas company registered with the Hong Kong Companies Registry or a Hong Kong resident.

the overall operation of the LPF, then the manager will be subject to the requirements set out in the SFC's Fund Manager Code of Conduct with respect to custody of client assets.[5]

7. Ongoing obligations of general partner

In addition to being ultimately responsible for the management and control of the LPF, for ensuring proper custody arrangements for the LPF's assets as specified in the limited partnership agreement, and for appointing the LPF's investment manager, responsible officer and auditor (and, if applicable, authorized representative), the general partner must:

(a) file annual returns in respect of the LPF with the Companies Registry;

(b) notify the Companies Registry of changes in particulars of the LPF after registration, including changes in the investment scope or registered address of the LPF, or the identity or particulars of the general partner, investment manager or responsible person; and

(c) maintain proper records in relation to the LPF (unless this responsibility has been delegated to the investment manager).

8. Licensing requirements

The SFC's Licensing Handbook (most recently updated in July 2020) states that a private equity firm may be required to be licensed to carry on one or more types of regulated activity, depending on its business model. As a general guidance:

(a) if a firm is delegated with discretionary power to make investment decisions on securities for a fund in Hong Kong, it is required to obtain a licence for Type 9 regulated activity (asset management);

(b) if a firm has not been granted any discretionary investment authority by the fund it serves, it may still need to be licensed for the following types of regulated activities:

- Type 1 regulated activity (dealing in securities) for marketing or distributing a fund or conducting any other securities dealing activities (e.g. deal negotiation and trade execution) for the fund;

- Type 4 regulated activity (advising on securities) for providing advice in respect of the investments or prospective investments of the fund.

In anticipation of the new LPF regime coming into effect, the SFC published on 7 January 2020 a circular to clarify licensing obligations of private equity firms which conduct business in Hong Kong, including licensing requirements for private equity firms' general partners, investment committee members and fund marketing activities.

The circular also clarifies how the SFC assesses private equity firms' discretionary investment authority and investments in securities of private companies, as well as the industry experience requirement for their responsible officers.

[5] These include the requirement to select and arrange for the appointment of, and entrust the fund assets to, a custodian that is functionally independent from the manager. Where self-custody is adopted, the manager should to ensure that it has policies, procedures and internal controls in place to ensure that the persons fulfilling the custodial function are independent from the persons fulfilling the fund's management functions.

Given the requirement for an investment manager of an LPF to be a Hong Kong private company, an overseas company registered with the Hong Kong Companies Registry or a Hong Kong resident[6], we expect that in practice investment managers of LPFs will generally be required to be licenced by the SFC to carry on Type 9 regulated activity (asset management).

9. Tax treatment

The Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 came into effect on 1 April 2019, unifying the profits tax exemptions for privately offered funds so that they apply (for transactions in specified assets and subject to meeting certain conditions) equally to onshore and offshore funds and to investments in both local and overseas private companies.

An LPF will be able to benefit from the unified profits tax exemption in the same way as an offshore fund if it meets the relevant criteria set out in the Inland Revenue Ordinance (Cap. 112).

The Hong Kong Financial Secretary, Paul Chan Mo-po, noted in his budget speech in February 2020 that with a view to attracting more private equity funds to domicile and operate in Hong Kong, the Government plans to provide tax concessions for carried interest issued by private equity funds operating in Hong Kong subject to the fulfilment of certain conditions. The Government will consult the industry on the proposal, and the relevant arrangement will be applicable starting from 2020-21 upon completion of the legislative exercise.

An interest in an LPF is not “Hong Kong stock” for the purposes of the Stamp Duty Ordinance (Cap. 117) and so transfers (and issuances and redemptions) of LPF interests should not be subject to Hong Kong stamp duty.

10. Migration of existing funds

The LPFO provides a streamlined process for an existing Hong Kong fund established under the Limited Partnership Ordinance (Cap. 37) to register as an LPF subject to meeting specified eligibility requirements.

[6] The option under the LPFO for the investment manager to be a Hong Kong resident individual does not sit well with the prohibition under section 114(3) on a person performing any regulated function in relation to a regulated activity (e.g. asset management) carried on as a business, unless the person is carrying on such regulated function as a licensed representative or for a registered institution.

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