

SYNOPSIS SERIES

Establishing a Private Investment Fund Management Platform in Hong Kong

Hong Kong is widely recognised as a leading fund management center in Asia. Hong Kong offers the fund management industry a developed and stable economic, political and competitive tax environment; transparent and independent legal and regulatory framework; and a mature financial market with sophisticated banking, foreign exchange and securities infrastructure. In addition, distinguishing itself from its global counterparts, the Hong Kong fund management industry has developed a strong expertise of investing in Asia, particularly in Mainland China. Hong Kong's unique characteristic of being the gateway of the Mainland market has attracted large numbers of international fund managers to the city, many having adopted Hong Kong as the Asia foothold from which to develop a China strategy and broader pan-Asian businesses. At the same time, the number of Mainland fund managers establishing a Hong Kong presence has risen.

We set out below the general considerations for fund managers who may wish to establish an asset management presence in Hong Kong, particularly with regard to private investment funds.

Regulatory Framework

The Hong Kong Securities and Futures Commission (“**SFC**”) is primarily responsible for regulating and overseeing the Hong Kong securities and futures market. A fund manager managing a private investment fund out of Hong Kong will need to be licensed by the SFC to conduct the regulated activity of asset management (type 9), unless it can satisfy certain exemptions or actually fall outside the regulatory scope (eg. not securities management).

Depending on the structure of the fund (described in further detail below) and activities involved, the fund manager may also need to be licensed for other regulated activities. These may include having to be licensed to conduct activities in the nature of dealing in securities (type 1), dealing in futures contracts (type 2), advising on securities (type 4) and/or advising on futures contracts (type 5) regulated activities.

Licensing

A fund manager applying for a licence with the SFC will need to satisfy the following criteria:

Fund Management Entity

Generally speaking, a fund manager applying for licence with the SFC must establish either a Hong Kong incorporated company or a foreign company registered with the Companies Registry in Hong Kong.

Fit and Proper

In considering whether the fund manager and relevant personnel (which generally includes substantial shareholders, officers or any other persons to be employed by, or associated with, the applicant for the purposes of regulated activity) are fit and proper to be licensed, the SFC shall, in addition to any other matter that the SFC may consider relevant, deliberate on the following with regard to the fund manager and relevant personnel involved:

- financial status or solvency;
- educational or other qualifications or experience having regard to the nature of the functions to be performed;
- ability to carry on regulated activity competently, honestly and fairly; and

- reputation, character, reliability and financial integrity.

Competence

Applicants are also required to satisfy the SFC as to its competence for conducting the proposed regulated activity. The competence requirements stem from the fitness and properness requirements. Competence generally refers to having a proper business structure, good internal control systems and qualified personnel, to ensure proper management of risks that the applicant will encounter in carrying out the fund manager's proposed business as detailed in the business plan and compliance manual.

Responsible Officers

The fund manager needs to appoint at least two responsible officers to directly supervise the conduct of the regulated activity, and the applications relating to the responsible officers should be lodged with the SFC for consideration, along with the license application. At least one responsible officer must be an executive director and all executive directors must seek SFC approval as responsible officers. At least one responsible officer must be available at all times to supervise the relevant regulated activity, which means at least one responsible officer must be resident in Hong Kong.

The SFC will assess the competence of the responsible officers. Generally, each responsible officer has to fulfil these fundamental requirements:

- required academic / industry qualifications;
- at least 3 years of relevant industry experience over the past 6 years prior to the date of application;
- at least 2 years of management experience; and
- passed relevant local regulatory framework papers in the past 3 years.

Financial Requirements

The SFC imposes requirements on minimum paid-up share capital and liquid share capital. The requirements are different for different regulated activities. For type 9, the required minimum paid-up capital is HK\$5,000,000 and minimum liquid capital is HK\$3,000,000. If the applicant applies for more than one type of regulated activity, the requirements shall be the higher or highest amount required amongst the regulated activities. In certain circumstance, if the company is subject to the licensing condition that it shall not hold client assets, the company shall not be subject to the minimum paid-up share capital requirement, and the minimum liquid capital is reduced to HK\$100,000.

Licensing application

The fund manager needs to complete prescribed forms that are available on the SFC's website in respect of the corporation, its personnel (particularly, the substantial shareholder, the responsible officer and the representatives (if any)). The prescribed forms will need to be submitted together with a business plan and the prescribed fee. The SFC may request to review the compliance manual during the licensing application process.

The SFC is most concerned with the business structure and internal controls of the fund manager. In particular, the SFC will study the proposed business operation of the company, consider the inherent risks and potential conflicts and consider whether the fund manager will have the necessary system and/or procedures in place to mitigate potential risks and conflicts, while complying with regulatory requirements. The fund manager must observe internal systems and procedures in its day-to-day operations. Once the fund manager is licensed, it will continue with its regulatory obligations, with the SFC conducting regular inspections on its licensed fund managers. Once the SFC has accepted an application, an application will generally take 6 to 18 weeks to process.

Private equity funds

There is a market perception that fund managers of private equity funds which invest in private company shares / debentures or real estate projects out of Hong Kong will not need to be licensed by the SFC. However, a fund manager of a private equity fund may be considered as carrying out type 9 (asset management) activity depending on its structure or its specific investment strategy. Therefore, it is prudent in each case where the fund manager manages a private equity fund to ascertain whether it may fall under the SFC licensing regime.

Taxation

Generally, where a business is carried on in Hong Kong through an entity or permanent establishment in Hong Kong, there may be applicable Hong Kong profits tax on income or gains derived from such business (although Hong Kong does not apply any capital gains tax).

The structure of the fund as well as the fund management and operational set-up will commonly be driven by tax consideration, together with regulatory requirements, taking into account the actual specific circumstances of the proposed fund management operation, investments and arrangement on fees.

Fund

It has been market practice for private investment funds established and managed out of Hong Kong to be domiciled in tax neutral offshore jurisdictions. Non-Hong Kong resident funds that meet relevant conditions for the Hong Kong offshore funds profit tax exemption can be exempted from Hong Kong profits tax on profits derived from certain “specified transactions” (broadly defined in the Securities and Futures Ordinance of Hong Kong) which are carried out through or arranged by “specified persons” (i.e. managers licensed by the SFC) and provided the non-Hong Kong resident funds do not carry on any other business in Hong Kong. In addition, since 1 April 2015, subject to meeting certain qualification and conditions, the exemption is extended to benefit private equity funds as the range of “specified transactions” was expanded, to now include investments in Hong Kong or offshore private companies.

Fund Manager

The fund manager will usually be entitled to fees for acting as manager of the investment fund (such as management fees, performance fees or carried interests) and the fees may be subject to profits tax in Hong Kong. Depending on the actual operational arrangement of the fund, where the fund manager is located, where and by whom investment decisions are taken, the potential Hong Kong tax implications may vary. Further, investment advisory entities may be established where relevant for providing investment recommendations, research and analysis or for deal sourcing in the case of private equity funds.

Investors

The fund manager and investors should bear in mind anti-avoidance provisions and conditions for the Hong Kong profits tax exemption. A Hong Kong resident investor who, alone or jointly with an “associate”, holds direct or indirect beneficial interest of 30% or more of the offshore fund, or holds any percentage where the offshore fund is an “associate” of the Hong Kong resident, will be deemed to have derived assessable profits in respect of the trading profits of an offshore fund otherwise exempt from profits tax, even where no distributions are made by the offshore fund. “Associate” broadly refers to

relatives, partner or any corporation controlled by the person. This anti-avoidance provision will not apply if the private offshore fund is intended to be bona fide widely held.

Fund Structures

Broadly speaking, the fund structure will depend primarily, among others, on the type of investments the fund will make, the investor base, projected fund size and the fund management structure.

An investment fund may be open-ended allowing investors to subscribe or redeem from time to time on the terms of the fund depending on the liquidity of the investments, or may be closed-end having a fixed term. For this reason, private equity funds tend to be closed-ended whereas securities investment funds are usually open-ended funds.

Standalone structure vs Umbrella structure

Funds may be established as a single standalone fund (fig. 1) or as an umbrella fund structure (fig. 2) with several sub-funds. Both umbrella fund structure and standalone fund structure are legally viable, and the choice between the two is largely driven by commercial considerations. Some key reasons are:

- (i) *Sharing resources and costs:* An umbrella fund offers the option to establish and operate several sub-funds within one platform of a single legal vehicle, which enables the resources and administration costs of the structure to be shared among the sub-funds, including such as the manager, trustee, regulatory and audit functions and needs to be shared. This is particular appropriate where the funds may be of smaller size and the cost of maintaining a single standalone fund is too high.
- (ii) *Administrative convenience:* Such a platform enables administrative convenience of maintaining several sub-funds under a common framework. It is beneficial where the sponsor or manager wishes to establish and operate a number of funds at the same time, instead of having a number of different standalone funds.
- (iii) *Speed to market:* Establishing and operating an umbrella fund also provides ease of setting up new fund as sub-fund, and facilitates speed to market new products. It is faster to plug a new fund into an existing umbrella fund with existing framework and service providers, than to establish a new fund which would involve more time to put in place new service providers and new extensive new legal documents for a standalone fund each time.
- (iv) *Switching:* An umbrella fund structure is also preferred where it is intended to offer different funds to investors and where investors may be provided with the ease of switching between sub-funds within a common structure that contains the same legal terms besides the commercial differences of one sub-fund from another sub-fund.

Some fund managers adopt a standalone structure as it may be considered as simple and more straightforward. This may tend to be used for new or smaller managers that are more conservative in the number of products to be offered. Where a manager intends to offer a small number of products, or intends to offer one product without clear plan to offer subsequent products, it may decide to establish the fund as a standalone fund. In doing so, the manager would only need to consider the terms of the structure with respect to the immediate fund, which is easier than having to consider longer-term issues for establishing a platform to allow and suit multiple different funds.

Sometimes, a standalone fund may be considered as adopted where there is a unique feature or its strategy is less appropriate for umbrella fund structure, such as where there is higher expected leverage (eg. hedge fund). These factors are however not necessarily conclusive or absolute.

Fig 1. Standalone structure

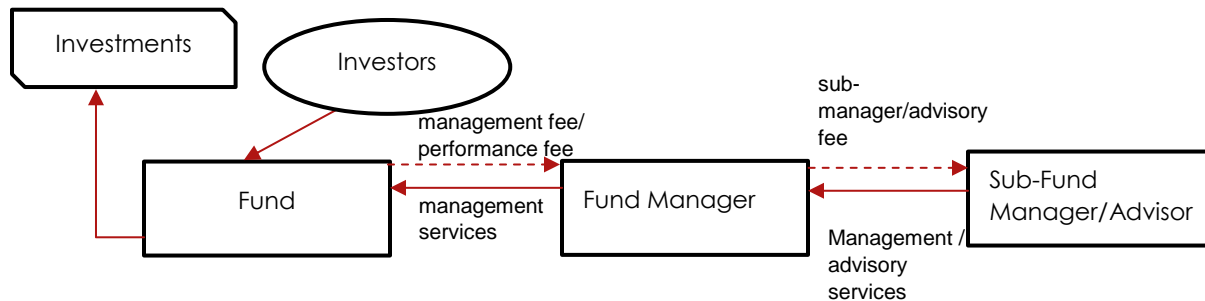
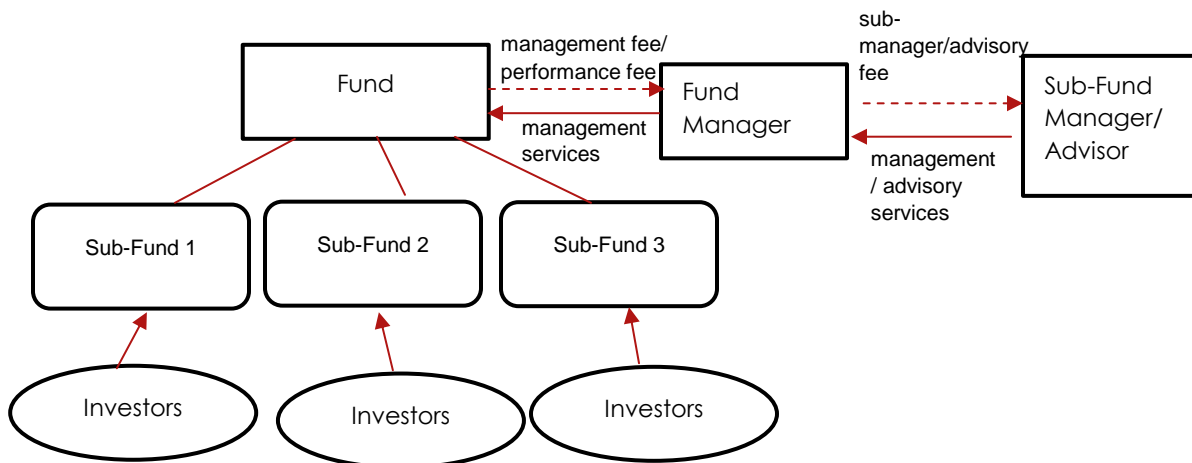


Fig. 2 Umbrella structure



Fund vehicles

Limited liability company

In Hong Kong market practice, a standalone fund is commonly established by adopting a simple limited liability company domiciled in an offshore jurisdiction. This is usual for standalone hedge funds. Current limitations in company laws in Hong Kong are such that Hong Kong limited liability companies cannot be adopted for open-ended funds (and although Hong Kong has initiated the legislative process for open-ended fund company structure, this may only be adopted pending further issue of relevant regulations and requirements).

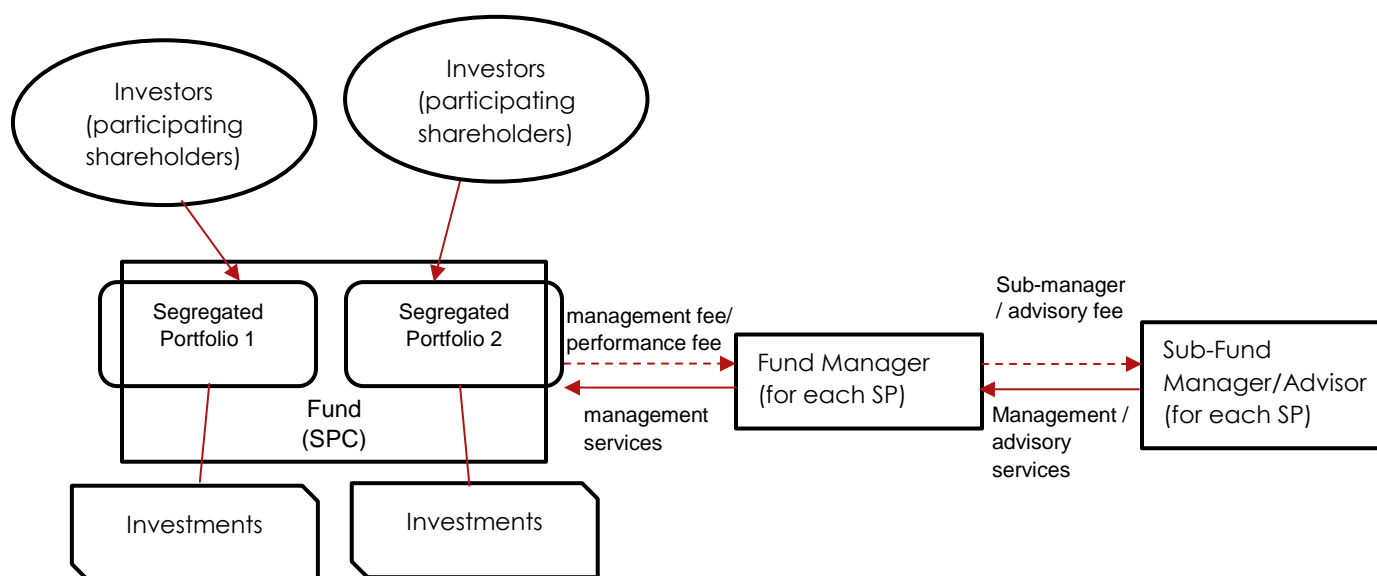
A limited liability company can be established as an umbrella fund by creating share classes for each sub-fund. However, in recent years, Cayman domiciled segregated portfolio company (discussed below)

is increasingly popular for establishing private investment funds structured as corporate umbrella fund structures (except this is not applicable for private equity funds).

Segregated portfolio company

One of the options for setting up umbrella structures is to adopt a segregated portfolio company (“SPC”), a form of exempted limited liability company in the Cayman Islands. Segregated portfolios (the “SPs”) may be created within a SPC whereby Cayman Islands law provides statutory segregation of assets and liabilities of each SP from any other SPs, or from the SPC’s general assets and liabilities.

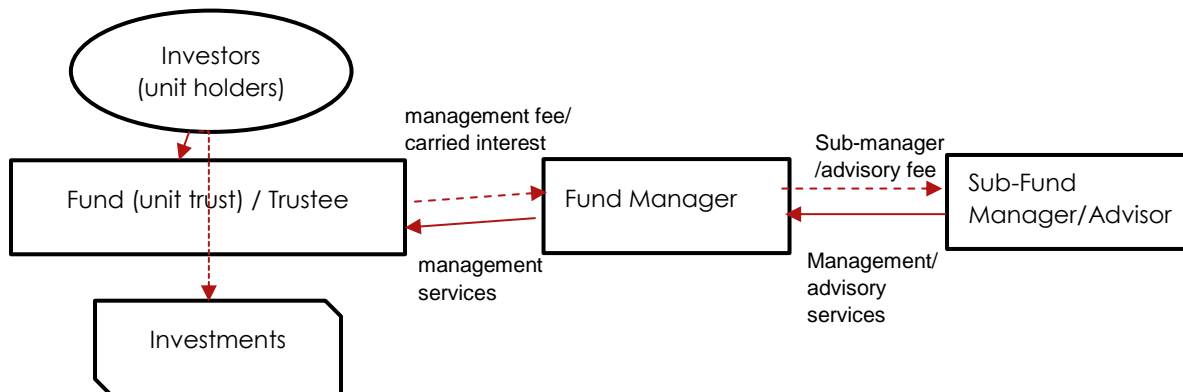
However, in considering whether or not to adopt the SPC structure, it should be noted that the SPC as a single legal entity is subject to restrictions applicable to a company. For example, a SP is not permitted to invest into another SP and a SP cannot enter into binding agreements with another SP, as they do not constitute two separate contracting parties. In addition, while the SP structure exists in various other jurisdiction, such as British Virgin Islands, Delaware, Bermuda, Guernsey and Jersey, and has become increasingly well recognised and adopted in Hong Kong and elsewhere, there is a potential risk that if proceedings were brought in a jurisdiction outside the Cayman Islands, the courts of that foreign jurisdiction may not give effect to the segregation principle that stops the assets of one SP from meeting the liabilities of another SP. Even though contractual terms such as exclusive jurisdiction clause may be added to any agreements, this risk cannot be fully mitigated. In some cases where applicable, the risk may be mitigated somewhat through the use of special purpose companies for investing in each deal. Appropriate advice on this issue should be obtained from offshore counsels if required.



Unit Trust

A unit trust is a form of collective investment constituted under a trust deed, whereby a trustee will hold the trust fund (including the cash, investments and assets of the fund) on behalf of the investors who shall hold units, each unit representing an undivided interest in the trust fund. A unit trust can be established as a standalone structure or an umbrella structure. If it is established as an umbrella structure, assets and liabilities of each sub-fund will be segregated pursuant to the provisions of the trust deed. Hong Kong domiciled funds are established as unit trust structures, as the only form of Hong

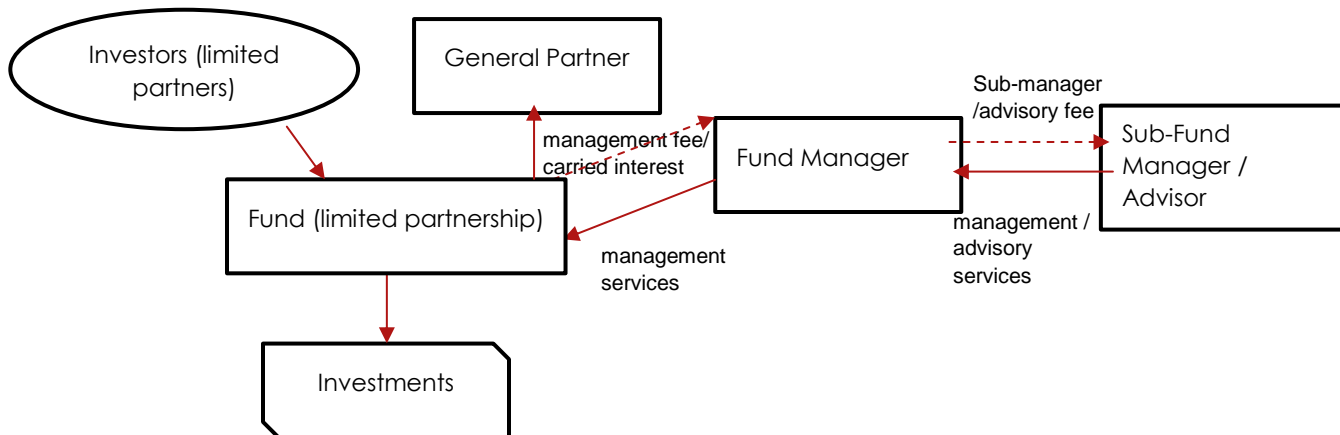
Kong domiciled legal vehicle suitable for investment funds under current Hong Kong laws and regulations (although an open-end fund company structure may be adopted in the future as mentioned above). For fund managers intending to set up an asset management base in Hong Kong to serve the wider Asian region, Japanese investors are particularly familiar with the unit trust structure and fund managers intending to raise capital from that market generally favour the unit trust structure.



Limited partnership

A limited partnership fund constituted by a limited partnership agreement typically affords flexibility in that provisions such as capital calls, capital accounts and distributions can be agreed with investors based on the commercial terms of the fund and investments. In this structure, investors are generally limited partners liable only to the extent of their committed or investment capital, while the general partner, commonly a limited liability company, assumes responsibility for the operations of the fund.

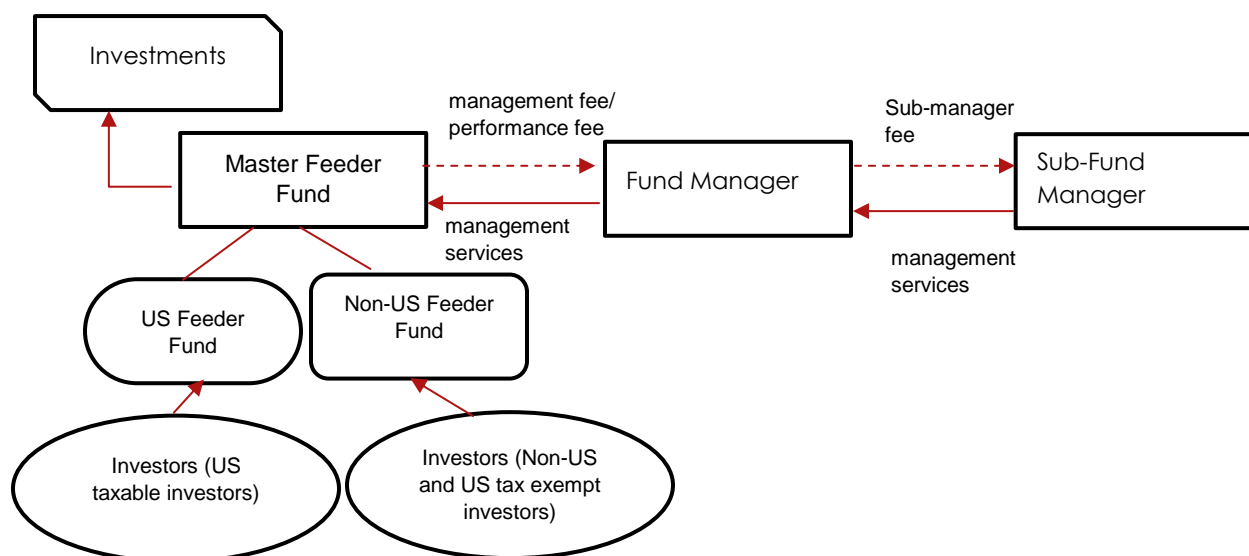
The limited partnership structure is commonly adopted for private equity funds, although we have seen in recent times the use of SPC for private equity type of funds. Generally, the SPC structure may be used for open-ended fund and may also be for closed-end fund.



Master Feeder Structure

The purpose of a master feeder structure is generally to create a tax efficient structure for US tax-payer investors. As noted in the diagram below, US taxable investors will invest in the fund through the US feeder fund, while US tax-exempt investors will invest, along with non-US investors, through the non-US feeder fund. The portfolio of investments will be held at the master fund level.

Some fund managers that are only expecting US taxable investors at a later date may initially establish a single-legged master feeder fund, which means the US feeder will be established later when the private investment fund is being offered to US investors.



Onshore – offshore structures for China

Quite naturally, Hong Kong has been used as a strategic base for establishing an investment platform and structures for investing in China. This is true for managers who target securities investments on the domestic stock exchanges or markets in China through the “Qualified Foreign Institutional Investors” (QFII) scheme, the equivalent scheme in Renminbi (RQFII) and since 2014, the Shanghai-Hong Kong Stock Connect. Whereas, many private equity managers have also based out of Hong Kong while investing in China companies and projects. In recent years, there has also been tremendous growth and development in China domestic private investment funds industry. The deep established expertise and infrastructure in Hong Kong now also attract China managers to seek a management and operational base in Hong Kong.

The operational needs of such managers often result in having to consider setting up certain onshore and offshore structures in the establishment of private investment fund platforms in Hong Kong. In addition, there is increased appetite among domestic China investors for investing in funds and alternative investments including hedge funds and private equity.

China outbound securities investments may be made by domestic investors under the “Qualified Domestic Institutional Investors” (QDII) scheme, while under certain relevant regulatory framework, foreign managers may establish domestic funds in China. For example, under the “Qualified Domestic

Limited Partner” (QDLP) scheme administered in Shanghai or the “Qualified Domestic Investment Enterprise” (“QDIE”) administered in Qianhai district in Shenzhen, foreign managers may apply to establish a domestic fund structure and set-up, thereby fund-raise from domestic investors for offshore investments.

Onshore-offshore structures may vary depending on whether any investment or management operations, target investments and/or investor base are in the Mainland China. Managers with operations and fund raising capabilities in both Mainland China and offshore may consider establishing parallel onshore and offshore funds.

Fund-raising in Hong Kong

Generally, private placements in Hong Kong may be made to “professional investors” (as defined in the Securities and Futures Ordinance of Hong Kong). Under Hong Kong securities offering laws, an offering is not a public offer where, if it is a corporate structured fund, it can only be offered to:

- (a) an unlimited number of “professional investors”;
- (b) no more than 50 people; or
- (c) with a minimum investment of not less than HK\$500,000 per investor.

Offering by way of (a) and (b) may be combined.

If a fund is not structured as a corporate, such as a unit trust or a limited partnership, it can only be offered to:

- (a) an unlimited number of “professional investors”; and
- (b) no more than 50 people.

In brief, “professional investors” refer to institutional investors such as financial institutions and specific bodies as prescribed in the legislation, or individuals or corporates that meet the relevant minimum net-worth or net assets requirements. A private offering of the interests of private investment funds in Hong Kong should be made through an entity licensed by the SFC to conduct the regulated activity of dealing in securities (type 1). While an exemption for offering as a principal to “professional investors” may be available, it requires some analysis whether indeed applicable as well as requiring compliance process on determining “professional investors”. The intermediary involved in the private offering and marketing of the private investment fund in Hong Kong should be instructed to strictly conduct the distribution, offering and marketing on a private placement basis

Contact Details

If you would like to know more information about the subjects covered in this publication, please feel free to contact the following people or your usual contact at our firm.

Vivien Teu
Partner
Vivien Teu & Co LLP
Tel: (852) 2969 5316
vivien.teu@vteu.co

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