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21 August 2020

Stepping Up the Game: Hong Kong to Welcome its Limited Partnership Fund Regime, Hopeful to Draw in Onshore Private Equity Investments

Private fund managers and investors now have an additional option to form or invest in Hong Kong domiciled private limited partnership funds under the Limited Partnership Fund Ordinance (“**LPFO**”) (Cap.637 of the Laws of Hong Kong), enacted and effective by 31 August 2020.

This addition to the local fund regulatory landscape caters for the trend of shift in private funds’ favoured domicile from offshore (such as the Cayman Islands and British Virgin Islands) to onshore jurisdictions in response to a worldwide regulatory clampdown on cross-border tax avoidance. Such onshore shift is largely driven by the increasingly stringent scrutiny over offshore fund vehicles, such as the BEPS initiatives¹ and the introduction of economic substance rules², which has inevitably reduced the economic feasibility of offshore jurisdictions as private fund domiciles.

To step up the efforts in promoting Hong Kong as a desirable domiciliation for private funds, changes are being introduced by the Limited Partnership Fund (“**LPF**”) regime through the LPFO to bring the city’s regulatory rulebook in line with international standards. Innovations introduced by the LPF regime are presented in the table below:

¹ Base erosion and profit shifting (BEPS) initiatives refer to the commitments by traditional offshore jurisdictions (e.g. Cayman Islands) to the Organisation for Economic Co-operation and Development (OECD) to implement transparency and effective exchange of information for tax purposes, which led to reforms to their laws to counter base erosion and profit shifting.

² Economic substance rules requires the “alignment of form and substance”, i.e. profits generated must align to where the core profit-generating activities are being carried out and where management and control are exercised with operating expenses incurred.

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Innovations introduced by the LPF Regime	
Capital Contribution and Profit Distribution Mechanisms	<u><i>Flexibility preserved for financial arrangements</i></u> Freedom of contract enjoyed by the partners entitles them to withdraw their contribution and receive any proceeds in accordance with the terms as agreed in the limited partnership agreement (“LPA”). ³
LP’s Management Involvement	<u><i>Scope of permissible management activities is sufficiently wide and in line with other jurisdictions</i></u> Limited Partners (“LPs”) are given certain latitude in relation to their involvement in fund management, with a non-exhaustive list of “safe harbour” activities, the partaking of which will not jeopardise their limited liability status.
Confidentiality	<u><i>Records kept in confidence</i></u> (Save as required by law or regulatory authority ⁴) The particulars of the LPs are not to be made available for public inspection. ⁵
Profit Tax	<u><i>Exempted</i></u> An LPF will enjoy tax exemption if it satisfies the conditions prescribed by the Inland Revenue Ordinance (Cap. 112) (the “IRO”). ⁶
Winding Up or Dissolution Mechanisms	<u><i>Pursuant to LPA without Court order</i></u> ⁷ (save in prescribed circumstances ⁸) More straightforward and cost effective.

1. Key Highlights

1.1 Must satisfy definition of “fund”

³ Clause 16 of the LPFO.

⁴ Clause 30(2) and (3) of the LPFO.

⁵ Clause 30 of the LPFO.

⁶ Section 20AN of the IRO.

⁷ Clause 70 of the LPFO.

⁸ Clause 71 of the LPFO.

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To establish under the LPF regime, an LPF must fall within the definition of “fund”⁹, and a two-year window was allowed for the recruitment of LPs that are not affiliated with the General Partner (“GP”) to satisfy the requirement that not all the partners in the LPF are corporations in the same group of companies.¹⁰

1.2 Constitution and Registration

An LPF must be constituted by a Limited Partnership Agreement (“LPA”) with ONE¹¹ GP (multiple GPs are not allowed) and at least one LP. An eligible fund must be registered with the Registrar of Companies and, upon successful registration, a certificate of registration will be issued.¹² Notably, registration and authorisation by the Securities and Futures Commissions (the “SFC”) are generally not required for an LPF as opposed to funds being structured as an open-ended fund company (“OFC”)¹³.

1.3 Requirements, Rights and Liabilities of GP

The GP must either be:

- a natural person at least 18 years of age;
- a Hong Kong private limited company;
- a registered non-Hong Kong company;
- an LPF; or
- a limited partnership registered under the LPO;
- a non-Hong Kong limited partnership with or without legal personality¹⁴.

⁹ Clause 3 of the LPFO.

¹⁰ Clause 7(1)(i) of the LPFO.

¹¹ Clause 7 of the LPFO

¹² Part 2 of the LPFO.

¹³ The OFC regime, as implemented by the SFC with effect from 30 July 2018, allows for a Hong Kong-domiciled OFC to be structured in corporate form, with added flexibility regarding the creation and cancellation of shares to cater for subscription needs or meet redemption requests by its investors.

¹⁴ The LPFO defines “non-Hong Kong limited partnership” (非香港有限責任合夥) as a limited partnership that (a) is not a limited partnership fund or a limited partnership registered under the Limited Partnerships Ordinance (Cap. 37); and (b) is permitted, authorized, formed or registered under the laws of a jurisdiction outside Hong Kong.

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With the LPF having no separate legal personality, the GP (with unlimited liability) shall shoulder all liabilities in relation to all debts incurred and obligations arising from the operation of the LPF and bear ultimate responsibility for the management and control of the fund. In connection with the foregoing, the GP thus has the duty to (and must), among other things, appoint:

- (1) an investment manager (“IM”), for the execution of day-to-day investment management functions;
- (2) an independent auditor; and
- (3) a responsible person (“RP”) to ensure compliance with anti-money laundering (“AML”) obligations and the implementation of all requisite measures.¹⁵

As the LPF regime specifically provides for the possibility of a GP donning both the roles of an IM and RP (i.e. effectively allowing for the GP’s self-appointment into such roles), the practical effect of such remains to be seen.

1.4 Requirements, Rights and Liabilities of LP

The LP must be a natural person, a corporation, a partnership, an unincorporated body or any other entity.¹⁶ The LPs have the right to participate in the income and profits arising from the management of the fund or withdraw their capital contributions to the extent that the fund remains solvent following such distribution or withdrawal.¹⁷ The LPs’ liabilities are limited to their agreed contributions provided that they have no control over the fund assets and are excluded from day-to-day management of the fund.¹⁸

1.5 Flexibility in fund management and operations

The LPF regime entails freedom of contract by the partners of an LPF regarding the operation of the fund, including, but not limited to, the determining of matters in the LPA in relation to the admission and withdrawal of partners, transfer of interest by the LP, management structure and governance, investment scope and strategy, power, rights and

¹⁵ Part 3, Division 2 of the LPFO.

¹⁶ Clause 7(d) of the LPFO.

¹⁷ Clauses 17 and 26 of the LPFO.

¹⁸ Save for those “safe harbour” activities that does not fall within the definition of “management” under the LPR regime.

obligations of the partners, financial arrangements (capital contributions, withdrawal of contributions, distribution of proceeds) and dissolution procedures.¹⁹

1.6 Streamlined Migration Procedures for Existing LPO Funds

Streamlined mechanisms are in place for funds established under the LPO to migrate to the new LPF regime, provided that the prescribed eligibility requirements are met.²⁰ Such migration would not affect a fund's continuity and identity, as well as the rights and obligations of its partners, nor would it risk incurring any adverse tax or stamp duty implications.²¹

1.7 Straightforward Winding up and Dissolution Mechanism

For private funds which are characterised by their fixed investment objectives and limited existence periods, the LPF regime offers a simple and flexible mechanism for dissolution to better align with their timely needs. The proposed dissolution and winding-up procedures are as follows:

- Without obtaining an order from the Court, the LPF could be dissolved according to the LPA, or dissolved where there are certain default events occur in relation to the GP or the authorized representative (the “AR”) who is not replaced within 30 days after such default events, these events include where the GP or AR goes bankrupt, dissolves, dies or ceases to be the GP or AR.²²
- By an application of a partner or a creditor of the LPF, the Court may order a dissolution of the fund where a partner willfully or persistently commits a breach of the LPA, the LPF can only be carried on at a loss, or it is just and equitable to dissolve the LPF.²³
- An LPF may be wound up by the Court as an unregistered company under Part X of the Companies (Winding Up and Miscellaneous Provisions) Ordinance.²⁴

¹⁹ Clause 16 of the LPFO.

²⁰ Clause 79(1) of the LPFO.

²¹ Part 7 of the LPFO.

²² Clause 70 of the LPFO.

²³ Clause 71 of the LPFO.

²⁴ Part 6, Division 2 of the LPFO.

2. Safe Harbour Provisions for LPs

Schedule 2 of the LPFO provides a non-exhaustive list of “safe harbour” activities, the partaking of which would not be considered management of the fund. As it is typical and at times essential for LPs to be involved in certain aspects of the fund’s establishment and execution, the clear-cut approach should help allay the concerns of LPs who are prone to having their limited liability protection stripped away through their participation in the management of the LPF. Below are some examples of such “safe harbour” activities:

- Acting as or appointing a person to be an agent, member, contractor, officer or employee of the LPF;²⁵
- Acting as or appointing a person to be an agent, director, member, contractor, officer or employee of the GP in the fund;²⁶
- Serving on or appointing a person to serve on a board or committee of the fund or of the GP in the fund, or revocation of such appointment;²⁷
- Serving on or appointing a person to serve on a board or committee of any corporation in which the fund has an interest, or which provides management, consultation, custody or other services to the fund;²⁸
- Approving or authorizing the GP, another LP or IM to engage in the business, prospects or transactions of the fund;²⁹
- Participating in a decision about change in fund management and investment scope, the term of fund and participation of partners.³⁰

3. Investor Confidentiality

In line with the international and Hong Kong AML standards, an RP is required, under the LPF regime, to implement recording-keeping measures in respect of accounting, partners, customers, transactions and the controller of each partner of the fund.³¹ Such

²⁵ Schedule 2, Clause 1 of the LPFO.

²⁶ Schedule 2, Clause 2 of the LPFO.

²⁷ Schedule 2, Clause 5 of the LPFO.

²⁸ Schedule 2, Clauses 7,8 of the LPFO.

²⁹ Schedule 2, Clause 10 of the LPFO.

³⁰ Schedule 2, Clause 18 of the LPFO.

³¹ Schedule 2 to Anti-Money Laundering and Counter-Terrorist Financing Ordinance (“**AMLO**”) and Clauses 29,

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records are required to be kept at the registered office of the fund or made known to the Registrar³² but is otherwise not open to public inspection, which would prove attractive to private fund investors who would certainly prefer to have their anonymity and confidentiality preserved.³³

4. Preferential Tax Treatment

4.1 Profits Tax Exemption for LPF

Albeit there being no explicit mention of tax exemption in the LPFO, an LPF is entitled to a profits tax exemption if it is a “fund” which falls under section 20AM of the IRO and being subject to certain exempted conditions under section 20AN of the IRO on transactions in assets specified in Schedule 16C to the IRO and in carrying on those transactions.

4.2 Stamp Duty Exemption for LPF

Generally speaking, no stamp duty will apply to an instrument that contributes, transfers or withdraws an interest in an LPF as an interest in the LPF is not a share, stock, debenture, loan stock, fund, bond or note issued by the LPF, nor is it a unit under a unit trust scheme within the meaning of “stock” under section 2 of the Stamp Duty Ordinance (Cap. 117).³⁴ However, any contributions in cash or in-kind relating to the transfer of dutiable assets, for instance, Hong Kong stock or immovable property, will still be subjected to stamp duty, and the same applies to the transfer of dutiable assets by an LPF to an LP.³⁵

5. Do the GP or the Investment Manager need to be licensed by the SFC?

The SFC’s Licensing Handbook published in February 2019 states that a private equity firm may be required to be licensed for one or more types of regulated activities depending on the types of business it conducts in Hong Kong. However, if the

³³ of the LPFO.

³² Clause 29 of the LPFO.

³³ Clause 30 of the LPFO.

³⁴ Paragraph 33 of the Legislative Council Brief:

https://www.legco.gov.hk/yr19-20/english/bills/brief/b202003201_brf.pdf

³⁵ Paragraph 33 of the Legislative Council Brief:

https://www.legco.gov.hk/yr19-20/english/bills/brief/b202003201_brf.pdf

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investments or the operations of the LPF do not involve in SFC regulated activities conducted by the GP or the IM (such as cases where the LPF does not deal in any “securities” as defined under the Securities and Futures Ordinance (Cap.571) and the GP or the IM does not need to deal or advise on “securities”), the GP or the IM may not need to be licensed by the SFC.

6. Can offshore funds redomicile to Hong Kong?

The LPFO does not contain provision that allows domestication or redomiciliation of LPFs established in other jurisdictions.

For enquiries, please contact:

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