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Dear Sze-ling

Consultation on 'Proposals to establish a Limited Partnership Regime for Funds'

Many thanks for your invitation on 31st July to provide views on the Proposal to establish a Limited Partnership Regime for Funds. The Hong Kong Venture Capital and Private Equity Association (HKVCA) welcomes the chance to comment on the consultation paper – and is strongly supportive of this initiative by FSTB.

Introduction

HKVCA represents a majority of the Private Equity firms based in Hong Kong and shares FSTB's desire to cement Hong Kong's position as the leading cross-border Private Equity centre in Asia. We believe the creation of competitive onshore fund legal-entities is an important part of the updating needed for Hong Kong to retain its leading position. The creation of a new, flexible, state-of-the-art Limited Partnership law is essential to enable this.

The general framework set out in the paper is excellent – and most of the key 'must have' features are included in the Proposals. We have some comments (see below) that mostly relate to clarifying details and optimizing flexibility for users. The details do, however, matter.

There are changes taking place to fund arrangements in the Caymans which are causing Private Equity firms to re-consider their structures. Hong Kong can benefit from this, if it can introduce attractive legislation soon.

We emphasise that Private Equity investors are using Limited Partnership vehicles in Cayman Islands, US, UK and elsewhere. The Hong Kong Limited Partnership has to be at least as competitive as these other jurisdictions if we are to persuade firms to select a Hong Kong fund entity over other, well established, regimes.

Comments on 31 July Proposals

- 1) In Paragraph 9, in some other jurisdictions, a limited partnership may elect to have ‘legal personality’ (by which we mean that the partnership has a legal identity separate from that of its partners). Ideally, the LPF regime would provide for this flexibility as it offers significant benefits. In US law, a limited partnership can elect to be treated as a flow through entity or a non-flow through entity for tax purposes and is understood to be a flow through entity, as a default, if no election is made.

In any event, it would be extremely useful if the LPF regime could provide specifically that an LPF may hold assets in its own name and we would propose that the following language be included: “The General Partner shall have the power to cause the assets of an LPF to be registered in the name of the LPF, or in its own name as general partner of the LPF.”

- 2) In Paragraph 9, can a clause be added that a partner may transact business with the LPF, unless the limited partnership agreement sets out a covenant providing otherwise.
- 3) Paragraph 10, it is stated that “the general partner has to be incorporated in Hong Kong” and it is likely that most LPF’s will be established with the intention that the LPF’s domicile and the GP and the investment manager will all be located in Hong Kong to achieve maximum economic substance in this jurisdiction. There are circumstances, however, where this will not be the case:
 - a) On migrating into Hong Kong there may be a need to preserve (or start with) a different location for the GP. For the growth in the usage of these vehicles, it will help if migrating into a HK entity is facilitated, since any restructuring of this nature is likely to be a multi-stage process taking into account any number of non-Hong Kong tax and regulatory provisions which may, as an interim step, require that a non-Hong Kong registered entity act as general partner of the LPF for a period. In particular, we are mindful of current regulatory changes in Cayman and other offshore jurisdictions as to economic substance requirements, which are examples of the types of changes which may provide significant impetus for restructurings of this nature;
 - b) There are circumstances where ‘economic substance’ in HK may not be important and the GP may have commercial reasons for being based elsewhere;
 - c) The LPF may want the flexibility, should its business change at a later date, to be able to migrate the GP entity away from Hong Kong without jeopardising the legal status of the LPF itself.

We would therefore like to see more flexibility available on the domicile of the General Partner (although we would be willing to consider whether any general partner which is not a Hong Kong incorporated entity (or LPF as referred to below) might be required to register a branch presence with the RoC).

Many private equity funds (possibly a majority) use limited partnerships as the general partner of their fund limited partnerships in order to ensure flexibility with respect to carried interest allocations, and we would strongly recommend that the LPF Regime should permit an LPF to act as the general partner of another LPF in order to ensure that the LPF Regime is not prejudiced as compared with similar regimes in other common fund jurisdictions.

- 4) In Paragraph 10(a), it may be helpful to add more detail on the flexibility of the LPF's characteristics. For instance, an LPF may have one asset, may be a co-investment vehicle, a parallel fund or hold multiple investments. It may have one LP or many LPs.
- 5) Paragraph 11. The LPF Regime will need to provide clearly that, to the extent that a general partner of an LPF would otherwise be required to be licenced by the SFC, it will be exempted from licensing in HK if it delegates its investment management functions to a Type 1 or Type 9 licensed entity.
- 6) Paragraph 12(b), there are certain classes of assets (eg a wine or art fund) where there may be no need to appoint an 'investment manager' as the nature of the assets to be acquired may not require licensing of the general partner or investment manager under the SFO. There are also circumstances where the day-to-day investment management functions are performed by the investment manager outside Hong Kong and would not trigger SFC licensing requirements, and might be delegated to an unlicensed corporation.
- 7) In Paragraph 12(b), some PE firms (eg some mainland PE firms) have a preference for performing the 'investment manager' activities inside the GP entity. They may prefer to use the GP as the 'investment manager' together with the consequential need to obtain a license for that entity.
- 8) In Paragraph 12(c), it mentions that "Hong Kong Financial Reporting Standards or equivalent standards". It is better to clarify this to read "Hong Kong Financial Reporting Standards or internationally acceptable standards including US GAAP, IFRS, Japanese GAAP, etc."
- 9) In Paragraph 12(d), there does not need to be any reference to 'proper custody' since, where a licenced investment manager is required by reason of the nature of the LPF's investment programme, the custody requirements are already addressed by way of SFC requirements applicable to the investment manager.
- 10) Paragraph 13, can the application to establish an LPF be submitted by a law firm/solicitor AND ALSO by an accounting firm or fund administration firm? It would also be helpful if an LPF can be registered prior to all the registration details (a) to (e) being available.
- 11) In Paragraph 13(a), can this be expanded to "The name must end with the words "Limited Partnership Fund" or "LPF"" to offer more flexibility in naming. Is it possible to provide for the reservation of fund names for future use?
- 12) In Paragraph 15, it indicates that the LPF will have to submit the annual return on time to RoC. A typical 'annual return' for a Hong Kong company requests significantly more information than is required to establish an LPF and would therefore not be appropriate. It is suggested that (i) the GP be obliged to notify ROC if there is any change to the original filing information or (ii) to annually confirm that there has been a change/no change. A simplistic "late filing shall render the LPF deregistered by the ROC" is unacceptably harsh.
- 13) In Paragraph 19, it indicates that the LPF's documents will be open for public inspection only of the information under 13(a),(b),(c),(e),(g) and the law should be clear that no more than this information (and subsequent changes) will be made available. Equally the RoC should be required to provide 'Certificates of Good Standing' if appropriate and if requested.

- 14) Paragraph 22 is good and should be carried over into the Ordinance/DIPN to provide certainty to all parties. Two possible additional 'safe harbour' activities:
 - a) voting as a limited partner on any transaction in which the GP has an actual or potential conflict of interest with the limited partner. The fact that a decision involves an actual or potential conflict of interest is not of itself a reason to regard a limited partner in the partnership who votes on that decision as taking part in the management of the LPF's business;
 - b) taking part in a decision about how the LPF should exercise any right as an investor in another collective investment scheme (i.e. a master fund), provided that the LPF's exercise of the right would not cause the LPF to be liable for the debts or obligations of the master fund beyond the amount contributed, or agreed to be contributed, by the LPF to the master fund.

- 15) In Paragraph 23, the Proposals suggest that further thought be given to the dissolution of LPFs. We note that the recent UK PFLP is a limited partnership not subject to prohibition from withdrawing capital. Also, the Cayman legislation ensures that the limited partnership agreement governs the obligations of limited partners to contribute capital to the partnership and the rights of limited partners to withdraw such capital at any time during the fund's term.

- 16) In the Paragraph 24, it should indicate that the GP is the responsible person to delegate the AML to fund manager, lawyer, accountant and fund administrator/corporate services firm.

- 17) Paragraph 25, the maintenance of records should include maintaining records in a secure electronic digital format.

- 18) Paragraph 27. This clause gives enforcement power to the Hong Kong regulator. Another method, that should be considered, is the Delaware model where the law adopts a contract-based approach whereby the GP is liable for misstatements to the extent that these cause actual damages to partners, counterparties and other stakeholders.

- 19) Paragraph 27(a)(iii), there could be some concerns about definition in this clause. "In operation" should include undertaking fund raising activities or holding at least one asset.

- 20) In addition to Paragraphs 31 and 32, it would be useful to have a clear statement on the following issues:
 - a) Distribution from the LPF to LPs is not taxable in the hands of the LPs;
 - b) An interest in an LPF is considered a "security" for the purposes of the Securities and Futures Ordinance, and therefore considered as a collective investment vehicle / scheme;
 - c) An LPF and its special purpose vehicles managed by a Hong Kong entity would be able to obtain tax residency certificates from the Hong Kong tax authority, to the extent they fulfil the relevant treaty definition;
 - d) There will be no capital duty to be levied on the LPF (on re-domiciliation, migration, admission & withdrawal of LPs and the transfer of partnership interests by the LPs etc.);
 - e) Whilst not an issue appropriate to be addressed in the LPF proposals, the tax treatment of private equity carried interest provisions should also be considered when the LPF details are finalised.

Summary

The Proposals for a new Limited Partnership law are greatly appreciated and come with much of the flexibility necessary to be welcomed by potential users in Hong Kong. We have highlighted above a few areas where the Proposals fall short of options offered in other Limited Partnership laws.

We would also like to emphasise that, once established, the LPF rules will need to be updated from time to time as operating practices, and other jurisdictions, evolve.

Equally important to developing the optimum legal framework, for the success of onshore private equity funds, is ensuring that Hong Kong's regulation and tax systems are clear and consistent to match the legal framework for being state-of-the-art and competitive.

Yours sincerely



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About HKVCA

HKVCA is a member-based trade association which was established in Hong Kong in 1987 currently with 450 members of whom 280 are Hong Kong based private equity managers across the full spectrum of the industry from venture capital, through growth capital and growth buyouts to institutional fund investors, fund of funds and secondary investors. HKVCA represents small teams investing in start-ups as well as 8 of the 10 largest global private equity firms.