HKVCA 私投募資
香港創業及私募投資協會
The Association for Private Capital in Asia

The Hon. Mr. Paul Chan, GBM, GBS, MH, JP
Financial Secretary,
Hong Kong Special Administrative Region
Tamar, Hong Kong

22nd September, 2023

Dear Paul,

<u>Suggestions for 2023 Policy Address</u>

The Hong Kong Venture Capital and Private Equity Association (HKVCA) is grateful for the invitation to participate in the consultation session on measures to enhance the competitiveness of Hong Kong as an international financial centre for the 2023 Chief Executive Policy Address.

The objective of the HKVCA is to promote and protect the interests of the private equity (PE) and venture capital (VC) industry in Hong Kong, and indeed more broadly in Asia. As a centre for regional investment, Hong Kong has been Asia's leading PE hub over last three decades. However, with the social unrest, COVID pandemic and related restrictions, as well as geopolitical impact, Hong Kong's status has come under threat from competition in the region and a growing number of PE funds have expanded their operations in Singapore and elsewhere at the expense of Hong Kong.

In this submission, we set out below specific comments that reflect measures we believe will enhance the competitiveness of Hong Kong as an international financial centre and work to promote its attractiveness relative to other players in the region.

Review of Policies Related to Asset Management

The HKVCA welcomes the review and refinement of the regulatory measures and tax arrangements for the asset management sector that is being performed as a result of the announcement made in the 2023-24 budget speech.

We believe this review is critical, given it is an opportunity to make practical tweaks to existing policies so that they can be usable, work well together and attract business activity. It is our one chance to ensure that our policies are competitive and support Hong Kong as an IFC.

Further, we would like to stress that time is of essence when it comes to the review as Hong Kong is going through some difficult times and we need to grasp this opportunity to sharpen our tools to attract businesses to Hong Kong.

Unified Fund Tax Exemption

The unified fund tax exemption (UFE) has proven to be a highly successful measure. Streamlining both onshore and offshore funds with tax exemption has worked to attract fund managers to reside in Hong Kong. However, some funds are still unable to leverage the scheme's benefit due to the following issues:

i. Fund managers usually offer co-investment opportunities to existing investors (LPs), and an SPE (or SPV) is generally used by the fund managers to accommodate co-investment demand. However, under current law, the profit generated by an SPE on qualifying transactions is only exempted to the extent that the SPE is owned by the fund and not the co-investors (unless they are funds as well). We recommend that the government loosen the rule and allow co-investment SPEs that are managed by the same manager to enjoy the same treatment of funds.

ii. Some assets classes that are important in the private market are excluded, such as private credit funds, as well as digital asset funds. To stay at the forefront of the alternative market in the region, we recommend the exemption include these categories of funds.

Private Credit/Debt Markets

Private credit in Asia is a nascent segment, but the region is quickly beginning to emerge in this particular sector. In response, the Association has established a new private credit committee to accommodate the demand from our members. To position Hong Kong in the vanguard of the asset management industry, developing the private credit/debt market is imperative. We highly recommend the government revisit the UFE and carried interest rules in order to offer an incentive to private credit fund managers residing in Hong Kong.

Concession Tax Rate for Carried Interest

There are several concerns with respect to the existing law and previous draft of the DIPN on the concession tax rate for carried interest, including:

i. The IRD continues to classify carried interest as management fee / ordinary income. This is fundamentally different to what the industry and other jurisdiction views carried interest – which is a profit share arrangement. The Association has concerns that this fundamental difference would make any concession unworkable.

ii. The IRD requires the fund to allocate the carried interest through a person in Hong Kong. Carried interest allocations from a fund are rarely, if ever, allocated to Hong Kong. Because more than 90% of funds are using a Cayman Island structure, they would be very reluctant to alter their documents to pay carried interest to Hong Kong for the sole reason of applying for a concession here.

iii. The incentive requires the fund to be certified by the HKMA in Hong Kong. This is a requirement for all funds, regardless of whether they are solely managed from Hong Kong or only partly managed from Hong Kong. As such, for carried interest paid by a European fund or a US fund to an eligible person in Hong Kong to qualify, the fund would need to be certified by the HKMA. Again, this is a condition that GPs would be reluctant to agree to.

iv. The incentive is restrictive in its application as it only applies, with very few exceptions, to a gain made on the sale of a private company. It does not apply to carry from other forms of gains made by a private equity fund's investment - for example, the disposal of a public company or a gain on transfer of an underlying business. There are also concerns it won't apply to a fund of funds.

v. The IRD seems to suggest that the incentive requires a hurdle rate of return above 0%. In fact, some carry arrangements do not have a hurdle rate. Hurdle rates are entirely a commercial arrangement between fund managers and investors. Having a zero hurdle does not change the fact that carry is a profit-related return. The Association urges removal of this condition.

PE Firms Licensing

Less than half of HKVCA members have an SFC license due to the fact that there is no specific standalone licensing type for PE firms in Hong Kong. Among those with SFC license(s), –the types of licenses they hold vary: some have a Type 1 license, others have a Type 4 or 9 or a combination thereof.

Encouraging PE/VC firms to obtain a Type 9 licence immediately makes the Hong Kong limited partnership funds structure available to these managers, given the expectation that the general partner of a limited partnership fund essentially will need to delegate asset management to a Type 9 asset manager.

In March 2023, the SFC issued a certain quick reference guide, including for PE firms regarding Type 9 license. Unfortunately, uncertainty still remains because of the language used in the guide, for example, regarding whether other licenses are needed for activities such as co-investments. In light of the above, we recommend that the SFC issues further clarification to confirm that s Type 9 license should be the primary license for PE/VC firms in Hong Kong.

Despite the attempt to make clarifications to make the PE/VC sector fit into the existing licensing regime, we continue to recommend that the SFC consider creating a sperate license for PE/VC firms in Hong Kong in order to provide competitive advantage for Hong Kong, compliance certainty for the regulators and the industry, as well as cost efficiency to attract more market participants to Hong Kong.

Source of Capital

Due in large part to geopolitical issues, PRC and Hong Kong fund managers have encountered difficulties in fundraising. In order to support them in capital raising, we would recommend stepping up efforts to attract alternative sources of capital, such as (but not limited to):

i. Concessions and outreach to ASEAN and Middle East investors to land in Hong Kong, through utilizing the various policy incentives discussed above.

ii. Review the inclusion of alternative assets in the MPF or other Hong Kong / mainland China pension pools in line with global pension allocation into alternative asset class.

iii. The State Council of the PRC announced the establishment of a dual currency fund in Lok Ma Chau Loop. The fund will be managed by the Shenzhen Capital Group and invested in GBA companies. The Association recommends that SFC-licensed PE fund managers be allowed to replicate this idea and setup a dual currency fund in the Loop and Hong Kong.

iv. Retail investors have become more interested in private equity due to the industry's record of outperformance. Hence, we suggest that HKEx revisit Chapter 21 in order to facilitate the demand of listed PE in the region. The London Stock Exchange began allowing listed investment funds over a century ago, but this has not been replicated by Asian stock markets. Hong Kong should be in the forefront of the alternative market in the region by exploring listed PE products.

Conclusion

The global perception of Hong Kong as being business friendly has certainly declined, especially when compared to Singapore, and we believe that Hong Kong PE-related policies need to be updated in order to ensure that we can regain our status as Asia's leading PE hub.

The Association would be keen to submit further comments to provide additional details around the important proposals discussed in this letter. We are at your disposal should you wish to discuss further as you finalize the policy address.

Your Sincerely,

Co-Chair, HKVCA Technical Committee

About the HKVCA

The HKVCA is a member-based trade association was established in Hong Kong in 1987. It currently has 520 members, of whom 340 are Hong Kong based private equity managers. Our members work 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. The HKVCA represents small teams investing in startups as well as the world's 10 largest private equity firms.