The Implementation Issue

HKVCA **Journal**

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Foreword

We call this issue of HKVCA Journal "The Implementation Issue". We hope this collection of studies, interviews and thought pieces can provide practical insights to the operating leaders of our private equity firm audience, i.e., the COOs and CFOs as well as "the firm architects".

In this issue, we examine the practical tax and regulatory considerations of operating a Hong Kong-based private equity practice. We also let our contributors share their best practice experience on a number of emerging operating themes that are relevant to running an Asian private equity firm, including FX hedging, ESG, fund reporting, and fund liquidation.

Finally, we look at some "business innovations" that are uniquely taking place in Greater China private equity, including the addition of cross-border investment capabilities and augmenting a private equity business with wealth management capabilities.

We would like to express our sincere gratitude to all of those who contributed to this issue of the journal, and especially to Alain Fontaine, Joseph Ferrigno and T.K. Chiang for their work as editors. We hope that this issue and the issues to come will be a useful platform for sharing the rich experience and innovative ideas of our HKVCA membership, and that we may serve to inspire investors and members of the private equity community worldwide.

Please enjoy.

Denis Tse
Chairman of Research Committee, HKVCA

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HKVCA Journal 3nd Issue: The Implementation Issue

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Have Regulatory Developments in Hong Kong Kept Pace with The Private Funds Industry?

By Ben Wong, Managing Director, AltQuest Partners

Hong Kong positions itself as a global financial center and the asset management industry is an important sector within the Hong Kong financial services industry. It is a sector which is fast changing, driven by product innovation, market forces and changing legal landscape globally. Hong Kong faces challenges both within the Asian region and globally to maintain its status as a centre for asset management. Has it done enough so far to keep pace?

Challenges from Onshore and Offshore Jurisdictions

Hong Kong faces challenges from a number of jurisdictions around the world to be a domiciliation of choice for funds. Whether it is a mutual fund, private equity fund, hedge fund or real estate fund, the choice of jurisdiction for fund domiciliation ranges from offshore jurisdictions such as Cayman Islands, BVI, Jersey, Guernsey and Malta, to the more mid shore jurisdictions such as Ireland and Luxembourg, to onshore jurisdictions such as Delaware, the UK and Singapore. As a general legal trend, most of these fund domiciliation jurisdictions have, in the past decade or two, either fine-tuned their existing company laws so that their existing legal vehicles can be more accommodating or may be more suitable to act as a fund vehicle, or introduced new laws altogether so as to create new legal vehicles that are designed specifically to be used as a fund vehicle. Take Luxembourg, for example – it has been prolific in its legal innovations to create different types of legal vehicles that are suitable for a wide range of funds.

Hong Kong as a Jurisdiction for Fund Vehicle Domiciliation

The Hong Kong experience is somewhat different. Legislative developments aimed at introducing new forms of legal vehicles designed to be used as a fund vehicle and with features designed to be funds friendly have been few and far between. For a start, it is rare to domicile a fund vehicle in Hong Kong except for the use of a Hong Kong trust as a fund vehicle for certain types of mutual funds. Even the use of a Hong Kong trust has only become more common for mutual funds in the past couple of years due to two main reasons: firstly, in order for a fund to qualify for the Hong Kong mutual fund recognition scheme between Hong Kong and mainland China that was launched on 1 July 2015, the mutual fund must be domiciled in Hong Kong, amongst other criteria; secondly, the amended trust laws enacted in 2013, which was the first significant update of the trust law in Hong Kong since 1934, made a Hong Kong domiciled trust more relevant as a 21st century fund vehicle. Besides the use of a Hong Kong trust as a legal vehicle for certain types of mutual funds, there is almost no usage of any other types of legal entity domiciled in Hong Kong as a fund vehicle. The reason is obvious – the absence of any legislative changes to create the types of legal vehicles which are suitable as fund vehicles. Take for example, once again, developments in trust laws – England went through in 2001 a similar exercise as Hong Kong did in 2013 in amending its trust laws, and Singapore completed in 2004.

Hong Kong is disadvantaged in its drive to be a fund domiciliation center because it lacks a legal creation which is directly comparable to the Open Ended Investment Company in the UK (which was introduced in the UK in 1997) or the European SICAV. Similarly, in the offshore world, there are comparable legal structures, such as the Cayman Island exempted limited company. In fact it is fair to say that most jurisdictions with a significant financial services industry and most offshore jurisdictions have some type of vehicles which share some characteristics of such open ended investment companies. However, this is not the case in Hong Kong. Essentially this form of legal vehicle has the following key features which are essential for it to be used effectively as a fund vehicle: (i) such vehicle takes the form of a company that allows for variable capital, i.e. can freely issue shares when money is invested and redeem shares when requested by investors; and (ii) shares can be bought and sold at a price which is based on the current net asset value. There has been some recent efforts from the Hong Kong government to lay the groundworks for the introduction of such open ended investment company in Hong Kong. For instance, the Hong Kong government issued a Consultation Paper on Open-Ended Fund Companies in March 2014. Further, the Hong Kong Financial Services Development Council (the “HKFSDC”) recently issued a Paper on the Tax Issues on Open-ended Fund Companies which set out certain suggestions on the tax aspects of a proposed open-ended investment company.

As a domiciliation for private equity funds, Hong Kong is almost never considered because (i) its limited partnership law, which was enacted in 1912 under the Limited Partnership Ordinance, has largely been unchanged since its original enactment and hence is not particularly accommodative for private equity fund vehicles; and (ii) there are uncertainties as to whether a limited partnership domiciled in Hong Kong is tax transparent for Hong Kong tax purposes.

In contrast to Hong Kong, many jurisdictions, both onshore and offshore either have introduced new legislation for the purpose of creating a type of legal vehicle which is suitable to be used as a private equity fund vehicle or have refined their existing laws to make their limited partnerships more suitable to be used as vehicle for private equity funds. For example, in Singapore, the Limited Partnership Act came into effect in 2009. Since its introduction, it has been widely used as a vehicle of choice for private equity funds, at least for private equity funds managed from Singapore. With legislative amendments made to the Limited

Partnership Act 1907 over the past decade, the UK limited partnership today is the market standard structure for European private equity and venture capital funds as well as many other types of private funds. Similarly in PRC, limited partnership laws have gone through many refinements over recent years and today the domestic PRC limited partnership is the vehicle of choice for RMB private equity funds managed from the PRC. Not to mention that the US which has the Delaware LLC and the Cayman Islands' widely used exempted limited partnership, etc. The need to update the existing limited partnership laws in Hong Kong to make it more suitable to be used as a private equity fund's jurisdiction has been recognised – once again the HKFSDC has recently issued a Paper on the Limited Partnership for Private Equity Funds and has suggested a number of updates to the limited partnership laws in order to make it possible to be used as a fund vehicle for a private equity fund.

Hong Kong as a Regional Hub for the Asset Management Industry

Legislative changes that are aimed at creating legal vehicles which are suitable as fund vehicles by themselves are of course not enough to ensure Hong Kong's global competitiveness as a centre for asset management. Legal and regulatory developments should be wide enough to capture the entire ecosystem and value chain that constitute the asset management industry. This would include not only fund domiciliation, but also fund management, fund distribution and fund product development.

In terms of bringing more fund management activities into Hong Kong, the Inland Revenue (Amendment) (No. 2) Ordinance recently enacted in July 2015, which extended profit tax exemption to private equity funds is an example of a regulatory change aimed at encouraging more asset management activities to be brought back to Hong Kong, in this instance in the private equity space.

As for fund distribution, most attention (and for good reasons) recently has been on Hong Kong's role as an offshore RMB centre and the role it can play in China's opening of its capital markets. In this regard the recently launched mutual fund recognition scheme between Hong Kong and mainland China has been a significant milestone. Against this background though, certain countries in the region have formed the Asia Region Funds Passport, which is expected to be launched in 2016. With its eyes firmly on mainland China, has Hong Kong lost sight of other regional and global opportunities?

In this age of intense global competition for capital, Hong Kong cannot afford to lose out in this race due its failure to modernize its laws. Legislative developments and regulatory changes need to be responsive to market demands and industry needs. These changes can be brought about with a collaborative approach between the Inland Revenue Department, the SFC and the various Hong Kong government departments.

Ben Wong, *AltQuest Partners*

Ben is the managing director of AltQuest Partners, a HK based compliance consultancy firm focused on the alternative funds industry. Ben is a qualified lawyer and, before founding AltQuest Partners, worked as a private practice lawyer specializing in alternative funds in the London, Hong Kong and Sydney offices of preeminent international law firms for over 10 years.

Fund Domicile Practice, Hong Kong or Singapore – Anonymous Case Studies

By HKVCA Research

In July 2015, the law of "Tax Exemption for Offshore Fund" was extended to private equity. This was expected to be seen as a positive change likely to encourage more general partners (GPs) to move their management companies to Hong Kong.

In this respect, for example, one of the largest Japanese buyout GPs, which employs a Cayman fund structure, has recently set up its management company in Hong Kong. To support the company's establishment in Hong Kong, management pointed out that, (i) as the tax treaties between Hong Kong and Japan became effective and (ii) as the extension to private equity of the law on "Tax Exemption for Offshore Fund" was passed, Hong Kong had undoubtedly upgraded its competitiveness versus other Asian countries and global locales. This is obviously beneficial to both the fund managers and the investors. More importantly, with these two significant developments established, the GP explained that it is now available to invest in Japanese companies through a Hong Kong entity which is invested by its Cayman fund. This is unprecedented.

Despite the extension of the "Tax Exemption for Offshore Fund" to private equity taking effect in order to encourage more fund managers to move their management companies to Hong Kong, a regional private equity fund manager headquartered in Hong Kong, focusing on real assets and mid-market growth investments, argued that there are still a number of tax issues outstanding and that further clarifications are required regarding this revision. For instance, the requirements of being registered as a qualified fund with the issue of the 10% threshold of Hong Kong assets also make the fund managers hesitant to shift to Hong Kong. Even though the tax exemption was published in the gazette, the regional fund quoted above believed that Singapore remains a long-standing rival to Hong Kong.

Indeed, Singapore has a clear view about the onshore and offshore relationship between funds, GPs and Advisors, which eliminates the uncertainty and any ambiguity that hinder investments and growth opportunities. These clear policies continue to attract fund managers to relocate. As Singapore has long been the major competitor to Hong Kong in Asia, the regional private equity fund manager further mentioned that better tax treaties with Korea and Japan lead them to move to Singapore, thus benefiting the LPs in saving the withholding tax.

Beyond Asia, the regional private equity fund manager suggested that Luxembourg would presumably be a logical choice particularly for those managers seeking to raise capital in Europe. Although it is by far the most complicated jurisdiction where to establish a tax efficient structure, Luxembourg has its own attractiveness for regional fund managers.. The Channel Islands would be an alternative location despite the fact that it has been blacklisted by a number of countries in the European Union.

Hong Kong has always been the home to some of the most prestigious funds within the region with the diversity of fund sizes and structures. Having the comparative advantage of locating in the heart of Asia, it has long fostered innovation and entrepreneurship in the field. The rise of Singapore and other Asian countries nevertheless has placed pressure onto Hong Kong private equity fund managers. The vagueness of policies about how to continue to attract more onshore investments is another worry within the industry as the regulator has previously penalized managers for trying their best to interpret and comprehend the ambiguous law.

It is therefore vital, should Hong Kong like to remain the industry leader around the region, to take further actions to simplify the fund management and the structuring process. At this stage, there are still doubts and inquiries on the qualifications to comply with the exemption law, as well as other major issues such as the jurisdiction of SPVs and the carried interest taxation.

Nonetheless, in the long run, by resolving the ambiguity of fund structure and implementing more flexibility and clarity on the "Onshore Fund" policy, the possibility for Hong Kong to be on top of the game in providing an essential platform for investors and fund managers can remain optimistic. After all, Hong Kong could become and shall remain the gateway to China and other Asian countries with attractive tax treaties with a number of countries.

PE Funds Considerations

By Malcolm Prebble, Principal, KPMG
Jade Stewart, Manager, KPMG

Introduction

2015 has been a notable year for tax developments in the Hong Kong funds industry with the impact set to continue into 2016. Hong Kong has long been an established global asset management centre and a key location for regional PE firm operations. However, it has been relatively rare for local tax changes to have a significant impact on this industry.

This has changed in 2015 with the introduction of welcomed changes to Hong Kong's Offshore Funds Exemption which are set to benefit many PE firms with operations in Hong Kong. While these changes are a good news story, the ongoing scrutiny by the Hong Kong IRD of the tax position of Hong Kong investment advisors continues to create uncertainty for the industry.

Further changes are expected in 2016. Perhaps the most important of these is the commencement of the implementation phase for OECD's various Base Erosion and Profit Shifting ("BEPS") initiatives. The changes to the international tax landscape resulting from the BEPS project are expected to be far reaching and have a significant impact on how PE investments are structured and how portfolio companies are taxed.

We briefly touch on each of these items below, including the impact on Hong Kong based PE funds.

Changes to Hong Kong's Offshore Funds Exemption

The changes to Hong Kong's Offshore Funds Exemption, which were introduced during the year, represent one of the more notable tax developments in Hong Kong in recent times and something that the industry has been seeking for a number of years.

The Offshore Funds Exemption has been in place since 2008 and has generally worked well for hedge funds operating in Hong Kong. However, for PE funds, the existing exemption has not been effective because the exemption did not apply to investments in private companies.

The key benefit of the Offshore Funds Exemption is to exempt a fund satisfying all of the qualifying conditions, from Hong Kong Profits Tax on certain investment returns. This is relevant for your typical Cayman Island limited partnership fund vehicle as the activities of investment team members in Hong Kong can result in the fund itself being subject to Hong Kong's Profits Tax. In order to mitigate this risk, PE teams based in Hong Kong have needed to adopt sometimes onerous operating protocols.

The changes implemented in July 2015 extend the scope of the Offshore Funds Exemption to cover investments in certain private companies incorporated outside of Hong Kong. These changes are expected to provide investment professionals based in Hong Kong with greater flexibility as to how they undertake their daily tasks without the concern that they may create a tax exposure in Hong Kong for the fund that they represent.

The changes have also resulted in the introduction of a separate SPV exemption for intermediate holding companies established by an offshore fund to hold private equity investments. This can include a Hong Kong incorporated company established to hold such investments. This new exemption will apply to exempt gains realised by an SPV from the disposal of a qualifying offshore portfolio company from Hong Kong's Profits Tax.

This new SPV exemption provides PE funds with scope to use Hong Kong companies as an investment holding platform for holding their offshore investments. This will enable PE funds to make use of substance that they already have in Hong Kong in order to qualify for treaty benefits on investment returns. As such, the changes should help to level the playing field with Singapore when PE funds are looking at jurisdictions in which they choose to establish investment platforms. They are also complementary with the efforts being made by Hong Kong to expand Hong Kong's double tax treaty network and promote Hong Kong as an investment holding jurisdiction.

Overall, the changes represent good news for the Hong Kong PE industry. However, as with the introduction of any new legislation, there are a number of uncertainties that will need to be clarified via consultation with the Hong Kong Inland Revenue Department ("IRD"). Perhaps the most important area requiring clarification is how the new rules apply to pre-IPO investments, given that an IPO is a key exit strategy for many PE investments. While it is clear that a gain realised from the disposal of shares in a private company should now be covered by the revised Offshore Funds Exemption or the new SPV exemption, the position is not as clear where an SPV disposes of an investment following an IPO (i.e., it realises a gain from the disposal of a listed security and not shares in a private company).

It is anticipated that the IRD will issue an updated version of its existing Departmental Practice Note (No 43 (Revised): Profits Tax: Exemption for Offshore Funds) in the first quarter of 2016. It is hoped that this will address most of the outstanding interpretation issues and enable PE funds to start introducing changes to the way that they operate in Hong Kong.

Hong Kong Inland Revenue Department Tax Audits and Transfer Pricing Considerations

An ongoing issue for funds operating in Hong Kong is a series of IRD audits of Hong Kong based investment advisors over the past few years. To date, in excess of 50 Hong Kong investment advisors to offshore funds have been the subject of IRD audits. In these tax audits, the IRD's focus has been on determining an appropriate

allocation of the overall management fee between the offshore fund manager and a Hong Kong-based investment advisor.

From the audits which have now been resolved, or are close to being resolved, it is clear that the traditional basis of remunerating a Hong Kong investment advisor on a cost plus basis is no longer sustainable in the absence of additional support. Going forward, there is likely to be an increased emphasis placed on the key activities undertaken by the Hong Kong investment advisor when determining an appropriate basis for remunerating the investment advisor. This includes assessing the value attributable to these services and understanding where they are performed.

As a result, PE funds should now consider reviewing the basis on which they remunerate their Hong Kong-based advisory companies. Whatever the remuneration basis ultimately adopted, it will be increasingly necessary for funds to be able to substantiate their remuneration structure and maintain transfer pricing support in the event of challenge by the Hong Kong IRD.

Impact of the OECD's BEPS initiatives

The OECD's BEPS project is a global initiative launched to modernise the international tax system and address concerns about aggressive tax planning and practices. The recommendations from this project are expected to fundamentally change the international tax landscape and over time should influence the way in which PE funds structure investments as well as expectations on the extent to which investment returns are taxed in investee jurisdictions.

In October 2015 the OECD released the final BEPS deliverables and will now move towards the implementation phase for the 15 actions items covered by the project. The most important recommendations for Asian focussed PE funds and their portfolio investments include:

- The introduction of standardised tests to limit the ability to claim interest deductions. If implemented this could fundamentally affect the extent to which PE funds can effectively push-down acquisition debt to the portfolio company level.
- Prevention of tax treaty abuse. These changes are likely to result in a greater emphasis being placed on establishing real economic and commercial substance in a portfolio holding company in order to qualify for treaty benefits.
- Greater scrutiny of payments to tax haven companies for the use of intangibles. Increased economic and commercial substance of the intellectual property owners is likely to be needed in order to support existing arrangements.
- Ensuring transfer pricing outcomes are in line with value creation. This will be achieved through the introduction of enhanced transfer pricing documentation requirements, including country-by-country reporting requirements. The latter aspect, in particular, is expected to highlight to tax authorities around the world instances where the level of tax paid in a particular country is not commensurate with the activities performed, or the assets owned, by entities in that country.

While it will take some time for the recommended changes to be implemented, it is anticipated that the changes could fundamentally alter the effective tax rate of certain portfolio investments. It is therefore recommended that PE firms look to start including additional procedures within their due diligence work to consider the potential impact of the BEPS changes on proposed portfolio investments. In addition, PE firms should be encouraging management teams of existing portfolio companies to fully understand the impact of BEPS on the businesses that they manage.

Malcolm Prebble and Jade Stewart, *KPMG*

Malcolm Prebble is a Principal in KPMG's M&A tax team in Hong Kong, with experience in M&A activities across a range of industries and investor types. He joined KPMG in 1999 and has worked in the Hong Kong office since 2009.

Jade Stewart is a Manager in KPMG's M&A tax team in Hong Kong who started in the Sydney office in 2010 before moving to Hong Kong in 2012.

ILPA's Transparency Initiative

By Jennifer Choi, Managing Director, ILPA
Nate Austin, Associate, ILPA

In May 2014, the United States Securities and Exchange Commission's Director of the Office of Compliance Investigations and Examinations gave a speech in which he revealed that through examinations of registered advisers to private equity funds conducted to that point, the agency had identified "violations of law or material weaknesses in controls over 50% of the time," in particular with respect to the allocation and disclosure of fees and expenses to Limited Partners (LPs).

The revelations in this statement sent shockwaves through the private equity industry. Trustees and CIOs made inquiries into the compliance records of their own institution's private equity fund managers. General Partners (GPs) began more closely examining their internal protocols to identify and address any potential violations that could trigger an enforcement action. Limited Partners, especially public organizations, began developing methods to collect additional information on how their investments were being managed, fueling the creation of a myriad bespoke templates.

While individual LPs achieved some success in tracking fees and expenses, the proliferation of unique templates introduced friction into the reporting process and, counterproductively, hampered the availability of complete and truly comparable information. Out of a desire to smooth the transfer of higher quality information between GPs and LPs, ILPA organized working groups comprised of members around a broader effort dubbed the Fee Transparency Initiative. The aim of these groups was to unify disparate LP efforts under a single, standardized approach to requesting this information from GPs and ensuring that fee and expense practices were fair and transparent.

The Transparency Initiative working groups seek to issue guidance that builds upon the [1]*ILPA's reporting guidelines first issued in 2011*, which identify the essential elements to be included in quarterly financial reporting and in capital call and distribution notices. The foundation of the Initiative's deliverables will be a [2]*reporting template* that details, at the level of the LP and on a periodic basis, all monies paid to the fund manager (or General Partner) and its affiliates, including fees, expenses and GP's profit share (also known as carried interest). LPs will also receive a clearer picture of the manager compensation received from other sources, such as portfolio companies and affiliated entities.

In addition to the reporting template, the Transparency Initiative will produce recommendations on the role of third parties (such as fund auditors and consultants) in ensuring compliance with a fund's governing documents. Additionally, the group will propose best practices related to fee and expense reporting and compliance disclosures to be appended to the [3]*2011 ILPA Private Equity Principles*. The ILPA Private Equity Principles, first released in 2009 and revised in 2011, provide a foundational operating framework for investors in private equity funds to engage in dialogue about fund governance, transparency and alignment of interests with other market participants.

These three goals (an improved reporting template, recommendations on third party partnership agreement auditors, and best practices recommendations) were directly informed by both requests from our members, engagement with the GP community and our own research. An ILPA survey conducted in the fall of 2014, just months after the SEC's revelations about the examination findings, indicated that fee allocations, reporting processes, and visibility into conflicts of interest were the most pressing concerns among LPs. The most powerful finding of our research was that a clear majority of LPs, 80%, were sufficiently alarmed by the SEC's findings that they intended to prioritize questions about fee and expense practices in their future fund due diligence or negotiation processes.

Interest in the Fee Transparency Initiative quickly spread, and dozens of ILPA members and investor advocates energized by the SEC findings or their own internal needs joined one or more working groups. By summer's end, the working groups had produced a draft fee reporting template and a plan for engaging the market in its adoption. That template was released to ILPA members in late September, and to the public for comment at the end of October. This consultative effort generated an outpouring of industry interest in supporting enhanced transparency, and arriving at a workable solution to get it. The ILPA received feedback from more than 100 GP and LP organizations, as well as numerous fund administrators, lawyers, accountants, auditors, and other service providers.

At the crux of comments received were concerns around harmonized definitions for certain terms and common expense categories. Cash management and operational practices and even terminology can vary a great deal depending on the type, size and jurisdiction of the funds being managed. As one of the aims of the template is to produce data that will inform LPs' evaluation of current and prospective fund managers, clarity and consistency in the terms used are critical. The guidance accompanying the template will address as many of these issues as possible.

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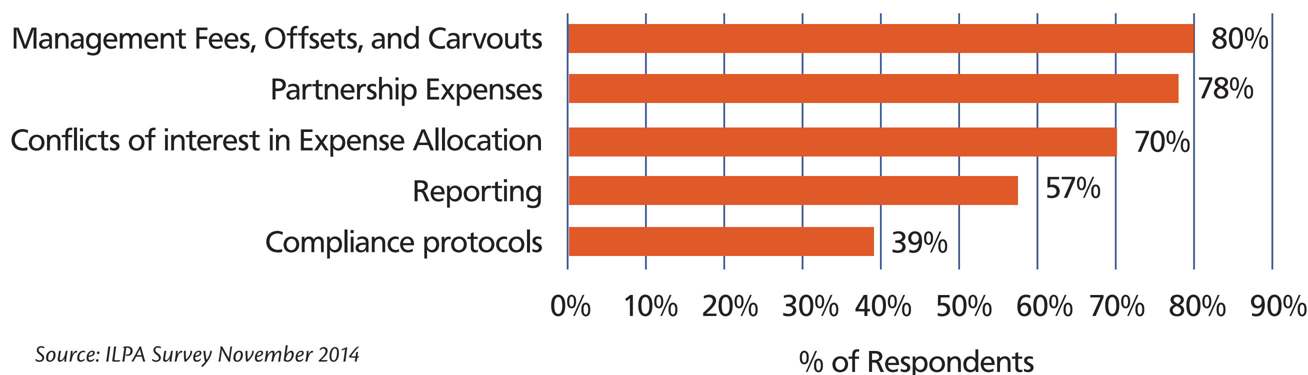
[1] http://ilpa.org/ilpa-standardized-reporting-templates/

[2] https://ilpa.org/ilpa-fee-reporting-template/

[3] https://ilpa.org/principles-version-2-0/

Investors Indicating SEC Exam Findings Will Impact LP Negotiation or Due Diligence Priorities



Source: ILPA Survey November 2014

Adoption of the reporting standards being proposed will be a meaningful departure from prevailing practices for many organizations and a potentially momentous change for our industry. Despite concerns regarding an approach that is simultaneously comprehensive and practicable, the response from the private equity industry has been very constructive. In fact a number of GP organizations have already begun adapting policies and procedures to reflect investor requirements. Several have signaled their intention to publicly endorse the recommendations of the Fee Transparency Initiative upon their release.

Development of a reporting template and best practices is only the first step. A considerable amount of work is still to be done. Full implementation of the required changes to accounting and reporting systems may take up to a year for some GPs. Moreover, not all of the information requested within the template is currently being tracked by every GP organization. As a result, "since inception" data will only be expected for new funds, and legacy funds data will be requested for a limited time horizon. Additionally, many service providers are contemplating the development of solutions that will comply with the new reporting template and broader recommendations of the Initiative. This includes portfolio administrators, compliance consultants, and importantly, software providers. Many back end reporting software providers are members of the AltExchange Alliance, a coalition of GPs, LPs and service providers seeking to introduce a uniform standard for the electronic exchange of private equity data.

No template can account for every circumstance. So long as there are variations in how limited partnership agreements are drafted and negotiated, there will be variations in the way fees are charged and how those fees are presented. Despite that variability, we fully anticipate that as reporting of fee and expense information becomes a condition of future partnership agreements, the Initiative's recommendations will serve as the foundation for the industry standard. Transparency, as expressed through better information transfer between managers and investors, is the logical next step down the path of becoming a more institutionalized asset class.

Jennifer Choi and Nate Austin, *ILPA*

The ILPA is the global, member-driven organization dedicated to advancing the interests of private equity Limited Partners through industry-leading education programs, independent research, best practices, networking opportunities and global collaborations. Initially founded as an informal networking group, the ILPA is a voluntary association funded by its members. The ILPA membership has grown to include over 300 member organizations from around the world representing over US $1 trillion of private assets globally.

ESG's Emergence as a Recognized Value Creator

By Steven R. Okun, Director, Public Affairs, KKR Asia Pacific

I recall hearing the term "ESG" for the first time some five years ago and needing to Google it. Now, ESG -- which stands for environment, social, governance -- will have been a key subject at private equity conferences at least four times in the past 12 months in the region. The proliferation and recognition of the term within the global private equity industry – including in Asia – has been remarkable.

Worldwide, many PE firms speak about how they promote ESG best practices within their portfolios and several firms release annual reports to keep stakeholders informed of their activities. These are necessary communications given the number of increasingly discerning LPs that have strict parameters on how they invest.

Likewise, we have seen a number of key regulatory developments in the ESG arena during the past year. In Japan, Prime Minister Shinzo Abe and his government moved to strengthen corporate governance practices across industries and enhance environmental safety provisions relating to the country's entrance into the Trans-Pacific Partnership. Japan's Financial Services Agency also recently introduced a Stewardship Code, a set of principles aimed at promoting best practices in the ways that investors discuss, disclose information and interact with their shareholders. To date, approximately 200 companies are signatories to the code, including KKR.

China also initiated its new Environmental Protection Law in 2015, which expanded the scope of projects subject to environmental policy, introduced stricter consequences for violators, and broadened legal channels for the public to prosecute polluters. Simultaneously, China launched a stricter Food Safety Law that holds food and beverage importers, producers, and distributors to higher transparency and safety standards.

These are just a few examples of governments encouraging and mandating better ESG management. Developments such as these, coupled with investors' increased focus on ESG practices, are setting increasingly high bars for the private equity industry to meet. Soon, incorporating ESG into the due diligence process and post-investment phase will be the rule, not the exception.

A focus on ESG does come at a cost. But, there is a cost to not focusing on it as well. Active management of material ESG considerations leads to better business practices, enhanced consumer trust, stronger community relationships and oftentimes improved financial results.

Why?

Viewing ESG as an opportunity to positively impact the bottom line – and not solely as an exercise in compliance – brings greater benefits than costs.

Take as an example KKR's Green Portfolio Program (GPP), an operational improvement program launched in 2008 that uses an 'environmental lens' to assess critical business activities of participating private equity portfolio companies. In practice, this has helped set operational strategies for companies to manage water and energy use and track their progress through specific benchmarking tools and resources.

A little more than a year ago Panasonic Healthcare was inducted into the program. The company is a leading provider of diabetes monitoring systems, specialized laboratory equipment and clinical healthcare IT systems. As part of the GPP, Panasonic focused on managing energy consumption in its facilities through a series of initiatives including LED lighting updates, the installation of energy-efficiency equipment, and the formation of a carbon dioxide-reduction committee to share best practices company-wide.

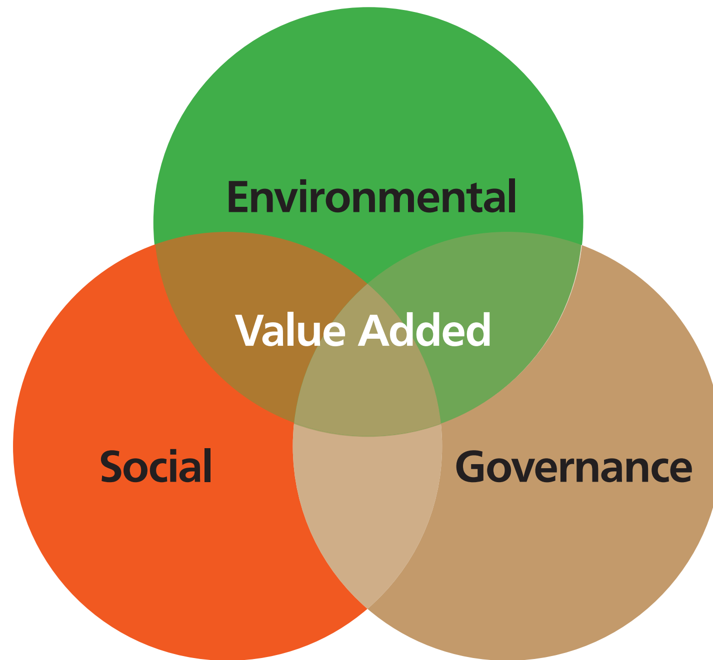
Through its efforts, Panasonic Healthcare saw greenhouse gas emissions from facilities decrease approximately 4% between 2012 and 2013, with an estimated 840 metric tons of greenhouse gas emissions avoided. Efficiency improved approximately 5% during the same period.

While these initiatives are certainly impactful to the communities where Panasonic Healthcare operates, what makes the program sustainable is the impact to the business' bottom line: The improvements in efficiency helped the company to avoid approximately JPY30 million in energy costs.

Worldwide, companies within the GPP have avoided a total of 2.3 metric tons of greenhouse gas emissions, 6.3 million tons of waste and 27 million cubic meters of water use as of October 2014. This collectively equates to nearly US$1.2 billion of savings, and the success of the program has laid the groundwork for a second iteration of the GPP – called the Green Solutions Platform – launched at the end of 2015.

KKR's Green Solutions Platform (GSP) seeks to drive business and environmental value by working with and highlighting the work of participating companies across a wide variety of focus areas. The program includes companies focusing on eco-efficiency improvements, advancing eco-innovation, and offering a solution to environmental problems as core to their business mandate. The GSP is a platform for a company to grow their business in a sustainable way.

In addition, the evolution of ESG includes engaging in what KKR calls 'solutions investing.' These are conventional investments made in companies that have an intentional focus on solving a societal challenge. Specifically, certain product and service providers build their businesses by solving problems in areas of waste management, water infrastructure, food safety, product quality, and raw material sourcing, among others. These



companies provide goods and services which are always in demand – i.e. clean water and healthy food – and gain significant support from governments and local communities because of the solutions they provide.

A few examples include private equity investments that support food safety and security in China: Modern Dairy, Asia Dairy, COFCO Meat, Sunner Development and Yuehai Feed Group.

KKR has partnered with these companies to enhance their already-robust health and safety practices across their respective areas of dairy, pork, chicken and fish feed production while keeping high production standards central to their efforts. It helped introduce scientific farm and facility designs, improved comprehensive vaccine programs, and implemented strict disease control systems to each of these companies.

Over the next five years, ESG will no doubt be more ubiquitous across the investment process, as investors, their partners and stakeholders, and regulators recognize the value it brings to the process.

Steven Okun, *KKR*

Steven R. Okun joined KKR as its first Director of Public Affairs for KKR Asia Pacific in 2011. He has lived and worked in Asia since 2003, and previously served in the Administration of US President Bill Clinton.

Investment Fund Liquidations – Common Themes and Challenges

By David Griffin, Senior Managing Director, FTI Consulting

Introduction

Seven years on from the global financial crisis, a large number of Cayman Islands funds are still struggling to generate sufficient liquidity to meet investors redemptions or to exit investments and return capital to investors in accordance with their governing documents. Many investors also continue to chase returns from funds placed into liquidation several years ago, having been innocently caught up in high profile frauds such as Madoff, Petters, Fletcher, Weavering and Axiom.

Structures

A Cayman investment fund may be open-ended or closed-ended. An open-ended investment fund is one in which the equity interests issued may be redeemed at the option of the investor at regular intervals. These are often referred to as "hedge funds". The overwhelming majority of open-ended funds are established as exempted limited companies, which are managed by a board of directors, although the directors typically will delegate investment authority to an investment Manager and/or Adviser (Manager) and administrative functions to other service providers. Open-ended funds are usually required to register with the Cayman Islands Monetary Authority (CIMA) under the Mutual Funds Law and are required to have at least two directors. It is common for such funds to appoint at least two independent directors (i.e. not connected with the investment manager of the fund).

Closed-ended funds are normally used for private equity funds and funds with extended lock-in periods. The terms "private equity" and "closed-ended" are often used interchangeably, principally to differentiate funds of this type from "hedge funds" investing in more liquid assets and giving investors the option to redeem their investments on regular liquidity dates. The term "private equity fund" commonly describes a non-retail fund investing in illiquid assets. Closed-ended/private equity funds established in the Cayman Islands normally take the form of exempted limited partnerships (ELPs). A general partner (GP) is the operative legal entity, responsible for managing the business of the ELP. The GP is usually an entity affiliated (and controlled by) the fund's Manager.

Restructuring v. Liquidation

In 2008/9, many funds took steps to restructure to deal with acute liquidity issues. This included, amongst other things, paying back investors in kind (i.e. with assets of the fund as opposed to cash), suspending or limiting investor rights to exit funds and/or ring- fencing illiquid assets in separate special purpose vehicles (side pockets) until they could be sold once market conditions improved. Whilst many of these restructuring techniques were successful in terms of providing an interim solution, many funds have still not managed to exit investments and return capital to investors. As a result, investors have lost patience with Managers and are increasingly seeking to place funds into a formal liquidation process. This article focuses on some of the main practical issues faced by a liquidator when dealing with an official liquidation of a Cayman fund.

Commencement of the Liquidation

An official liquidation of a fund is typically commenced by an investor presenting a winding up petition on the basis that: (i) the fund is insolvent as it has failed to satisfy an undisputed redemption debt in a timely fashion (often because of illiquidity issues); or (ii) it is just and equitable that the fund be wound up because of allegations of fraud, a lack of probity of management or where the purpose of the fund can no longer be achieved (often referred to as loss of substratum)[1].

Petitions on just and equitable grounds have become more common in recent years, with investors frustrated at the lack of progress made by Managers in liquidating investments and investors paying much closer attention to performance and management. In a recent case, Rhone Holdings LP, the limited partners asserted that the fund's investment manager (and related entities) had charged unjustifiable fees that were rapidly dissipating the fund's assets. However, the Cayman Court cast doubt over this long-standing remedy for aggrieved investors by striking out the petition, as the petitioner was prohibited from presenting a petition under the fund's limited partnership agreement. This decision was met with disapproval amongst many local practitioners and is expected to be appealed, but highlights the need for investors to scrutinize constitutional documents.

Financial Position

A fund in official liquidation will often be solvent with sufficient assets to meet liabilities, but that does not mean it will be straightforward. Investors will have a significant economic interest in the outcome of the liquidation by virtue of the amounts they have invested to subscribe for shares and the liquidators will have a duty to maximise recoveries to investors.

Upon appointment, the liquidator will immediately wish to take possession of the fund's books and records, which are usually in the possession of the Manager, administrator, directors and registered office provider. Some will be reluctant to provide full disclosure for fear it might result in claims being brought against them later. It is also common for Managers to argue that the books and records are property of the Manager as opposed to the fund.

[1] If investors hold voting shares, it is also possible for them to pass a special resolution to place the fund into voluntary liquidation and the voluntary liquidator can, in certain circumstances, make an application to bring the liquidation under supervision of the Court.

However, under s.103 of the Companies Law (2013), a liquidator can obtain orders from the Cayman Court that the relevant party delivers up all documents belonging to the fund and/or attends a court examination to give additional information. This power has extra-territorial effect, so will be available even if the service provider is outside of the Cayman Islands, although the liquidator may need to enforce the order by obtaining a letter of request to the local court. In July 2014, the Hong Kong court made an order to enforce such a letter of request on behalf of Cayman liquidators, which published the legal position and paved the way for foreign liquidators to require the co-operation of service providers based in Hong Kong, without the need for ancillary proceedings in Hong Kong.

Service Providers

An early decision needs to be made by the liquidator as to whether to retain or replace the fund's Manager. This will depend upon (i) ongoing cooperation; (ii) existence of disputes (e.g. historical fees); (iii) any allegations of negligence or wrongdoing; and (iv) the views of the fund's investors. The liquidator will need to balance the risks and cost of retaining the Manager with the practical need to quickly understand and get control of the investment portfolio.

As the Manager will have accumulated knowledge of the portfolio and investment strategy, a liquidator will normally retain them in the short-term to stabilise the fund. Thereafter, it may be necessary to negotiate varied terms and a liquidator may seek to move away from the standard 2% management fee/20% performance fee to a structure based on the achievement of particular milestones, usually focused on the timing and quantum of recoveries.

Investor Claims

A common feature of many fund liquidations are disputes regarding the standing of investors and the priority of claims for distribution purposes. Such disputes normally stem from investors who have attempted to redeem, or subscribe for, shares in close proximity to the commencement of liquidation.

A recent example of such a dispute arose in the liquidation of Herald Fund SPC, one of the larger Cayman Madoff feeder funds. In late 2008 a Herald investor, Primeo Fund, submitted a request for the redemption for the 1 December 2008 redemption day. However, on 11 December 2008, before the redemption proceeds could be paid, Madoff confessed to his criminal scheme and the directors of Herald suspended redemptions. Sometime later, Herald went into liquidation and the Cayman court was required to determine that Primeo's redemption became effective on 1 December 2008 and, therefore, Primeo's claim ranked ahead of the other unredeemed investors in the fund.

In terms of subscriptions, if an investor paid for, but did not receive shares prior to the liquidation or the suspension of

subscriptions, such prospective investors may advance trust claims or argue that they are a creditor entitled to be reimbursed in priority to investors. This was the case in proceedings commenced against the BVI Madoff feeder fund, Kingate Global Fund (In Liquidation), in which the Bermuda Court of Appeal held that share subscription monies were held on trust for subscribing investors until shares had actually been issued.

Litigation

A large number of Madoff feeder funds, and investors in such funds, have spent several years defending claw back proceedings to recover fictitious profits. Although many claims have been determined or settlements have been concluded, others continue to work their way through the Courts almost seven years on.

In many fund liquidations, investors allege that the cause of the fund's failure or deficiency in assets, is a result of the actions (or inaction) of the directors or service providers and require the liquidator investigate any possible claims. Before embarking on any litigation, the liquidator must pay close attention to statutory indemnities in articles of association and contractual indemnities and exoneration clauses in agreements with service providers. These are usually summarised in a funds offering memorandum.

Exoneration provisions provide that a fund will have no cause of action against the relevant party to the agreement. Indemnity provisions have a broader effect, providing the service provider with a right to be indemnified by the fund against all claims or liabilities incurred as a result of the services provided. In both cases, there is usually a carve-out for certain exceptions, such as fraud, wilful misconduct or gross negligence. In some cases, indemnities apply to costs associated with threatened action, which highlights the importance of treading carefully.

Valid claims under indemnities rank ahead of the claims of investors, so litigation should not be commenced unless there are very good prospects they will meet the high threshold needed for the exclusions to apply. In February 2015, the Cayman Court of Appeal overturned the first instance decision in Weavering Macro Fixed Income Fund Limited (in liquidation)[2], which held former non-executive directors liable for US$111m on the basis they had acted with "wilful neglect and default" in failing to spot that the fund's main "assets" were fictitious swap agreements purportedly worth $637 million. This decision underscores the high threshold that must be met in such cases.

Conclusion

There are many other challenges that frequently arise, such as regulatory issues, funding constraints (when portfolios are illiquid), confidentiality restrictions and stakeholders with conflicting expectations and objectives. All of these issues, and those summarised above, highlight the importance of investors selecting a liquidator with specialist fund expertise to deal with such complex, time critical and value sensitive situations.

Cayman Islands - Facts and Figures

Over 92,000 registered companies

9,200 average number of new company registrations annually (last 10 years)

6,900 average number of companies terminated annually (last 2 years)

0.5% percentage of terminations by official liquidation in 2014

Winding up petitions and supervision applications presented:

- 2013 - 47
- 2014 - 35
- 2015 (five months) - 34

11,215 – number of licenced Mutual Funds active at 3rd quarter 2015

New York & UK – top Investment manager locations, with growing number of managers based in Hong Kong

David Griffin, *FTI Consulting*

David Griffin is a Senior Managing Director in the FTI Consulting Corporate Finance & Restructuring practice and is based in the Cayman Islands. He has more than 13 years' experience of insolvency and restructuring matters, including seven years based in the Cayman Islands and British Virgin Islands, where he specialised in cross border insolvency and restructuring matters involving offshore companies.

[2] Weavering Macro Fixed Income Fund Limited (in liquidation) v (1) Stefan Peterson and (2) Hans Ekstrom CICA 10 of 2011 (unrep., 12 February 2015)

Cross-border Private Equity Investments: The Checklist

By Denis Tse, Managing Principal, Asia-IO Advisors

Cross-border investing has been a widely discussed topic in Asian GP circles for the past few years. Slowdown in home markets, anticipated streak of RMB depreciation, and policy-driven rhetoric like "One Belt, One Road" further propel interest by Chinese investors to look abroad. As more liquidity and hence more peer competition is expected to go after cross-border deals, here are a few key pointers for fund managers to maintain their investment competitiveness-- and sanity.

Origination

- Look beyond the obvious names.
- Avoid just chasing after auctions. Take the time to cultivate relationships with prospective targets and with intermediaries. There is no shortcut. In developed markets, intermediaries are highly specialized by industry and deal size.
- Develop domain focus, in order to have granular understanding about the market segment landscape and high alertness about where cross-border value-creation opportunities may arise, rather than just proceeding with high-level untested hypothesis. There are industries where the community is closely knitted on a global basis, which facilitates sourcing.
- GPs are a good source of deal idea generation. With intelligence made available by service providers, compile a database that delineates what transactions have been made by which firms, and importantly, in what vintage year.

Collaborating with a trade co-investor

- Be very sure who is taking the lead.
- Agree at the beginning the road-path to exit: Is the strategic partner planning to relist the target separately and use the target as a future offshore listing platform? If the strategic partner plans to absorb the target eventually, how should your stake be acquired, or swapped, and at whose option? Where should the fund invest, the target or the acquirer?
- Think through the strategic rationale for the trade co-investor, rather than hovering around a superficial thesis. Develop a detailed actionable value-creation plan and set realistic tenets on team integration.

Collaborating with locals

Is Asia central or corollary to the thesis of the deal? You do not have to be the lead investor all the time, and may position yourself as a co-investor with a corollary angle creating value with an Asian strategy. Again, just be very sure who is taking the lead.

Know where your source of local insights lies. This helps you determine whether it is better off bringing in a local co-investor or relying on your internal team and resident operating/venture partners.

Structuring

- Structured securities may be a solution to ensure exit when collaborating with a trade co-investor.
- Pay attention to exchange rate impact. It may make sense to restructure the target or the bulk of the target's assets from its original jurisdiction to alleviate the deal from foreign exchange volatilities.
- Pay attention to tax impact. Investing into offshore (including Asian) growth initiatives may doubly function as a powerful tax shield.

Business case

As Asia is losing steam as a growth engine, pursuing growth with cross-border linkage to Asia is no longer a straightforward investment thesis. Here are a few microeconomics-driven value creation deal ideas for ponder in a slower macro growth environment:

- Bringing something refreshingly new to Asian customers;
- Leveraging core technologies of the target to expand into new business lines that have rich prospects with Asian customers;
- Leveraging capabilities in Asia to expand into new business lines;
- Offering better Asian execution than the incumbent;
- Enabling better upstream control by Asian procurers;
- Mitigating patent barriers by an Asian competitor;
- Utilizing excess/more competitive capacities in parts of Asia; and
- Replicating a successful recipe or augmenting network effect by growing/consolidating market share over a wider geographical span.

Denis Tse, *Asia-IO Advisors*

Denis Tse is the founding managing principal with Asia-IO Advisors, which specializes in implementing Asia co-investment programs for large institutional and corporate investors.

FX Hedging Strategies

Interview: H. Chin Chou, Managing Director, Morgan Stanley
Sunil Mody, Managing Director, Morgan Stanley

China changed the basis for setting the value of the yuan through diminishing the mid-point trading price against the US dollar on 11th August, 2015. This unanticipated change caused currencies in the region to drop significantly and caused general partners of private equity funds ("GPs") of to consider the pros and cons of hedging currency risks.

One fund manager who has actively managed currency risks in Asia since the early 2000s is H. Chin Chou, CEO of Morgan Stanley Private Equity Asia (MSPEA). He introduced his partner, Sunil Mody, to the HKVCA Journal and shared their recent experiences in dealing with currency risks. Sunil is an Managing Director, of Morgan Stanley with the role of assessing the various Morgan Stanley portfolios' currency and interest rate exposures and of managing and executing the corresponding risk management strategies.

Mody stated that the increased currency volatility in Asia can materially impact the returns for the limited partners ("LPs") at the fund level directly. For instance, assuming that an investment can generate a 20% IRR over 5 years, the return would decline by 1.2% from a currency depreciation of 5%. For the first eleven months of 2015, the FX returns in Asia have gone down by approximately 18.5% in MYR, 10.9% in AUD, 6.2% in KRW, 4.7% in INR, 4.4% in CNY, and 3.8% in TWD. Consequently, the extent private equity performance has a positive correlation to emerging market currencies, a further decline in valuations is very possible.

In addition to the impacts on fund portfolios, the private equity firms take into account the currency impacts at the investee company level to determine whether hedging needs to be done for individual firms.

Private banks and financial advisors provide FX hedging services to private equity firms. However, most fund managers have hesitated to utilize such services due to their high cost.

A few GPs, like MSPEA, have employed a team of experienced hedging advisors to deal with currency risk. MSPEA is one of the few global alternatives managers with dedicated centralized expertise for currency and interest rate hedging. Chou said in-house professionals regularly give advice regarding hedging strategies, which frees up the investment team to focus on its basic mandate: - investing.

To evaluate suitable hedging strategies - when the investment is denominated in a currency other than the one used for the reporting metrics of the fund, the private equity firm reports that there is currency risk at the fund level. When cash flow of a portfolio company is generated in a currency other than the currency in which the investment was made, the currency exposure may be hedged at the company level.

US-dominated fund managers typically hesitate to use FX mitigation strategies to reduce the volatility of their reported returns. They are reluctant to spend on hedging products due to the nature of private equity which has relatively uncertain future distributions in terms of both size and time horizon, as compared with other asset classes such as real estate and infrastructure.

Mody stated that MSPEA often hedges with options-based structures and that the funds consider the cost of hedging, the overall downside risk sentiment of a currency, and the specific elements of each transaction. Forwards and other hedge instruments are also used and depended on investment nature, time horizon as well as expected returns and perceived risk profiles.

Chou advised that private equity firms should consider using hedging during the period of investment to mitigate the risk of currency depreciation, and until the expected exit. Post-closing of an investment, GPs should monitor the effectiveness of the hedging strategies and alter the hedges when the valuation of the investment changes. Hedging is a dynamic process, not a static one-time process.

H. Chin Chou and Sunil Mody, *Morgan Stanley*

H. Chin Chou is the Chief Executive Officer of Morgan Stanley Private Equity Asia and a Managing Director of Morgan Stanley. He is based in Hong Kong. Mr. Chou also serves on the Firm's Asia Pacific Executive Committee, which is comprised of the Firm's senior business leaders within the Asia Pacific region.

Sunil Mody is a Managing Director and leads a team responsible for the FX and IR hedging activities within the Merchant Banking and Real Estate Investing division of Morgan Stanley Investment Management. This includes constructing strategy, hedge execution, and performance reporting to the senior business leaders of the firm.

Exploring Wealth Management Business in Private Equity World

Interview: CDH Wealth Management

Conventional private equity fund managers have begun to launch wealth management businesses to satisfy their own High Net Worth (HNW) clients' needs.

In mainland China, the growing number of HNW individuals have fueled the wealth management industry. In addition, provincial and local governments in China recruit financial advisors to divest their state-owned assets to private investors. With such an attractive dynamic, a number of Greater China private equity firms have been keen to enter the wealth management industry.

Independent research has shown that private equity funds have outperformed capital markets and other asset classes regularly; it has enticed individual investors to allocate more capital into private equity funds and related transactions as a consequence. For example, CDH and JD Capital (formerly known as Jiuding Capital) have through their CNY-denominated funds, raised commitments from hundreds of ultra HNW limited partners in the past decade.

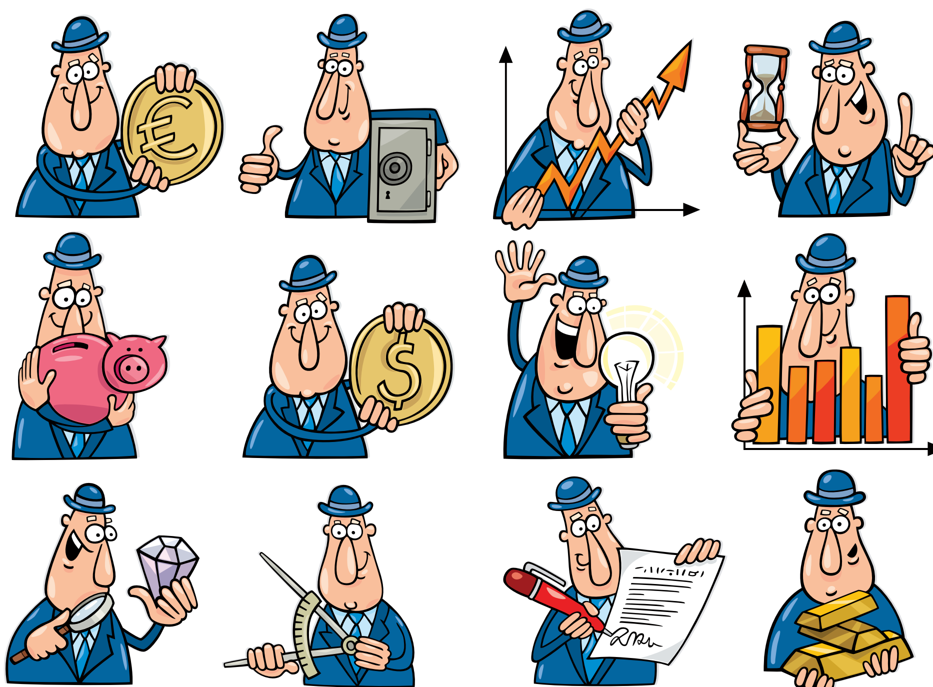
Many of these sophisticated clients are especially interested to collaborate with institutional investment managers to develop solutions for their wealth management needs. Private equity managers appear to have the upper hand in addressing what HNW clients seem to want, namely direct access to deals. Giant Interactive is just one of the private equity deals privatized by private equity firm's wealth management team. During the investment period, wealth management professionals conducted the same investment standards and internal due diligence process as how the General Partners did in their typical private equity transactions.

Despite private equity's unique skills and access, commercial banks' private banking divisions still maintain the comparative advantage in developing certain complex product structures. For instance, the private equity firms' wealth management team cannot offer the breadth of cash management products and securities lending which are staple products offered by commercial banks.

Private equity firms are adapting. Of the CNY 26 billion CDH allocated on behalf of its clients, only 56% were in private equity products. Globally, Blackstone, Carlyle and KKR have developed alternative-focused retail funds targeting an even broader client base. While commercial banks still control the bulk of HNW clients' wealth, private equity sponsored wealth management firms are fast moving up the learning curve.

CDH Wealth Management

CDH Wealth Management (WM), a leading high-end wealth management firm in China, was established in 2012 by Mr. Ying Wei to meet the booming wealth management needs from CDH super HNW LP clients. Since its inception, CDH WM has allocated over RMB 26 billion financial products which were mainly alternative assets, such as PE, Real Estate, Credit and Mezzanine funds etc., for thousands of clients. CDH WM is committed to providing comprehensive global wealth management products and services for super HNW clients in China.



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HKVCA Wine Tasting Events

HKVCA Young Professionals Mixer

HKVCA 15th China Private Equity Summit 2016 • 30 May

HKVCA Private Equity Fundamentals Course 2016 • September-October

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