

**For discussion
on 2 December 2019**

Legislative Council Panel on Financial Affairs

Proposals to Establish a Limited Partnership Regime for Funds

PURPOSE

This paper briefs Members on the proposals of the Government to establish a limited partnership regime for funds in Hong Kong.

BACKGROUND

2. We have witnessed in recent years robust growth in wealth creation in Asia, increase in portfolio allocation to the Asian markets, and deepening financial market liberalisation in Mainland China. All these are beneficial to Hong Kong's development as a premier international asset and wealth management centre in the region. The Government has been stepping up efforts to sharpen Hong Kong's competitive edge on asset and wealth management through a multi-pronged approach –

- (a) diversifying our fund structures and streamlining the licensing processes to encourage fund formation;
- (b) adopting a more user-friendly approach to attract family offices;
- (c) providing a more facilitating tax environment for funds; and
- (d) expanding our fund distribution network through deepening our mutual access with other major financial markets.

Private Equity (“PE”) Funds

3. Further to the introduction of the new open-ended fund company regime in July 2018, we see the merits of further diversifying our fund structures to meet changing needs. In recent years, private equity (“PE”)

funds (including venture capital funds) are gaining popularity amongst investors and have become a key impetus to the growth of asset and wealth management business. The PE industry would continue to play a pivotal role in channelling capital into corporates, especially start-ups in the innovation and technology field in the Greater Bay Area. As at end-2018, the total capital under management by some 520 PE firms operating in Hong Kong reached about HK\$1.21 trillion¹. This puts Hong Kong second in Asia, after Mainland China. With an active initial public offering market for PE-backed companies and proximity to Mainland China with the availability of major PE deals, Hong Kong is well placed to expand its PE business.

Limited partnership as a vehicle for PE fund

4. Currently, a fund may be established in Hong Kong in the form of a unit trust or an open-ended fund company. These fund structures are, however, more popular among public funds or hedge funds. Meanwhile, it is more common for private funds such as PE funds to be established in the form of a limited partnership.

5. In Hong Kong, our Limited Partnerships Ordinance (Cap. 37) (“LPO”) was enacted about a century ago. It is not tailored to and cannot quite meet the needs of investment funds which are a relatively modern invention. For example, the LPO does not have provisions which allow flexibility in capital contributions and distribution of profits, or allow a fund to have the necessary contractual flexibility, or provide a straightforward dissolution mechanism. The absence of these features under the LPO discourages fund managers from establishing PE funds in Hong Kong in the form of a limited partnership and hampers the development of a more thriving domestic PE market locally. At the moment, PE funds in Asia are typically established under the limited partnership regime in other jurisdictions such as the Cayman Islands.

6. The industry has been calling for an early introduction of a tailor-made limited partnership regime for attracting investment funds to establish and operate in Hong Kong. This will bring more jobs and business opportunities to the local fund and related industries. The

¹ Source: Asian Venture Capital Journal.

industry also points out that it would be vital to grasp the opportunity of potential shifting of fund structures and activities from offshore to onshore, as a result of Base Erosion and Profit Shifting package of the Organisation for Economic Co-operation and Development which requires taxation to happen where asset management activities take place. This development should incentivise the funds to align their structures with business activities. Against such a backdrop, the Financial Secretary announced in his 2018-19 Budget that the Government would examine the feasibility of introducing a limited partnership regime specifically for funds in Hong Kong.

7. A task force led by the Financial Services Branch and comprising members from the Hong Kong Monetary Authority, the Securities and Futures Commission (“SFC”), the Treasury Branch and the Inland Revenue Department (“IRD”) has come up with the proposals as set out in paragraphs 9 to 24 below. In doing so, the task force has taken into account the local market landscape, overseas regulatory experience², as well as international market and regulatory trends. The objective is to facilitate industry development whilst ensuring investor protection and sufficient economic substance in Hong Kong. We expect the new fund vehicle to be a pull factor for private funds (especially PE and venture capital funds) to set foot in Hong Kong and a crucial piece of the puzzle in developing Hong Kong into a full-fledged fund service centre.

FEATURES OF THE PROPOSED REGIME

8. We propose to introduce a new piece of legislation to put in place a limited partnership regime specifically for funds (“the LPF regime”). The key features of the proposed regime are set out in paragraphs 9 to 24 below.

² Examples include the United Kingdom, Ireland, Singapore, the Cayman Islands, Delaware/USA and Luxembourg.

Constitution of an LPF

9. A limited partnership fund (“LPF”) will be an arrangement meeting the definition of fund³ that is structured in a limited partnership form and will be used for the purpose of managing investments for the benefit of its investors (i.e. the limited partners). Like other limited partnerships registered in Hong Kong, the proposed LPF structure is not in itself a legal person.

10. Similar to the regime under the LPO and the prevailing overseas practice in major fund formation centre, the LPF regime will be a registration scheme⁴. A fund qualifying for registration under the LPF regime shall be constituted by at least two partners (one general⁵ and one limited⁶) under a written agreement (i.e. “limited partnership agreement”). The general partner of an LPF has unlimited liability in respect of the debts and liabilities of the fund and ultimate responsibility for the management and control of the fund. On the other hand, the limited partner(s) of an LPF, whose liability will generally be limited up to the commitment they make to the fund, will not have day-to-day management rights or control over the underlying assets held by the LPF. They, however, will have the right to participate in the prescribed/agreed safe harbour activities (see paragraph 21).

11. The LPF shall have a registered office in Hong Kong. The general partner shall appoint an investment manager⁷ and an auditor⁸ to

³ The proposed definition is broadly the same as the definition of “collective investment scheme” under Schedule 1 to the Securities and Futures Ordinance (Cap. 571) and the definition of “fund” under section 20AM of the Inland Revenue Ordinance (Cap. 112), with suitable modification.

⁴ Apart from registration under the proposed LPF regime, SFC authorization is required if any of an LPF’s activities fall under the regulatory remit of the Securities and Futures Ordinance (Cap. 571) and no exemption under Cap. 571 is applicable.

⁵ A general partner shall either be a private company limited by shares incorporated in Hong Kong, a non-Hong Kong company registered with the Companies Registry of Hong Kong, a limited partnership (whether domestic or foreign) or an individual (whether domestic or foreign).

⁶ A limited partner may either be an individual, a corporation, a partnership, a trustee, an unincorporated body or any other entity or body, whether domestic or foreign.

⁷ An investment manager shall either be a Hong Kong resident above 18 years old or a corporation registered in Hong Kong.

⁸ An auditor should be a practice unit under section 2(1) of the Professional Accountants Ordinance (Cap. 50). It shall be independent of the general partner and the investment manager.

carry out the day-to-day investment management functions and annual audits of the financial statements of the LPF respectively. The general partner shall also ensure that there are proper custody arrangements for the assets of the LPF as appropriate.

Registration requirements

12. Under the proposed LPF regime, a fund wishing to register shall submit an application to the Registrar of Companies (“RoC”), similar to the arrangement for registration with the RoC under the existing LPO. The application shall be submitted by a registered Hong Kong law firm or a solicitor admitted to practice Hong Kong law in Hong Kong (“the presentor”) on behalf of the fund. The application shall contain documents/information such as the name of the LPF, the name/identification of the general partner⁹, investment manager and presentor, the address of the LPF’s registered office, the investment scope and principal place of business of the LPF, a declaration and undertaking from the general partner that the LPF intends to operate as a fund and the partnership is limited, together with an acknowledgement that it is an offence to make a fraudulent, false or misleading statement. The application shall be submitted with a fee at a prescribed amount.

13. Upon receiving an application, if the RoC is satisfied that the application contains the documents/information made in the prescribed manner and the prescribed fee is paid, the RoC will register the fund as an LPF and issue a certificate of registration of LPF as proof of registration.

14. The RoC will maintain a register of LPFs containing the documents/information submitted by an LPF in its application and any subsequent changes reported. The register of LPFs will be open for public inspection upon payment of a prescribed fee. Maintaining a register of LPFs will provide useful information to investors and parties

⁹ If the general partner has no legal personality, the application shall also contain the name/identification of the authorized representative of the general partner who should be a legal person (can be an individual or corporation) and bear all liabilities in relation to the LPF.

which deal with an LPF. It is in line with the existing practice of maintaining a register of companies for public inspection.

15. If there is any change in the particulars provided upon registration, the general partner of an LPF shall notify the RoC within a specified period of time, and pay a prescribed fee to the RoC.

Annual return

16. The registration of an LPF will remain valid subject to the filing of an annual return to the RoC by the general partner on behalf of the fund. The return shall include a declaration by the general partner that the LPF has been and will be in operation or will carry on business as a fund during the year, together with a prescribed fee. Failure to file the annual return on time may render the fund being struck off the register by the RoC.

Anti-money laundering/counter-terrorist financing (“AML/CTF”) requirements

17. To fulfil the AML/CTF standards set out by the Financial Action Task Force, an LPF must appoint a person/corporation which is either an authorized institution, a licensed corporation, an accounting professional or a legal professional¹⁰ as the “responsible person” to carry out AML/CTF functions for the LPF. The responsible person will be required to conduct, on behalf of the LPF, preventive AML/CTF measures as stipulated under Schedule 2 to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615), including for example, conducting customer due diligence in respect of all investors (including all general and limited partners as well as their beneficial owners, as the case may be) of the LPF, and keeping records obtained in the course of customer due diligence and files relating to every customer’s account and business correspondence with the customer and

¹⁰ For definitions of “authorized institution” and “licensed corporation”, please refer to the Banking Ordinance (Cap. 155) and the Securities and Futures Ordinance (Cap. 571) respectively. For definitions of “accounting professional” and “legal professional”, please refer to the Anti-Money Laundering and Counter-Terrorist Financing Ordinance (Cap. 615).

any beneficial ownership of the customer, as well as documents of each transaction between the LPF and the investor. The name and identification number (if any) of the responsible person should be made known to the RoC.

Maintenance of records

18. A general partner/investment manager will be required to maintain proper record of documents/information in relation to the LPF's operation and transactions, including its audited financial account, the particulars (including beneficial ownership information) of all partners, and documents kept for the purpose of AML/CTF functions (see paragraph 17). These records should be kept at the registered office of the LPF or any other place in Hong Kong made known to the RoC.

19. The financial account of an LPF shall be made available to all partners of the LPF. Whilst all the above records would not be open for public inspection, they shall be accessible by law enforcement officers as and when necessary.

Contractual freedom among partners

20. To cater for the operational needs of PE funds, we propose that the partners of an LPF will have freedom of contract in respect of the key operations of the LPF. These would cover admission and withdrawal of partner(s), organisation and governance of the LPF, investment scope and strategy of the LPF, the rights and obligations of partners, financial arrangements among the partners, custodial arrangement etc..

Safe harbour activities for limited partner(s)

21. We appreciate that clear-cut limited liability for limited partner(s) of an LPF lies at the core of its attractiveness to investors. With reference to overseas experience, we propose that a limited partner may conduct certain safe harbour activities, which will not be regarded as management of the LPF and hence will not compromise its limited liability protection in respect of that LPF. Some examples of safe harbour activities include serving on a board/committee of the LPF,

advising or approving the general partner/investment manager on the business, accounts, valuation or assets of the LPF, taking part in a decision about the admission/withdrawal of any partner, the term of the LPF, the appointment of investment manager, changing the investment scope of the LPF and so forth.

Dissolution and liquidation mechanisms

22. PE funds often have specific investment targets and cycles and hence a limited term (normally around eight to ten years). A straightforward and cost efficient dissolution mechanism to bring an LPF's business to an end is critical to fund operation. We propose that the general partner of an LPF would have the right to agree among the partners the conditions under which the fund could be dissolved voluntarily. Upon the partners' agreement to dissolve the fund and receipt of tax clearance from the IRD, the general partner can proceed to carry out the procedures of dissolution specified in the limited partnership agreement. When completed, the general partner shall file a notice of dissolution to the RoC to bring into effect the dissolution and deregistration of the LPF.

23. For the sake of investor protection, an LPF may still be liquidated by the Court if any partner/creditor of the LPF or the Financial Secretary/RoC presents a winding up petition to the Court against the LPF under certain conditions. In this case, an LPF may be liquidated by the Court as an unregistered company in accordance with the Companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32). In a court liquidation of an LPF, a provisional liquidator and subsequently a liquidator would be appointed to carry out the administration of the liquidation. The Court has a number of powers including by order directing that all or any part of the property of the LPF shall vest in the liquidator, ordering any person from whom money is due to the LPF to pay the amount due into such bank account of the liquidator, allowing inspection of the books and papers of the LPF by creditors and contributories, etc.. When the liquidation is completed, the LPF will be dissolved following the procedures laid down in the law.

Migration of LPO-fund

24. We intend to provide a streamlined channel for fund(s) already registered under the LPO to migrate onto the LPF regime. Upon migration by submitting the same documents/information as set out in paragraph 12 to the RoC, the fund would have the same right and responsibility as any other LPF registered under the LPF regime. Such migration would not affect the identity and continuity of the fund concerned, and would not in itself be deemed as a transfer of assets or change in beneficial ownership for tax purposes. In this connection, there should be no profits tax and stamp duty implications arising from the migration.

TAX AND STAMP DUTY TREATMENT

25. Like other funds operating in Hong Kong, an LPF meeting the definition of “fund” under section 20AM of the Inland Revenue Ordinance (Cap. 112) and subject to certain exemption conditions set out in the provisions of Cap. 112 can enjoy profits tax exemption on transactions in qualifying assets specified in Schedule 16C to Cap. 112 and transactions incidental to the carrying out of qualifying transactions. Since the limited partners are not expected to manage the LPF though allowed to perform safe harbour activities, the general partner of an LPF has to comply with all requirements and bear all obligations under the provisions of Cap. 112 (for example, record keeping requirement, filing of profits tax returns and employer’s returns within time limits, and payment of tax due on time). An LPF is also required to apply for a Business Registration Certificate under the Business Registration Ordinance (Cap. 310).¹¹ Separately, as announced in the 2019-20 Budget Speech, we are also studying the case of introducing a more

¹¹ Taking into account the fact that the confidentiality of limited partners of PE funds is considered critical, we propose that when an LPF submits an application form for a business registration certificate to the business registration office of the IRD, the identity of limited partner(s) of an LPF would not be disclosed on the form, and such information would not be published on the register. That said, an LPF is still required to maintain a proper record of information about its limited partner(s) for inspection by the law enforcement agencies when necessary (see paragraph 19) and perform AML/CTF control (see paragraph 17).

competitive tax arrangement to attract PE funds to set up and operate in Hong Kong.

26. As to stamp duty, we intend to apply the same arrangements of a limited partnership to an LPF.¹²

INDUSTRY CONSULTATION

27. The Government conducted an industry consultation on the proposed LPF regime in Q3 2019. 27 submissions were received. There was general support for the introduction of an LPF regime in Hong Kong which was considered a very positive and significant move in entrenching Hong Kong's position as a premier asset and wealth management centre. We have taken into account the comments received in finalising the proposals under paragraphs 9 to 24 above.

ADVICE SOUGHT AND WAY FORWARD

28. Members are invited to note and comment on the proposals as set out in paragraphs 9 to 24 above. Our target is to introduce the Bill into the Legislative Council for first and second reading in the first half of the 2019-2020 legislative session.

Financial Services and the Treasury Bureau November 2019

¹² An interest in an 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. It does not fall within the definition of "stock" under section 2 of the Stamp Duty Ordinance (Cap. 117). Accordingly, an instrument under which an interest in an LPF is contributed/transferred/withdrawn is not chargeable with stamp duty. Meanwhile, an LPF may accept capital contributions in cash or in kind as provided in its limited partnership agreement. In-kind capital contributions in relation to the transfer of dutiable assets (such as Hong Kong stock or immovable property) would be subject to stamp duty. The distribution of profits and assets of LPF to the limited partner(s) will also be permitted in accordance with the terms of the limited partnership agreement. Transfer of dutiable assets by an LPF to a limited partner would be subject to stamp duty.

