

# Oversight

## Hong Kong Limited Partnership Funds

August 2020

### Background

The Limited Partnership Fund Ordinance of Hong Kong (LPF Ordinance) comes into effect on 31 August 2020. The LPF Ordinance creates a new Hong Kong domiciled legal vehicle called a limited partnership fund (LPF) which shares many, if not all, the characteristics of a Cayman Islands exempted limited partnership registered under the Exempted Limited Partnership Law (2020 Revision) of the Cayman Islands. LPFs will be able to be used by venture capital (VC), private equity (PE) and buy-out funds, real estate (RE) funds, infrastructure and project funds, special situation and hybrid funds, credit funds, and funds that target digital assets (including any cryptocurrency and other virtual assets). The bill received the Chief Executive's assent on 31 July 2020 having been published/gazetted on 20 March this year.

The LPF Ordinance's history is relatively brief. The Hong Kong Financial Services Development Council (FSDC) issued "A Paper on Limited Partnerships for Private Equity Funds" – FSDC Paper No. 17 (FSDC Paper) in December 2015. The FSDC Paper highlighted Hong Kong's lack of suitable vehicles domiciled in jurisdiction for use as VC or PE funds. The FSDC Paper identified a number of benefits for Hong Kong if a suitable limited partnership regime were to be created: (i) the substantial community of VC and PE firms already based in Hong Kong, which are otherwise motivated to establish onshore entities in other jurisdictions (such as the Cayman Islands or those with a good double tax agreement (DTA) network), will be able to use Hong Kong DTAs, (ii) foreign VC and PE firms that wish to benefit from Asian investment returns may set up in Hong Kong, (iii) the number of Mainland VC and PE investors (encompassing State Owned Enterprises, pension and insurance funds and domestic VC and PE funds) using Hong Kong that are expanding their outbound investment activities may be increased, and (iv) the Hong Kong based advisory firms which provide services to VC and PE firms in fund administration, accounting, legal and tax advice will benefit from more business.

Hong Kong has a Limited Partnership Ordinance (LPO) of 1912 which is based on the United Kingdom's Limited Partnership Act of 1907 – although unlike the latter, the LPO has not been materially modified or updated during the more than a century of its existence. The difficulty of utilising a limited partnership established under the LPO to date has been due to (i) the LPO not covering issues relating to the distribution of capital; (ii) the general partner (GP) of such limited partnership would possibly be subject to licensing requirements under the Securities and Futures Ordinance (SFO); and (iii) such a limited partnership and its GP would likely be subject to Hong Kong profits tax. However, rather than update the LPO, the Government of Hong Kong stated in the 2019-20 budget speech that it proposed the establishment of a limited partnership regime for funds. This Oversight summarises and comments on the LPF Ordinance as well as the related issues of (i) taxation, and (ii) licensing by the Securities and Futures Commission (SFC).

## Investment Scope

There is no minimum capital requirement or restriction on the investment scope for a LPF. Unlike Hong Kong's open-ended fund company (OFC) regime administered by the SFC, LPFs can invest in anything. LPFs can be open-ended or closed-end.

## Legal Structure

The LPF regime, pursuant to the LPF Ordinance, is a registration regime for a fund structured as a limited partnership. Unlike the OFC regime, it does not directly involve the SFC. Like limited partnerships under the LPO, registration is effected through the Companies Registry of Hong Kong (CR)

The LPF, like a limited partnership under the LPO or in England and Wales, has no legal personality. It needs to be a "fund", which is similar to that of a "fund" under the revised Inland Revenue Ordinance (IRO) and that of a "collective investment scheme" under the SFO. Like most limited partnerships, for example those established in the Cayman Islands or under the LPO, an LPF must have to have at least one partner that is a GP with unlimited liability as regards the debts and liabilities of the LPF. Other partners have limited liability provided they do not have day-to-day management rights or control over the assets of the LPF.

An LPF is constituted by a written agreement, i.e. a form of limited partnership agreement (LPA), and the limited partners (LPs) as to who invest in the LPF can agree the terms of the LPA with the GP as the parties wish, including:

- admission and withdrawal of LPs, as well as transfer of partnership interests by LPs;
- organisation, management structure, governance and decision-making procedures of the LPF;
- investment scope and strategy of the LPF;
- powers, rights and obligations of the partners (subject to other applicable statutory obligations of the GP under the LPF regime);
- scope of the GP's fiduciary duties, and remedies for breach of default; and
- financial arrangements among the partners, such as capital contribution, distribution of proceeds, and clawback obligations of partners.

There are no prescribed contents for LPAs under the LPF Ordinance. The LPF needs to maintain a registered office in Hong Kong (in practice most likely the same office as that of the GP which will often be the office of the LPF's investment manager (Manager) or its lawyers).

## GP and Manager

A Hong Kong based Manager needs to be appointed by the GP and must typically be licensed by the SFC although this will depend on the underlying investments.

The LPF Ordinance does set out requirements for the eligibility of the GP. The GP can be a Hong Kong private company incorporated under the Companies Ordinance (CO), an individual, another LPF, or a non-Hong Kong company with a branch registered in Hong Kong under Part 16 of the CO. If the GP of the LPF is (a) another LPF; or (b) a non-Hong Kong limited partnership without a legal personality, the GP must appoint a person as the authorized representative of the LPF to be responsible for the management and control of the LPF. The authorized representative of the LPF should be (i) a Hong Kong resident who is at least 18 years old; (ii) a Hong Kong incorporated company; or (iii) a registered non-Hong Kong company. The authorized representative and the GP in the LPF are jointly and severally liable for all the debts and obligations of the LPF. Also, both the authorized representative and the GP in the LPF have ultimate responsibility for the management and control of the LPF.

The GP must appoint the Manager. The Manager must be any of (i) a bank regulated by the HKMA, (ii) a licensed corporation under the SFO, (iii) an accounting professional or (iv) a legal professional. If the Manager carries on any business in a regulated activity under the SFO for the LPF then the Manager has to hold at least a Type 9 (asset management) license granted by the SFC.

In addition to appointing a Hong Kong auditor in respect of the LPF, the GP needs to ensure that there are proper custody arrangements for the assets of the LPF. Where the LPF will invest in securities this requirement, in effect, repeats the obligation binding on the Manager (which in that circumstance would have to be SFC licensed) under the SFC's Fund Manager Code of Conduct (FMCC). The GP must ensure that there are proper custody arrangements for the assets of the LPF according to the terms of the LP. The GP must:

- Appoint a custodian that is functionally independent. If self-custody is adopted, the GP must have policies and procedures in place to ensure that persons fulfilling the custodial function are independent from those carrying out the management function.
- Exercise due skill and diligence in the selection of a custodian.
- Ensure that the custodian is (a) a registered trust company, (b) authorized financial institution or subsidiary of a licensed bank, (c) a banking institution or trust company outside Hong Kong that is subject to prudential supervision or (d) any other appropriately qualified institution.

Finally, the LPF must have a "responsible person" to carry out the customer due diligence required by the Anti-Money Laundering and Counter Terrorist Financing Ordinance of Hong Kong. The responsible person must be authorized institution, licensed corporation, accounting professional or legal professional. This will likely usually be the Manager.

## Limited Partners

Under the LPF Ordinance, LPs need not be Hong Kong residents or meet any other eligibility requirement. Because the LPF is, by its nature, a fund falling within the definition of a collective investment scheme under the SFO it is subject to the prohibitions on the marketing of its interests under the SFO to the public unless within an exemption. Accordingly most LPs in LPFs will likely be professional investors as defined by the SFO (although this is not a requirement).

A key feature of any limited partnership regime is the limitation of liability attaching to LPs. The LPF Ordinance provides that LPs will enjoy such statutory limitation up to the amount of their respective capital commitments to the LPF. However, as with successful limited partnership legislation elsewhere (such as the Exempted Limited Partnership Law (2020 Revision) of the Cayman Islands), the LPF Ordinance sets out express safe harbours from what constitutes any LP as participating in the management of the LPF (which would otherwise cause such LP to lose its limited liability). The safe harbours cover where a LP is:

- acting, or authorising a person to act, as an agent, director, shareholder, member, contractor, officer or employee of the LPF or the GP. Serving or appointing a person to serve, on a board or committee of the LPF or the GP, or revoking such appointment. Exercising any powers or authorities or performing any obligations in the capacity of the above positions;
- entering into, or acting under, a contract with the GP or any LP(s) of the LPF, provided that the contract does not require, or the action under the contract does not involve, a LP taking part in the day-to-day management of the LPF business;
- serving, or appointing a person to serve, on the board of directors, or a committee of any corporation in which the LPF has an interest, or any corporation providing management, consultation, custody or other services to the LPF or having a business relationship with the LPF, or revoking such appointment;
- discussing, advising, approving or authorising the GP, any LPs or the Manager on the business, prospects or affairs or transactions of the LPF;
- calling, requesting, attending or participating in a meeting of the LPs;
- exercising any right or power conferred under the LPA, other than any power to carry out management functions, but including the right to vote on or signify the approval or disapproval to any proposed transaction of the LPF;
- consulting, investigating, reviewing, approving or advising on the accounts, the valuation or the assets of the LPF or affairs of the LPF;
- acting as a guarantor for the LPF or the GP;
- approving or disapproving any amendment to the LPA or taking part in a decision about the variation of, or waiver of a term of, the LPA or associated documents;
- commencing or instructing someone to commence, continue or defend legal proceedings on behalf of the LPF where the GP has refused to do so without good reason; and

- taking part in a decision about: (i) whether a person should become or cease to be a GP or LP; (ii) whether the LPF should end or the term of the LPF should be extended; (iii) changes in the persons responsible for the day-to-day management of the LPF; (iv) the incurrance or renewal of indebtedness by the LPF; (v) a change in the investment scope of the LPF; (vi) entering into contract with other parties in relation to the business of the LPF; (vii) enforcing an entitlement under the LPA, provided that the entitlement does not involve a LP taking part in the day-to-day management of the partnership business; (viii) the exercise of the LPF's rights in respect of an investment; (ix) the participation by a LP in a particular investment by the LPF; and (x) the creation, extension, variation or discharge of any other obligation owed by the LPF.

## Hong Kong Tax

As reported in the Oversight of March 2019, the IRO was amended from 1 April 2019 to exempt all funds, no matter where established or domiciled, from Hong Kong profits tax arising from qualifying transactions provided that the relevant fund is managed by a specified person (essentially a SFC licensed corporation). This has given OFCs equality of treatment with Cayman Islands mutual funds and LPFs are also be able to rely on this tax exemption, in the same way as offshore funds can, in respect of qualifying transactions.

The FSDC Paper, proposed not only tax neutrality as outlined above, but also that no stamp duty should be payable on assignment of interests (including any transfers or withdrawal) in LPFs under the new regime. This has been implemented – interests in LPFs are not “Hong Kong stock” as defined in the Stamp Duty Ordinance of Hong Kong and so, on assignment, should not be chargeable to Hong Kong stamp duty. However, in-kind capital contributions of shares or real estate to a LPF or distributions by a LPF of Hong Kong stock are dutiable in the normal way.

Hong Kong resident LPs and the GP of a LPF will be subject to profits tax, as applicable, in the normal course.

## Licensing

A Manager appointed by the GP of a LPF will not necessarily always be regulated by the SFC (for example if all the underlying investments of the LPF are shares in private companies under the CO and are therefore not “securities” under the SFO). However, the requirement that a GP must appoint a Manager which is licensed by the SFC where appropriate to the investments of the LPF means that, given full delegation, the GP itself will not need to be licensed by the SFC (or fulfil any other regulatory eligibility requirement) to merely act as GP of the LPF.

Any LPF only needs to be authorised by the SFC as a collective investment scheme under the SFO if it is offered on a retail basis, i.e. to the Hong Kong public other than within an exemption.

With regard to the licensing of managers or advisers of VC and PE funds in general it should be noted that the applicability of the regulated activities under the SFO to VC and PE fund managers and advisers based out of Hong Kong is well established. Whilst the old Securities Ordinance (replaced by the SFO in 2003) allowed an express exemption for investment advisers servicing only professional investors and investors outside Hong Kong and whilst the definition of securities under the SFO excludes shares in Hong Kong private companies (which has often been misinterpreted to mean unlisted or non-public securities) there is no exemption for VC and PE managers under the SFO.

The LPF Ordinance is not ambiguous in this regard and confirms the SFC's approach – like any fund managed from Hong Kong, an LPF investing in securities must have a SFC licensed Manager (and by extension the Manager will need to comply with the FMCC in respect of the LPF).

However it should be noted that a RE fund structured as a LPF would not necessarily need to have a SFC licensed Manager if it only invests in real estate.

## Formation

Under the LPO the establishment of a limited partnership is simple. A specified form must be delivered to the CR for registration together with the relevant fees. On registration (which gives a partnership its limited liability status subject to compliance with the LPO), a Certificate of Registration of a Limited Partnership is issued by the CR within 5 working days.

LPFs have a similarly straightforward registration process as set out in the LPF Ordinance and, unlike OFCs, the body which will handle LPFs is the CR and not the SFC. However, an application to register an LPF differs from that of a LPO limited partnership in that it has to be presented via a Hong Kong solicitor and include the following:

- the name of the LPF (which, it is proposed, will have to end with the words “Limited Partnership Fund”, “LPF” or the equivalent in Chinese);
- the full name, correspondence address (natural person) / registered office address (private company limited) / principal place of business (registered non-Hong Kong company / limited partnership) and signature / signature of director / company secretary / Manager / authorised representative (as the case may be) of the GP;
- the number of the Hong Kong identity card or the number and issuing country of the passport (natural person) or the number of the Business Registration Certificate (private company limited / registered non-Hong Kong company / limited partnership) (as the case may be) of the GP;
- the registered office address of the LPF;
- the investment scope and principal place of business of the LPF;
- the full name, the number of the Hong Kong identity card or the number and issuing country of the passport or the number of identification document of the responsible person;
- a declaration and undertaking by the GP that the LPF will operate as a fund;
- a confirmation as to the location of the records of the LPF; and
- the full name and the contact information of the Hong Kong solicitor presenting the application.

When submitting the application it must be accompanied by an application/registration fee of HK\$3,034. A certificate of registration of a limited partnership fund will then be issued by the CR if the LPF meets the requirement of the LPF Ordinance.

An existing limited partnership under the LPO can, if it wishes, migrate or transfer by way of continuation as a LPF if it re-registers (presenting the same information as above). The LPF Ordinance allows for the automatic survival of all legal rights and obligations in such a case.

## Publicly Available Information

The CR is required to maintain an index of the names of every LPF (LPF Index), as well as a register which will record up-to-date information about each LPF that is first provided to the CR by the GP during the registration process and subsequently updated if necessary (LPF Register). These details include the name of the LPF, address of its registered office and principal place of business, investment scope and the name and contact details of its GP, Manager and/or authorized representative.

The LPF Index and LPF Register is available for public inspection at all reasonable times to enable members of the public to ascertain the “particulars” of the fund and the identities of the current and former GP, Manager and/or authorized representative. The LPF Ordinance does not specify the “particulars” that will have to be disclosed, so the CR will determine the scope of the information in the LPF Register that will be publicly available.

## Records

An annual return must be filed by the GP with the CR within 42 days after each anniversary of the LPF’s registration date. The GP or Manager is required to keep proper records of documents or information pertaining to the operations and transactions of the LPF (such as financial statements, transaction documents and a register of LPs) at the registered office of the LPF (or any other place in Hong Kong made known to the CR). The records must not be made available for public inspection, although the financial statements of an LPF must be made available to all LPs.

## Enforcement by the CR

The CR may, after issuing an inquiry letter and publishing a notice in the Hong Kong Gazette, revoke the registration of an LPF under at least one of the following circumstances:

- The LPF does not meet the eligibility requirements in the LPF Ordinance.
- The LPF does not have Manager, responsible person and/or authorized representative (if applicable).
- After the second anniversary of the registration date of the LPF, the LPF is not in operation (or not carrying on business as a fund) or all the partners in the LPF are corporations in the same group of companies.

## Winding-Up and Dissolution

Most PE or VC funds are wound up and dissolved upon the expiry of a pre-determined term. Accordingly the winding-up and dissolution mechanisms in the LPF Ordinance are straightforward (and cost-efficient).

The LPF Ordinance provides that an LPF may be dissolved without a Court order according to the terms of the LPA. Additionally, if the GP or authorized representative is incapacitated (bankrupt, would up, dissolved or dead) and a replacement has not been found after 30 days, the LPF will be dissolved upon the expiry of such period.

The LPF Ordinance also provides for dissolution of the LPF on application to the Court by a partner or creditor of the LPF on at least one of the following grounds:

- The Court is of the opinion that a partner of the LPF (other than the applicant) has acted in a way prejudicially affecting the business of the LPF.
- A partner in the LPF (other than the applicant) has wilfully or persistently breached the LPA, or has conducted themselves in matters relating to the LPF's business such that it is not reasonably practicable for the other partners to carry on business with that partner.
- The business of the LPF can only be carried on at a loss.
- The Court is of the opinion that it is just and equitable that the LPF be dissolved.
- The GP is mentally incapacitated or permanently incapable of performing its obligations under the limited partnership agreement.

Additionally, the LPF Ordinance provides that an LPF will be an unregistered company for the purposes of the Companies (Winding Up and Miscellaneous Provisions) Ordinance of Hong Kong. This means that a partner or creditor may present a winding up petition to the Court, and the LPF may be wound up by the Court under the following circumstances:

- If the LPF is dissolved, or has ceased to carry out business, or is carrying on business only for the purpose of winding up its affairs.
- If the LPF is unable to pay its debts.
- If the Court is of the opinion that it is just and equitable that the LPF should be wound up.

The LPF Ordinance also provides for the following additional circumstances: (i) The LPF is used for an unlawful purpose, or for any purpose that is lawful but cannot be validly carried out by the LPF in accordance with the LPF Ordinance; and (ii) the obligations under the LPF Ordinance have been persistently breached in relation to the LPF.



## Conclusion

The LPF Ordinance is a significant and welcome change to the VC, PE and RE funds regime in Hong Kong. Combined with greater clarity with regard to the licensing and taxation of Managers and their funds respectively the LPF regime will bolster the further development of fund industry in the Special Administrative Region.

The availability of LPFs creates a lightly regulated, tax neutral, tailored Hong Kong vehicle with the capacity to utilise DTAs. The quick low cost establishment process through the CR, and lowering of costs by removing the need for (and significant expense of) offshore counsel should make LPFs a popular choice. It should be noted that the Government of Hong Kong also announced in the 2020-21 budget that a concessional tax arrangement regarding taxation of carried interest will be introduced starting from this year of assessment. More details are expected to be published in August 2020 – further enhancing the Hong Kong PE, VC and RE fund ecosystem.

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