

Structuring Investment Funds Under Hong Kong Law

Introduction

This update focuses on the establishment of open-ended fund companies in the context of other possible fund structures under Hong Kong law. Open-ended fund companies are a new structure although the relevant amendments to Hong Kong's Securities and Futures Ordinance (Cap. 571) (SFO) have not yet come into force.

By way of background, under existing Hong Kong laws, an open-ended investment fund is typically established in the form of a unit trust constituted by a trust deed (but not in the form of a company due to various restrictions on capital reductions, on making distributions out of profit and on filing of returns of allotments in respect of new shares under the Companies Ordinance (Cap. 622) (CO)) and a closed-end investment fund may be established in the form of a limited partnership constituted by a limited partnership agreement.

It is noted that, from an international perspective, a corporate structure with variable capital for open ended funds and LLCs (as described below) and limited partnerships for closed-end funds are popular structures in other jurisdictions. This update also explores these structures.

Funds Formed in Hong Kong as Open-Ended Fund Companies (OFCs)

An open-ended fund company with variable capital is a collective investment scheme set up in the form of a company with the freedom (not available to conventional companies) to create and cancel shares to accommodate subscriptions and redemptions by investors in the funds and to make distributions to shareholders out of share capital (subject to solvency and disclosure requirements).

The Securities and Futures Commission (SFC) will be the primary regulator responsible for the

registration and regulation of open-ended fund companies (OFCs) under the SFO while the Companies Registry (CR) will be responsible for the incorporation and statutory corporate filings of OFCs. The enabling provisions are set out in the Securities and Futures (Amendment) Ordinance 2016 which was gazetted on 10 June 2016 while the detailed operational and procedural matters are expected to be in the form of Securities and Futures (Open-ended Fund Companies) Rules and a new Code on Open-ended Fund Companies to be issued by the SFC governing both privately and publicly offered OFCs.

The essential requirements of an OFC are that it (1) is constituted by an 'instrument of incorporation' with provisions which comply with all regulatory requirements; (2) has a registered office located in Hong Kong; (3) is governed by a board of directors who must at all times delegate the investment management function of the OFC to an investment manager licensed by or registered with the SFC under Part V of the SFO to carry out Type 9 (asset management) regulated activities; and (4) entrusts its assets to a custodian who satisfies the SFC's eligibility requirements.

Under the new legislation, the assets and liabilities of a sub-fund of an OFC may be ring-fenced to that particular sub-fund, so as to limit the contagious effect from the insolvency of another sub-fund of an OFC with an umbrella fund structure. However, as it is uncertain whether foreign courts would recognise this protected cell regime, the SFC will require the OFC offering documents to include a risk factor highlighting this risk for investors.

In line with the existing regime available to distributors of offshore domiciled corporate funds being marketed in Hong Kong, marketing and distribution of shares in the OFC will be exempt if one of the safe harbours set out in the existing

legislation applies which include, for example, where an offer is made to no more than 50 persons, with a minimum denomination of HK\$500,000 or a maximum size of HK\$5 million. Under section 103(2)(ga) of the SFO, where an advertisement, invitation or document relates to an offer falling within paragraph (b)(ii) of the definition of “prospectus”, it will be exempted from SFC’s authorisation requirements.

In practice, once the SFC is satisfied that the registration requirements are met, it will issue a notice of registration to the CR. The SFC will forward relevant incorporation and business registration documents together with the notice of registration and the fees to the CR for the OFC’s incorporation and business registration purposes. The CR will incorporate an OFC if it has received the notice of the registration and other relevant documents from the SFC and is satisfied that the requirements for incorporation have been met. The registration of the OFC will take effect only on the day of issue of the certificate of incorporation by the CR. Under the one-stop company incorporation and business registration regime, the CR will issue the first business registration certificate on behalf of the Commissioner of Inland Revenue simultaneously together with the certificate of incorporation. Following the incorporation of the OFC, corporate filings are largely expected to be made solely with the CR.

Tax is usually one of the main considerations influencing the decision of fund managers on where a fund is to be domiciled and managed. On par with the profits tax treatment under the existing tax exemption regime, publicly offered OFCs will be exempt from profits tax on qualifying income and privately offered OFCs will be subject to profits tax. Exempting onshore privately offered OFCs may give rise to concerns for tax avoidance, notwithstanding such OFCs will be domiciled in Hong Kong as regulators are conscious of the possible adverse base erosion and profits shifting implications.

Funds Formed in Other Jurisdictions as Closed-End Limited Liability Companies (LLCs)

The amendments to the SFO do not extend to the formation of LLCs which are a popular fund structure available in jurisdictions such as Delaware and the Cayman Islands. An LLC is an entity which combines the characteristics of a company with those

of a limited partnership. Like a traditional company, an LLC is a body corporate with separate legal personality, but unlike a traditional company, an LLC does not have share capital. Member liability is limited, capital accounts are permitted, and the members are free to determine in the LLC agreement how profits and losses are allocated and how and when waterfall distributions are made, similar to the freedoms afforded to partners of a limited partnership.

An LLC can be used as a real estate, private equity or other closed-ended fund vehicle, as an alternative to a limited partnership, which may not, depending on its jurisdiction of establishment, enjoy separate legal personality, or a conventional company, which can be constrained by capital reduction and increase rules and can be cumbersome when addressing capital call and default mechanics.

An LLC may be managed by any one or more of its members, or the members may, in the LLC agreement, appoint a manager to manage the LLC’s affairs. In addition, the members or manager may appoint advisory boards or investment and conflicts committees in the same way as a limited partnership.

A member of an LLC may, when voting, act in its own best interests even though that may not be in the best interests of the LLC. Board and committee members may, if expressly permitted by the LLC agreement, act in a manner which that person believes to be in the best interests of particular members, even though it may not be in the best interests of all members or the LLC itself.

Investors in an LLC structured as an umbrella fund may also benefit from the statutory segregation of assets and liabilities with respect to creditors such as the “series” feature under Delaware law just like a segregated portfolio company under Cayman Islands law.

Closed-End Funds Formed as Limited Partnerships

The amendments to the SFO do not impact on the formation of a fund as a limited partnership which is a structure already permitted under Hong Kong’s Limited Partnerships Ordinance (Cap. 37) and also available in jurisdictions such as the Cayman Islands, Delaware and the United Kingdom. Similar to an LLC, the terms of the limited partnership agreement, can regulate how and when waterfall distributions are made and can also specify that each member of any committee formed by the general partner may

act only in the interests of the limited partner it represents and may disregard any fiduciary duties it may otherwise owe to other limited partners except for the duty to act in good faith. However, the appeal of a limited partnership structure lies in the tax transparency it offers as there is no taxation at the fund level. Instead, limited partners are only taxed on their share of the income and capital gains derived from the investments made by the fund thereby avoiding double taxation. However, relatively few funds are formed as Hong Kong limited partnerships. It is therefore not surprising that Hong Kong law in this area has not kept pace with legislative developments and case law in other jurisdictions.

Conclusion

The establishment of open-ended fund companies under Hong Kong law is a welcome development which will diversify Hong Kong's fund domiciliation platform. It remains to be seen whether lawmakers and regulators in Hong Kong will next focus on a review of the laws applicable to LLCs and limited partnerships to further enhance the development of alternative legal structures for the formation of investment funds in Hong Kong.

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