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KEY ISSUES IN GETTING AN SFC LICENSE FOR ALTERNATIVE FUND MANAGERS

One of the first challenges facing potential alternative fund managers (ie hedge fund, private equity and real estate fund managers) when setting up their new fund management business in HK is getting the appropriate SFC license. This article will examine the key issues often faced by potential alternative fund managers when getting an SFC license and the main requirements for getting an SFC license.

There are 10 types of SFC licenses each covering a different type of “regulated activity”. The first question often asked by potential fund managers is whether or not they need to get a license for one or more of these. Whereas the differences between some of these regulated activities are conceptually and practically easily distinguishable, some are differentiated by subtle nuances and may, at first, appear overlapping.

The most relevant types of licenses concerning alternative fund managers are Type 1 (Dealing in Securities), Type 4 (Advising on Securities) and Type 9 (Asset Management) licenses. Whether the fund manager needs one or more of these depends on the exact nature of the business and activities the fund manager intends to undertake in Hong Kong. Although prima facie a fund manager managing a fund from Hong Kong would require at least a Type 9 license, the Hong Kong Securities and Futures Ordinance and its subsidiary legislations, regulations and guidelines do provide a number of important exemptions which may apply to the fund manager. One example is the “private company” exemption — the definition of “securities” excludes shares in a company which is a “private company” within the meaning of the Hong Kong Companies Ordinance. Activities which constitute “asset management” which require a license involve the management of a portfolio of “securities” and hence, if the portfolio managed by the fund manager consists only of shares in “private companies” as defined then it may be arguable that the fund manager may not require a license for such activities on the basis of the exemption noted above. Whereas this exemption would not apply to hedge funds trading listed stocks (because such listed stocks would not fall within the exemption of being shares in a “private company”), this argument may apply to some private equity fund managers whose portfolio consists only of investments in “private companies”. Similarly it may be arguable that managing a portfolio of physical real estate assets may fall outside of the ambit of “managing a portfolio of securities” on the basis that such portfolio of physical real estate assets is not portfolio of securities or any one of the categories of financial assets or instruments in relation to which the activity of “asset management” is regulated.

If the portfolio which the fund manager manages does consist of securities or any one of the other types of financial assets or instruments in relation to which the activity of asset management is regulated, and that no other exemption applies, then it should be safe to conclude that the fund manager would need a Type 9 license. However, a question is often raised as to whether the activity of managing a portfolio of securities undertaken by the fund manager is actually conducted in Hong Kong. In a typical hedge fund where its trader places trades on a frequent basis at a desk in Hong Kong on a discretionary basis, it is clear that such activities amount to Type 9 asset management activities conducted in Hong Kong. However, less clear is the case of a private equity styled fund where investment decisions are less frequently made and, when made, is made by a committee (eg an investment committee) which may be composed of members some of whom may be resident in Hong Kong and some of whom may be resident outside of Hong Kong. This type of arrangement begs the question as to whether investment decisions are actually made in Hong Kong and, therefore, whether it triggers any licensing requirements in Hong Kong. The answer to this question depends on a number of factors including, for example, whether the Hong Kong based personnel of the investment decision making body individually or collectively has the veto power, whether such investment decision making body is constituted by the offshore fund entity or the Hong Kong based fund manager, amongst many other factors. The conclusion of such analysis may well be that investment decisions are made outside of Hong Kong (ie no Type 9 activities are conducted in Hong Kong), and that the Hong Kong based personnel is conducting advisory activities only (hence Type 4 regulated activities). This would mean that the license which may be required is the Type 4 license and not the Type 9 license.

With fund managers (especially first time fund managers) continuing to face headwinds on capital raising, we see fund managers often take the route of initially managing client's money on a managed account basis, with a view of forming a blind pool fund after gaining some traction with investors. The question we see often being asked in these arrangements is what kind of licensing requirements would these types of activities trigger. The answer to this question would depend on, amongst other things, the extent of the discretion to which the fund manager has over the investment decision concerning the client's assets. In the case of hedge fund managers it is often the case that they would have complete discretion over the client's assets and therefore this issue is less problematic. However, in the case of private equity styled fund managers, often the fund manager has less than complete and total discretion – ie the client may have some degree of say over the investment decisions concerning their assets. The more the fund manager moves away from having complete and total management discretion, the more likely that licensing requirements other than just Type 9 license may be triggered. In such a case, the most likely license which may be needed are the Type 4 and Type 1 licenses depending on, amongst other factors, the nature of services provided to the client, extent of advisory work undertaken, the fee arrangement with the client, the way investment opportunities are originated and the nature of the relationship the licensed entity has with both the sell and buy side of a transaction, etc.

If a fund manager's proposed activities fall within the definition of one of the regulated activities, then it needs to obtain an SFC license. It needs to incorporate a Hong Kong company (the Applicant Company), which will need to appoint at least two individuals as responsible officers (ROs). ROs are licensed representatives of the Applicant Company who actively participate in or directly supervise the regulated activity to be

conducted by the Applicant Company. At least one RO must be an executive director of the corporate entity that actively participates in, or is responsible for directly supervising, the conduct of the regulated activity for which they are licensed. At least one RO must be resident in Hong Kong.

There are a number of requirements relating to both the Applicant Company and its proposed licensed representatives, such as requirements related to being fit and proper, and being competent. For example, the proposed ROs must possess a minimum of 3 years relevant industry experience over the 6 years immediately prior to the date of application and possess a minimum of 2 years of proven management skill and experience.

A licensed corporation is also subject to capital requirements, the amount of which varies depending on the type of license and the conditions to which the license may be subject.

For a Type 9 licensed corporation, that does not hold client assets, there is a minimum liquid capital requirement of HK\$100,000. Other capital requirements apply to different types of licenses subjected to different conditions imposed. To apply for an SFC license, the applicant must fill in a number of prescribed SFC forms which elicits information about the Applicant Company, the proposed licensed representatives (and ROs) and also the substantial shareholders of the Applicant Company. The Applicant Company needs to provide a detailed business plan, a compliance manual as well as drafts of client agreement. The application process typically takes up to 15 weeks from the time the SFC accepts the applicant's submission documents.

GOING FORWARD

There are currently proposals to:

- introduce 2 new types of regulated activities, namely:
 - Type 11: Dealing in and/or advising on OTC derivatives transactions; and
 - Type 12: Providing clearing and settlement services in respect of OTC derivatives transactions

- expand the scope of the current:
 - Type 7 regulated activity (Providing automated trading services) (RA 7); and
 - Type 9 regulated activity (asset management) (RA 9)

The definition of "OTC derivatives transactions" is yet to be finalised by the SFC. However, it is likely to be based on the current definition of "structured products" in the SFO which would therefore cover the commonly traded equity derivatives, FX derivatives, interest rate swaps /options, non-deliverable forwards and credit derivatives.

Current and future fund managers are likely to be most impacted by the new Type 11 and the expanded Type 7 and 9.

If, as part of the fund manager's business, the fund manager deals in or advises on OTC derivatives, then the fund manager will need a Type 11 license unless one of the carve-outs applies to the fund manager. For example, if fund manager is licensed for Type 1 and / or Type 4 regulated activity, it may be exempted from licensing for the new Type 11 license.

Currently, Type 9 regulated activities does not include OTC derivatives products. Therefore, existing fund managers who manage a portfolio of OTC derivatives products do not currently require a Type 9 license. However, going forward, the definition of Type 9 regulated activity will be expanded to include OTC derivatives products. Existing fund managers who are not currently licensed for Type 9 regulated activities because they manage only OTC derivatives products may need to apply for a Type 9 license. These fund managers will need to take into account of the competency and management experience of the ROs in managing OTC derivatives when applying for a new Type 9 license.

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