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BRIEFING

HAVE REGULATORY DEVELOPMENTS IN HONG KONG KEPT PACE WITH THE PRIVATE FUNDS INDUSTRY?

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.

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