

Hong Kong's new limited partnership fund regime comes into operation today

31 August 2020

Following on from our [alert](#) on 28 August 2020, today sees the coming into force of the Limited Partnership Fund Ordinance (Cap. 637) (LPFO), heralding a new era for private funds in Hong Kong. The LPFO establishes a limited partnership fund (LPF) regime (the LPF regime) which enables funds to be registered in the form of limited partnerships in Hong Kong.

As we have discussed, together with the Hong Kong government's recent proposal to provide a tax concession for carried interest, this development is intended to help the city attract investment from funds, including private equity (PE) and venture capital funds, that might otherwise establish themselves in offshore jurisdictions. It is hoped that this will bolster Hong Kong's role as a hub for private capital and enhance its ability to take advantage of the business opportunities that being part of the Greater Bay Area presents.

In our view, the changes will also help to further develop the growth of Hong Kong as a family office hub.

The Hong Kong Financial Services Development Council (the FSDC) has identified that the "...unique advantages of Hong Kong should already make it a natural choice for family offices looking to establish a presence in the Asia-Pacific Region."¹ Those advantages include:

- Mature and sophisticated financial markets.
- Alternative and sustainable investment opportunities.
- Prominent role as part of the Greater Bay Area and an investment gateway into and out of Mainland China.
- Strong professional services sector.
- World class judicial system.
- A thriving startup ecosystem (both technology and other).

More is needed to be done to create the most advantageous environment for family offices and others within the private wealth management sector (as the FSDC makes clear) but the LPF regime and carried interest concession are absolutely steps in the right direction.

¹https://www.fsdcc.org.hk/sites/default/files/FSDC_Paper_No_45_Family_Wisdom_A_Family_Office_Hub_in_Hong_Kong_Paper_Eng.pdf

Why it's needed

Hong Kong's Limited Partnerships Ordinance (Cap. 37), has been the bedrock legislation for professional practices in the legal and accountancy sector since its enactment in 1912. Perceived shortcomings identified, for example, in a December 2019 Legislative Council paper, "Proposals to establish a limited partnership regime for funds" include a lack of flexibility in capital contributions and distribution of profits, the absence of contractual flexibility, and the availability of a straightforward dissolution mechanism.

The absence of such features was thought to discourage fund managers from establishing PE funds in the form of a limited partnership and hampered the development of a thriving domestic PE market.

As we have explored, it is hoped that the introduction of the LPF regime will also contribute to making Hong Kong an attractive onshore destination for fund managers looking to relocate their funds and activities in light of the Organization for Economic Co-operation and Development's introduction of base erosion and profit shifting measures (including the "economic substance" requirements).

Further details and how to apply

An LPF is an arrangement meeting the definition of fund in section 3 of the LPFO, that is one that is structured as a limited partnership and which is used for managing investments for the benefit of investors (i.e., the limited partners). There must be at least two partners, one general and one limited, under a limited partnership agreement.

The general partner has ultimate responsibility for the management and control of the LPF and has unlimited liability in respect of it. The general partner appoints an investment manager (either a Hong Kong resident above the age of 18 or a Hong Kong registered corporation) to carry out the day-to-day investment management functions, as well as an auditor, independent of the general partner and the investment manager, to perform an annual audit.

According to section 7, the general partner must be:

- A natural person who is at least 18 years old.
- A private company limited by shares.
- A registered non-Hong Kong company.
- A limited partnership registered under the Limited Partnerships Ordinance, Cap. 37).
- A limited partnership fund.
- A non-Hong Kong limited partnership with or without a legal personality.

Every limited partner of the LPF must be:

- A natural person (whether in the person's capacity as trustee, or in the person's own or any representative capacity).
- A corporation, partnership of any kind, an unincorporated body or any other entity (whether in its capacity as trustee, or in its own or any representative capacity).

A fund wishing to register submits an application to the Registrar of Companies (RoC), containing information such as the name of the fund, the name of the general partner, investment

manager, address of the registered office (which must be in Hong Kong), 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 that the partnership is limited.

Once the registrar is satisfied with the documents submitted, the registrar will register the fund as an LPF and issue a certificate of registration.

A record of the LPF will be kept in an index and register which will be open for public inspection. The registration remains valid subject to the filing of an annual return by the general partner. The return must include a declaration that the LPF has been and will be in operation or will carry on business as a fund during the year. Failure to file on time may lead to the LPF being struck off the register.

Freedom of contract

According to section 16 of the LPFO, the partners have freedom of contract in respect of the operation of the LPF. This includes:

- The admission and withdrawal of partners in the LPF.
- The transfer of interests in the LPF by the limited partners.
- The organization, management structure, governance, and decision-making procedures of the LPF.
- The investment scope and strategy.
- The powers, rights, and obligations of the partners.
- The scope of the fiduciary duties of the general partner or authorized representative and the remedies for breach or default.
- The financial arrangements among the partners, such as capital contributions, withdrawal of capital contributions, distribution of proceeds, and clawback obligations of the partners.
- The life of the LPF with possibility of extension.
- The frequency of financial reporting and verification of net asset value.
- The custodial arrangement.
- The dissolution procedures.

Records maintenance

The general partner or investment manager must keep proper records of documents and information as to the operation and transactions of the LPF, including its audited financial accounts, particulars of all parties (including beneficial ownership), and documents kept for the purposes of anti-money laundering/counter-terrorist financing.

The general partner must ensure proper custody arrangements are in place for the assets of the LPF, complying with the relevant custody requirements under the Hong Kong Securities and Futures Commission (SFC) Fund Manager Code of Conduct where the general partner is licensed for Type 9 (asset management) activities.

Key duties and obligations

As we reported in our [previous alert](#):

- Any person or entity, whether the general partner or otherwise, deemed to be the investment manager must obtain a license to conduct investment activity from the SFC, as specified under [Section 114](#) of the Securities and Futures Ordinance.
- The general partner must appoint a "responsible person" to carry out anti-money laundering (AML) and counter-terrorist financing measures. This role may be occupied by a variety of institutions and professionals, including SFC-registered entities, banks, and legal professionals.
- The fund sponsor must maintain compliance with the LPFO and comply with RoC inquiries. The RoC has broad regulatory authority over LPFs and their operations. The LPF must also maintain a registered office in Hong Kong and a Hong Kong business registration, as specified under the Business Registration Ordinance. Additionally, the LPF must appoint a third-party fund administrator to oversee net asset value calculations and certain other investor services.

Dissolution

To recap, a LPF can be dissolved without a court order according to the terms of the limited partnership agreement. If a general partner or authorized representative is incapacitated, and a replacement not found within 30 days, the LPF will be dissolved once this period has expired.

The LPFO also provides for dissolution on application by a partner in, or a creditor of, a LPF if:

- The court, having regard to the nature of the business of the LPF, is of the opinion that a partner in the LPF (other than the applicant partner) has done any act or made any omission calculated to affect prejudicially the carrying on of the business of the LPF.
- A partner in the LPF willfully or persistently commits a breach of the limited partnership agreement or conducts themselves in matters relating to the business of the LPF such that it is not reasonably practicable for the other partner or partners to carry on the business in partnership 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 general partner is mentally incapacitated or becomes in any other way permanently incapable of performing their part of the limited partnership agreement (section 71).

An LPF may also be wound up under the relevant provisions of the companies (Winding Up and Miscellaneous Provisions) Ordinance (Cap. 32) if:

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

In addition, the court may order a winding up if the LPF is being carried on for an unlawful purpose or any purpose that is lawful itself but cannot be carried out by the LPF or if obligations under the LPFO have been persistently breached in relation to the LPF (section 75).

Carried interest concession

As we touched upon in our previous alert, the new regime should be bolstered by the new proposal, announced on 7 August 2020, for tax concessions for carried interest issued by PE funds with operations in Hong Kong.

According to the proposal, announced by Financial Secretary Paul Chan Mo-po, "a tax concession should be provided for carried interest arising from eligible transactions of a fund subject to meeting specified conditions."

The tax concession would have retrospective effect and apply as from the tax year commencing 1 April 2020.

Hong Kong's Inland Revenue Department had previously taken the stance that carried interest is a disguised management fee, however the proposal appears to recognize that genuine carried interest should be considered on a par with the returns made to other investors.

To be eligible, the fund must be validated by the Hong Kong Monetary Authority, involving an application submission with supporting documentation and the presence of an external auditor who can certify that the applicable "substantial activities" criteria are met. A report must be made to the Commissioner of Inland Revenue of all distributions made to Hong Kong recipients. An authorised local representative must also be appointed. Eligible recipients include persons providing investment management services to a validated fund in Hong Kong.

The proposed changes, together with the introduction of the LPF regime, should boost Hong Kong's attractiveness as a location for fund managers and enhance its position as a family office hub in Asia-Pacific.

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