Private Equity Fund Formation in Hong Kong

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Fund Formation in Hong Kong

- A Brief Outline on Limited Partnership Funds

Private equity funds are investment vehicles formed by investment managers looking to raise capital to make investments in a specified sector or region. Passive investors make a commitment to put a set amount of capital into the fund and entrust the fund's sponsor to source, manage, acquire and divest the investments.

When properly structured, the sponsor of a fund will be incentivized by management fees and profit sharing of the fund's investments, whereas the investors will have the opportunity to earn a high rate of return on their committed capital through expert management of the portfolio.

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The recent years have witnessed a surge in private equity fund formation activities in Hong Kong. This article summarizes the salient features regarding such funds and practicalities about their establishment

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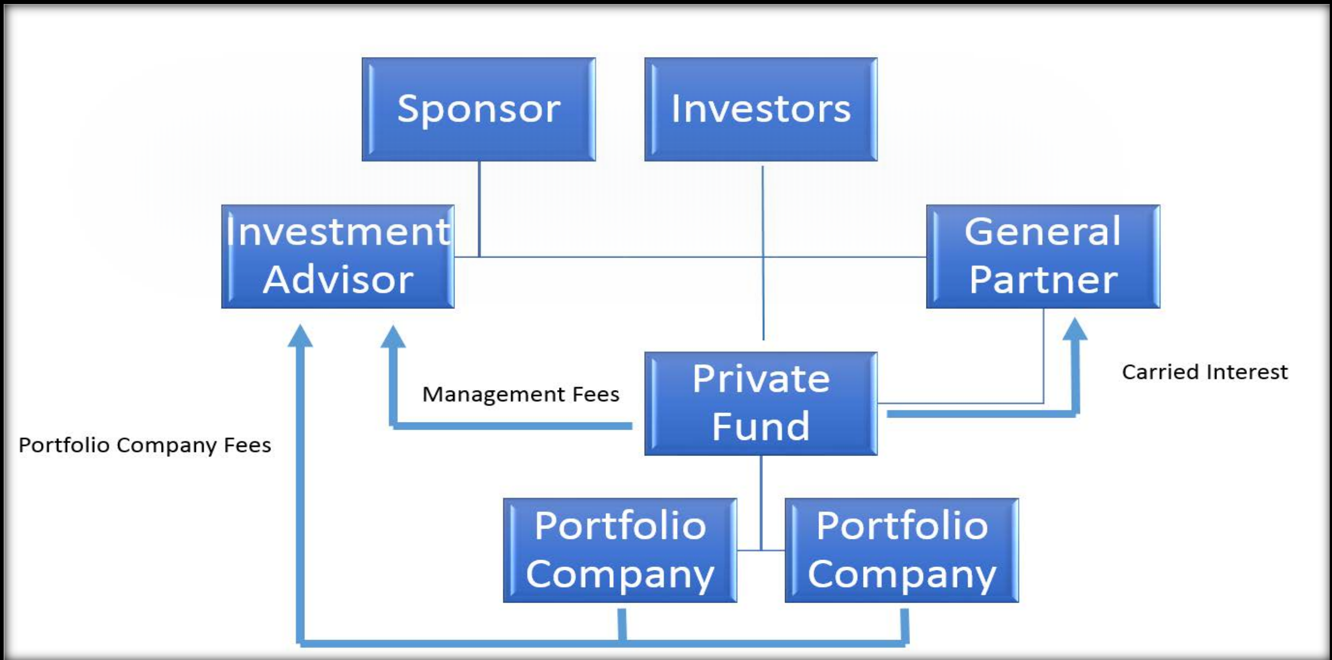

Fund Structure

Private equity funds are usually structured as closed-end investment vehicles. The fund's governing documents, for example, the Limited Partnership Agreement (the "LPA"), usually allow the fund to raise commitments or capitals only during a specified fundraising period. During the period, the sponsor of the private equity fund seeks investors to subscribe for capital commitments to the fund. Capital contributions are usually called on an as-needed basis to make investments during the investment period and pay the fees and expenses over the fund's life.

Limited Partnership

In Hong Kong, private equity funds are usually structured as limited partnerships with the sponsor being the general partner (which is, for example, a company incorporated in Cayman Islands) and investors acting as limited partners. It is because such structure offers limited liability of investors, allow for flexibility in the terms of their constitution and are treated like flow-through vehicles for tax purposes. There are two types of partners in a limited partnership: the limited partners, whose liability is capped at the amount of their investment or commitment ; and the general partner(s), who have unlimited liability for the liabilities of the limited partnership. This can be mitigated through having a limited liability company to serve as the general partner.

To achieve flexible distribution allocations, limited partnerships are not separate legal entities. They are partnerships of persons who, by means of registration (under, for instance, the Exempted Limited Partnership Law of the Cayman Islands, or the Limited Partnership Ordinance (Cap. 37 of the Laws of Hong Kong) (the "LPO"), limits the liability of the investors as limited partners.

For partnerships registered outside of Hong Kong, in order to limit the liability for the limited partners, they can register their partnerships in Hong Kong. Otherwise, they may be treated as general partnerships who bear unlimited liabilities.

However, registration in Hong Kong does not provide absolute protections to limited partners from Hong Kong liabilities because when a limited partner participates in the management of the business which involves business decision making, the limited partner can lose its limited liability under those circumstances.

Management arrangements

Usually in Hong Kong, a sponsor of a private equity fund under the structure of limited partnership would set up a separate legal entity to serve as the general partner and another separate legal entity to serve as the manager. The manager, created by the sponsor of the private equity fund, can control and administer the fund, and take actions on behalf of the fund. The specific type and function depends on the form of the investment funds, which can be venture capital funds, growth equity funds, buyout funds, or distressed funds, etc. The general partner will be entitled to a certain percentage of the profits of the fund (the "carried interest") and the manager will be entitled to the management fees.

The use of a separate entity to serve as the general partner can insulate the unlimited liability to the general partner when the general partner is organized in a form that limits the liability of its owners.

The sponsor may establish one or more investment advisers to the manager. The fund or its general partner or manager enters into an investment advisory agreement with the investment adviser. Under this arrangement, the fund pays management fees to the investment adviser to employ the investment expertise, evaluate potential investment opportunities and undertake the day-to-day activities in respect of investment advisory services. If the management team will be spread out across different jurisdictions, the sponsor may establish several separate advisers in each jurisdiction.

Terms of the partnership

Most of the terms governing the operations and management of the limited partnership, which may be freely determined and negotiated between the limited partner and general partner, are laid out in the LPA. LPA is the constitutional document of the limited partnership negotiated and agreed by both parties and it governs the terms and conditions of the partnership, sets out the rights and obligations of the partners, and other specific terms agreed upon by the partners. LPA is also an agreement by and amongst the limited partners with each other.

There are certain basic economic terms of a fund which are applicable to all private equity funds, including (i) investor capital commitments, (ii) allocations and distributions of profits and losses of the fund, (iii) fees paid the investment advisers and (iv) fund expenses.

Capital structure

An investor becomes a participant in a fund by subscribing for a capital commitment, and the commitment, usually, is not funded at subscription or all at once, but in separate installments. The sponsor makes capital calls on an as-needed basis to make investments and pay fees and expenses.

Usually, investors would like to see that the sponsor has its own capital commitment to the fund to better align the interests of the sponsor with those of the investors so that they both share losses as well as profits.

The sponsor's ability to call for capital contributions from its investors is restricted to the extent of each investor's agreed amount of total commitment less contributions already made, which is also known as unfunded commitments.

Also, a private equity fund structured as a limited partnership and registered in Hong Kong should consider accepting investor commitments through a mixture of debts and equities. The fund can take the equity up front and take the debt in the form of loans in several drawdowns under this arrangement.

On registration as a limited partnership, a private equity fund will be liable to pay capital duty of 0.8% of capital contributed by each limited partner. But debt capital contributed by a limited partner is not liable to any capital duty.

Moreover, the LPO prohibits a limited partner from withdrawing his equity capital contribution; otherwise; he will be liable for the debts and obligations of the limited partnership up to the amount so withdrawn. The fund will have more flexibility to return capital before winding-up by requesting capital to be contributed in the form of debt.

Allocation and Distributions – Distribution Waterfall

The allocation provisions and the distribution waterfall are typically set out in the operating agreement of the fund, which requires the fund to track allocations and distributions through book entry capital accounts.

In setting out the economic arrangement between the sponsor and the investors, a distribution waterfall provides that the proceeds from investments are paid in order of priority.

Though tiers may be customized, generally, there are four tiers involved in a typical distribution waterfall schedule as follows:

Return of Capital Contributions

The first tranche of a private equity fund waterfall usually provides that all capital contributed on account of an investment must be returned to the investors who provided it before any other distributions. The distribution waterfall then typically provides a preferred return, often 7% to 9 % of a cumulative compounded rate of return. The purpose of such a preferred return is to guarantee investors a minimum return on their committed capital before sharing profits with the sponsor. The sponsor of a private equity fund then is entitled to a profits participation, known as carried interest, usually 20%, which is lower in priority to the return of capital contributions and the hurdle rate.

The general partner can choose to define many hurdle rates linked to a specific allocation. Higher hurdles are linked to allocations more favorable to the general partner. A higher hurdle rate typically means more carried interest to the general partner.

Distribution waterfall schedules are either European or American style. A European style means the stated schedule is applied at an aggregate fund level whereas an American style is applied on a deal-by-deal basis, and not at the fund level, which spreads the total risk over the deals and is more beneficial to the general partner.

"Clawback" clause

Operating agreements for private equity funds often provide for a "clawback" provisions regarding the sponsor 's carried interest. It is basically an adjustment payment that the sponsor must make to the fund at the end if its term when the fund's remaining assets must be liquidated. When liquidating the private equity fund, if the limited partners were distributed less than the agreed preferred return, they can claw back the missing amount from the carried interest distributed to the general partner. It is usually trigged at the very end of the fund.

Taxation

Hong Kong taxes profits arising in or derived from Hong Kong from a business carried on in Hong Kong. Therefore, both the fund and the private equity sponsor itself may be liable to profits tax. However, a fund may be exempted from profits tax if its central management and control is located outside of Hong Kong and it only enters into transactions in securities carried out through or arrange by a person licensed with the Securities and Futures Commission ("SFC") and transactions incidental thereto. Incidental transactions cannot account for more than 5% of the fund's total trading receipts. Also, the Hong Kong government clearly states that the tax exemption would apply to private companies as long as such companies do not hold any real estate in Hong Kong and do not carry out any business in Hong Kong.

The tax payable by each partner will depend on the applicable profits tax rate of each partner applied to the partner's share of the fund's profits and losses. Individual partners are taxed at 15% whereas corporate partners are taxed at 16.5%. There is no capital gains tax or withholding tax on dividends.

Fund Fees, Management Fees, and Fund Expenses

As mentioned before, a sponsor usually establishes an entity to act as the investment adviser or management company. This entity enters into an investment advisory agreement with the fund, or its general partner or manager; in return, the fund pays management fees to the investment advisers in exchange for the investment adviser's agreement.

The sponsor will receive a management fee for managing the fund, and the fee rate depends on the aggregate size of the fund and other factors.

It has historically been around 2% per annum of the aggregate amount of committed capital.

The fund expenses include expenses relating to establishing and organizing the fund, the operation of the fund, and the manager's expenses.

Licensing

This is one of the key issues regarding the formation of private equity fund in Hong Kong. Private equity sponsors with offices in Hong Kong may be subject to licensing requirements under the Securities and Futures Ordinance (the "SFO").

In recent years, many such sponsors choose to license their Hong Kong offices. Whether a private equity sponsor has to license its Hong Kong office or presence, if any, depends on whether it carries on a business in SFO regulated activities, including Type 1, Type 4 and Type 9 under Cap 571 of the SFO. The details of these activities in Hong Kong are specified as follows:

Type 1- Dealing in securities (證券交易)

Dealing in securities, in relation to a person, generally means making or offering to make an agreement with another person, or inducing or attempting to induce another person or to offer to enter into an agreement-

(a) for or with a view to acquiring, disposing of, subscribing for or underwriting securities; or

(b) the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities, if any, by the person.

Type 4 – Advising on securities (就證券提供意見)

Advising on securities means giving advice on whether, which, the time at which or the terms on which, securities should be acquired or disposed of. It also means issuing analyses or reports, for the purposes of facilitating the recipients of the analyses or reports to make decision on whether, which, the time at which or the terms or conditions on which, securities are to be acquired or disposed of.

Type 9 – Asset Management (資產管理)

Asset management means real estate investment scheme management or securities or futures contracts management.

If the sponsor is subject to licensing requirements in Hong Kong, the regulatory capital requirements as to paid-up capital and ongoing liquid capital are usually higher for Type 1 than for Type 4 and 9.

The general partner would not be subject to SFC licensing in its own right if it delegates the asset management function to a Type 9 licensed or registered asset management firm.

Under the Securities and Futures Ordinance, Hong Kong type 9 license will be required for the fund manager in respect of asset management. Type 1, Type 4 and/or Type 6 licenses may also be required if there are marketing/ dealing/ advisory activities in Hong Kong. In all cases, if the investors are potentially not professional investors, there may be additional concerns (e.g. prospectus registration and/or marketing restrictions). A PE fund with a typical fund structure usually has a licensed fund manager. If you do not want to have a fund manager to act as asset manager for the investors, you may, for instance, set up a holding or consortium company for investments, and the investors become shareholders of the company (so that there is no need for a licensed asset manager).

Capital raising

1. regulations

Hong Kong's securities laws set up parallel regimes governing the offer of investments under the Companies (Winding-up and Miscellaneous Provisions) Ordinance (the "CWMPO") and the SFO.

Both require marketing material for funds to be authorized by the SFC unless exempted. Both the CWMPO and SFO regimes exempt offers to professional investors, as defined under the SFO. A simplified list of professional investors[1] under the SFO is as follows:

Institutional professional investors	regulated financial firms (Examples: investment banks, commercial banks, asset management companies)
	regulated funds
	non-municipal government bodies
Non – institutional professional investors	high-net worth individuals (with a portfolio of cash, securities and certificates of deposit the value of which exceeds HK$8 million)
	substantial corporations and partnerships (with a portfolio of cash, securities and certificates of deposit the value of which exceeds HK$8 million; or total assets of more than HK$40 million)
	substantial trusts (with total trust assets of more than HK$40 million)

[1] Licensed persons generally must undergo onerous due diligence and client maintenance requirements prior to providing services to corporate professional investors; however, those requirements are partly exempted where the corporate professional investor can meet specific assessment criteria regarding their internal control measures, experience and risk tolerance under paragraph 15.3A(b) of the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission.

During the fundraising period, generally the fund should not communicate with the press regarding the fund or its offering and it should not to address any communication to a general audience. These kinds of communications may be regarded as general solicitations even if it is believed that all recipients are all qualified as professional investors under the SFO. In June 2014, a fund and its director were convicted on four charges of issuing advertisements to promote a collective investment scheme without the authorization of the SFC. The fund was fined $20,000 and the director was initially sentenced to four weeks' imprisonment suspended for 12 months. They were charged with issuing advertisements and promoting a collective investment scheme without first obtaining the SFC's authorization for the advertisements. They were also charged with issuing an advertisement regarding the launch of the fund to the public by email without the authorization of the SFC. While the Court of First Instance ruled that the exemption only applies where the advertisement states on its face that the terms of the offer are limited to professional investors, the Court of Final Appeal overturned the ruling on the basis that the exemption applies if the securities are or are intended to be disposed of only to professional investors. However, the exemption would not apply if a person published an unauthorized offer to the public and sold the advertised securities to a retail investor.

Marketing related communications should also include an appropriate legend on any written materials so as to make it clear whom the materials are directed to.

2. placement agents

Many private equity funds use a placement agent to market and sell interests in the fund. The agent introduces the sponsor to potential qualified investors under the SFO. A placement agent agreement sets out basic terms relating to the engagement, which includes the compensation of the agent, and the scope of the engagement. Such agents would generally be licensed under the SFO.

3. fund closings

A first closing of the fund occurs when the sponsor identifies investors who are willing to commit enough capital to the fund. After the first closing, subsequent closings may be held throughout the fundraising period, which often ends over a year after the first closing or until the fund has reached its fundraising cap. At each closing, investors submit their commitments by signing a subscription agreement and other agreements required to be executed.

Fund formation documentation

The documentation involved may include (using a Cayman limited partnership fund as example):

(i) drafting/reviewing the section 9 statement and resolutions,

(ii) drafting, reviewing and amending subscription agreement,

(iii) drafting, reviewing and amending investment management agreement,

(iv) drafting, reviewing and amending offering memorandum,

(v) drafting and amending the limited partnership agreement,

(vi) incorporation of the general partner and (if required) the Cayman information memorandum,

(vii) formation of the partnership and filing with the Cayman registrar,

(viii) reviewing the offering memorandum from a Cayman law perspective,

(ix) reviewing the subscription agreement from a Cayman law perspective,

(x) preparing or reviewing the general partner's directors' resolutions in connection with the launch of the fund from a Cayman law perspective,

(xi) reviewing and commenting investment management agreement from a Cayman law perspective,

(xii) attending to the subsequent filings in the Cayman Islands,

(xiii) preparing and submitting the declaration for exemption under Securities Investment Business Law of Cayman Islands; and

(xiv) preparing board resolutions for the investment manager.

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