

# How to Start a Hedge Fund in Hong Kong: A Legal Primer

*Hong Kong is a premier centre for hedge fund management in Asia, boasting easy access to North Asia deal flow, world-class infrastructure, an internationally regarded regulatory framework and a relatively benign tax environment. This article provides the portfolio manager with an overview of the key legal issues that are likely to arise when establishing and managing a hedge fund in Hong Kong, covering the choice of fund structure, business licensing requirements and capital raising.*

October 15, 2007 (corrigendum date:  
February 19, 2008)

---

TIMOTHY LOH  
*Financial Services & Law Review*  
Vol. 1 (2007)

---

**Timothy Loh,**  
Principal  
tloh@timothyloh.com  
Hong Kong: +852 2899.0179

**Gavin Cumming,**  
Registered Foreign Lawyer  
gcumming@timothyloh.com  
Hong Kong: +852 2899.0149

## Recent Articles

*Update: Lowering SFC Requirements to Manage a Hedge Fund* ..... 17  
**June 18, 2007**

*Take-Private Transactions: The Emergence of a New Approach?*..... 9  
**June 11, 2007**

**F**or the portfolio manager intent on establishing and managing a hedge fund in Asia, Hong Kong remains a leading choice. The reasons include:

- Hong Kong is the leading financial market for the Greater China Region. It has an open, developed and sophisticated foreign exchange, banking and securities infrastructure and serves as the Asian hub for many of the world's leading prime brokers, custodians and administrators.
- Hong Kong has an established legal system with a stable and business oriented government and an independent judiciary.
- Hong Kong offers a favourable low-tax environment which can accommodate tax

efficient structures for hedge funds and hedge fund managers.

- Hong Kong has a rigorous regulatory environment offering, for those who comply with its standards, international credibility. At the same time, Hong Kong provides flexibility for hedge fund managers to select from the full range of global options for fund structuring to facilitate fund raising and, except to protect market integrity, does not restrict hedge fund managers in the strategies they deploy in the management of institutional money.

This article provides guidance to the portfolio manager on establishing and managing a hedge fund from Hong Kong.

# Fund Structure

The target investor base often determines the basic structure of the fund, regardless of the location of the portfolio manager.

Each jurisdiction has its own securities, tax and other regulatory requirements. As a result, subject to costs, it is generally preferable at the outset to seek advice from legal counsel in each jurisdiction where the manager expects to raise significant capital to minimize the risk that the manager will be unable to market the fund as a result of legal prohibitions.

## Simple Fund

In a simple fund, there is a single fund vehicle which accepts invest-

ments from investors around the world. A common form of a simple fund is described in Illustration 1 below.

As there is only 1 fund vehicle, a simple fund generally has less flexibility to cater to different requirements of different investors. In particular, if the portfolio manager intends to target U.S. investors, a simple fund cannot cater simultaneously to U.S. taxable investors and U.S. tax exempt investors, such as pension funds.

### U.S. Taxable Investors

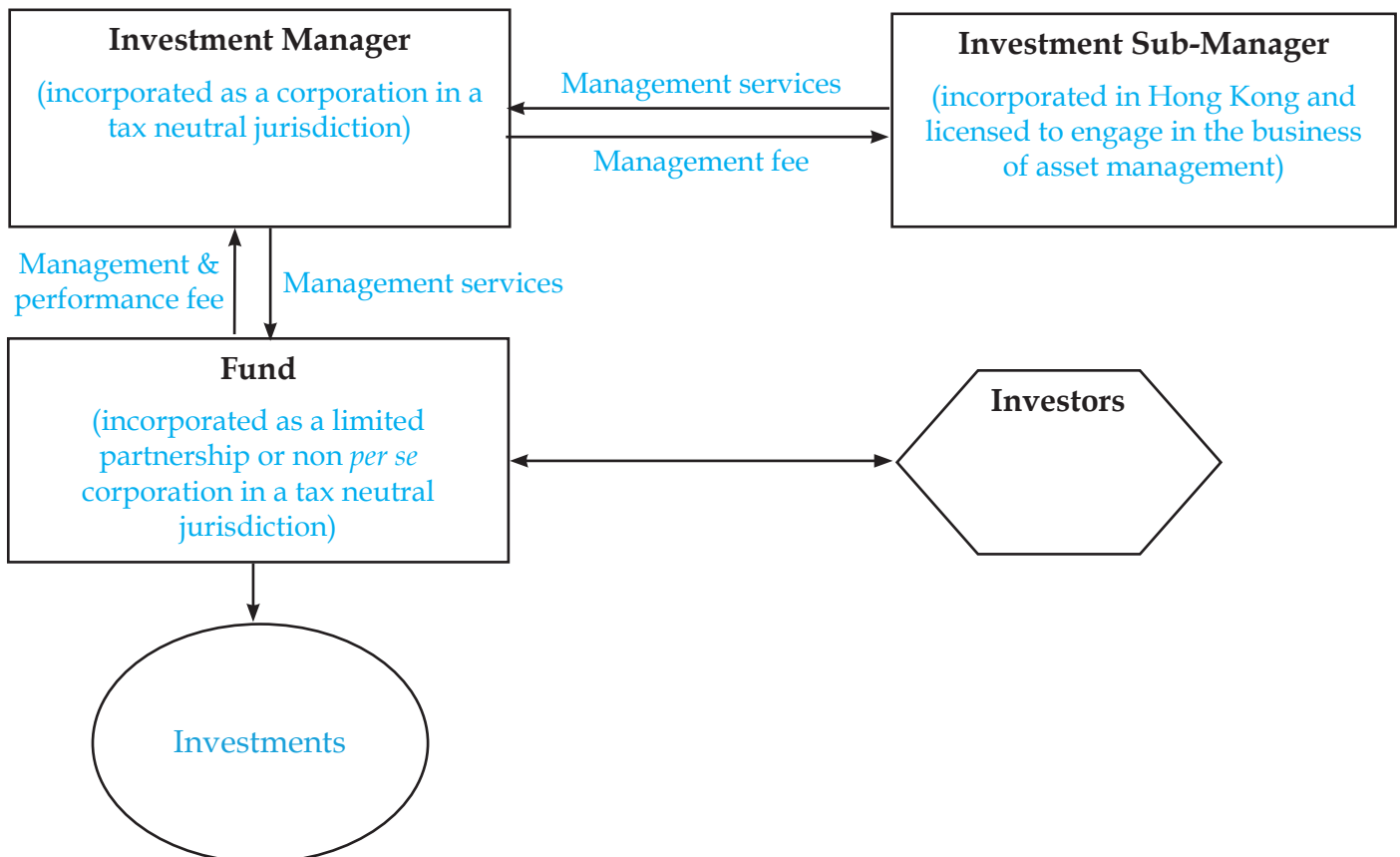
U.S. taxable investors investing in a hedge fund may be subject to onerous tax rules applicable to investments in a passive foreign

investment company (“PFIC”). These rules penalize the sheltering of passive investment income in a PFIC to defer tax. To avoid these rules, U.S. taxable investors prefer to invest in flow-through entities such as partnerships or corporations that make an election to be treated as a partnership for U.S. tax purposes.

### U.S. Tax Exempt Investors

U.S. tax exempt investors investing in flow-through entities on the other hand may be subject to tax on unrelated business taxable income (“UBTI”). UBTI may arise where the fund earns income using leverage. As a result, U.S. tax exempt investors prefer to avoid flow-through entities.

Illustration 1 - Simple Fund Managed from Hong Kong



## Master-Feeder Fund

A master-feeder fund is often the structure of choice where the manager expects to raise significant amounts of capital from both U.S. taxable and U.S. tax exempt investors in the United States and investors outside the United States (“**non-U.S. investors**”).

### Structure

While the precise structure of master-feeder funds will vary, in a classic master-feeder fund, there are 3 separate fund vehicles which comprise the hedge fund: (i) a U.S. feeder fund established as a limited partnership in the United States, (ii) a non-U.S. feeder fund established as a corporation in a tax neutral jurisdiction, and (iii) a master fund established in a

tax neutral jurisdiction either as a limited partnership or as a non *per se* corporation that elects to be treated as a partnership for U.S. tax purposes.

Under these arrangements, U.S. taxable investors invest in the U.S. feeder fund and non-U.S. investors and U.S. tax exempt investors, such as pension funds, invest in the non-U.S. feeder fund. Both the U.S. feeder fund and the non-U.S. feeder fund then invest all their assets into the master fund. A common form of the master-feeder fund is shown in Illustration 2 below.

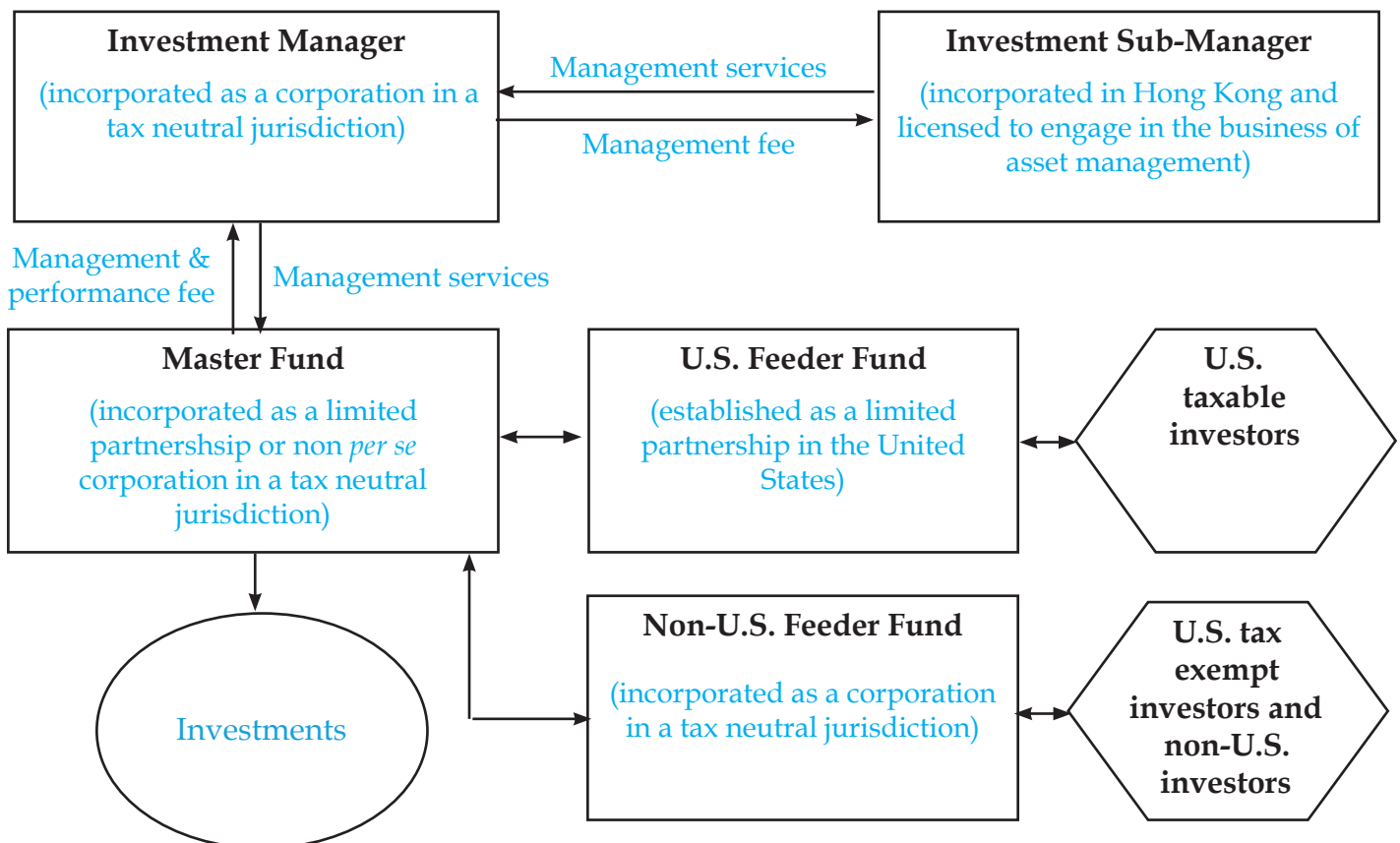
Whilst the appropriateness of a master-feeder structure will depend upon individual circumstances, the master-feeder can cater to both U.S. and non-U.S. investors.

### U.S. Taxable Investors

U.S. taxable investors who invest in the hedge fund through the U.S. feeder fund may be able to avoid the more onerous PFIC regime. Assuming the hedge fund does not itself invest in PFICs and provided that the U.S. feeder fund is a flow-through entity such as a limited partnership and the master fund is a limited partnership or a non *per se* corporation which has made an election to be treated as a partnership for U.S. tax purposes even though it is a corporation, U.S. taxable investors should only be subject to tax on their *pro rata* share of the earnings and capital gains of the hedge fund, whether or not distributed.

At the same time, U.S. tax exempt investors may invest in the hedge fund without being subject to tax

Illustration 2 - Master Feeder Fund Managed from Hong Kong



on UBTI even though the master fund is a limited partnership or a non *per se* corporation which has made an election to be treated as a partnership for U.S. tax purposes. As the non-U.S. feeder fund is a corporation and hence, is not a flow-through entity, the income which flows from the master fund to the non-U.S. feeder fund does not flow through down to the U.S. tax exempt investors and non-U.S. investors invested in the non-U.S. feeder fund.

### Parallel Fund

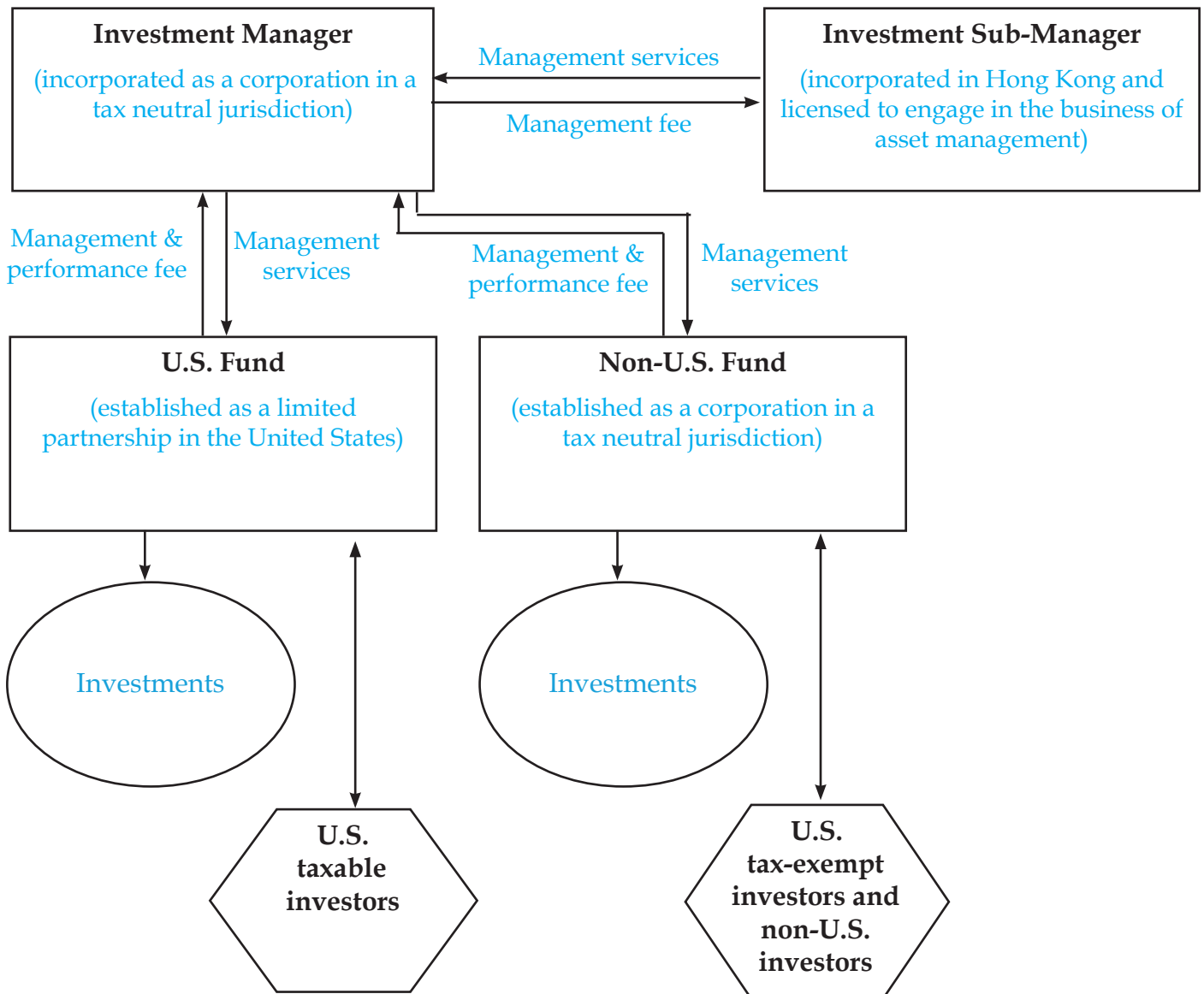
A parallel fund, also known as a side-by-side fund, comprises at least 2 fund vehicles, each catering to the requirements of different investors. For example, one fund vehicle may be designed for U.S. taxable investors and a different fund vehicle may be designed for U.S. tax exempt and non-U.S. investors.

In a parallel fund, each fund vehicle has its own portfolio but

the fund generally shares similar investment strategies across these vehicles.

The disadvantages of a parallel fund are that the assets under management are split amongst different portfolios, necessitating separate accounts for each fund with each service provider (e.g. each fund would need to appoint a prime broker and an administrator) and splitting of deal tickets between those accounts. As a result, additional expenses may be incurred.

**Illustration 3 - Sample Parallel Fund Managed from Hong Kong**



## Taxation

The portfolio manager will typically wish to minimize his or her own tax liabilities and, to facilitate capital raising, ensure that the fund's profits themselves are sheltered whenever possible from tax.

fees earned by it from the asset management company. The tax neutral jurisdiction is selected because it does not tax the investment management and performance fees earned by the investment manager.

### Structure

For portfolio managers based in Hong Kong, the traditional approach (as shown in the illustrations above) calls for the portfolio manager to establish an asset management company (the "investment manager") in a tax neutral jurisdiction and a sub-management company (the "sub-manager") based in Hong Kong. Under this arrangement:

- The investment manager delegates investment discretion to the sub-manager which in turn employs the portfolio manager to manage the fund.
- Investment management and performance fees accrue to the management company in the tax neutral jurisdiction. The investment manager pays the sub-manager a small fee which will cover the costs of the sub-manager plus a pre-determined markup.

### Taxation of the Manager

Provided certain limits established under the law are respected, this structure shelters the investment management and performance fees from taxation. Hong Kong only taxes the sub-manager on the

### Taxation of the Fund

In structuring management arrangements, it is important to ensure that the arrangements do not subject the fund itself to taxation in Hong Kong.

#### Exemption

In broad terms, a fund will be considered to be non-resident for Hong Kong tax purposes and thus, exempt from Hong Kong profits tax where the central management and control of a fund is exercised outside Hong Kong and transactions are executed through SFC regulated intermediaries in specified asset classes such as securities, futures and foreign exchange.

#### Effect of Hong Kong Base

The presence of a sub-manager in Hong Kong who makes investment decisions on behalf of the fund is unlikely by itself to result in the central management and control of the fund being exercised in Hong Kong.

Nevertheless, steps should be taken to ensure that the central management and control of the fund lies outside Hong Kong. These steps include appointing a majority of non-Hong Kong directors, holding board meetings outside of Hong Kong and ensuring that the board has a real function.

---

*In broad terms, a fund will be considered to be non-resident for Hong Kong tax purposes and thus, exempt from Hong Kong profits tax ...*

---



## Regulation of Manager

---

In the common fund structures described above, the sub-manager is based in Hong Kong and will be subject to the requirement under the Securities and Futures Ordinance (“SFO”) to obtain a license for Type 9 (asset management) regulated activity from the Securities and Futures Commission (“SFC”).

However, variations on these common structures may dictate requirements for Type 4 (advising on securities) or Type 5 (advising on futures contracts) licenses instead. These variations are sometimes attractive in that they may offer lower regulatory hurdles in Hong Kong.

### Overview of Licensing

The process of applying for a license from the SFC involves completing prescribed forms for the firm, be it a sub-manager or otherwise, and its individual representatives. This is because under the SFO, licensing requirements extend to both the firm and its individual representatives.

#### Firm

Generally, to license the firm, the SFC forms are supplemented with a business plan and compliance manual. These supplements set out the nature and scope of the business, operational work flow, organization structure and internal controls. They are intended to demonstrate to the SFC that the firm understands its business, that it has the experience and systems to manage the business and its attendant risks and that it will be able to comply with applicable regulatory requirements.

#### Internal Controls

In this regard, the SFC has historically scrutinized the firm’s risk management, compliance, valuation and conflict of interest policies and procedures with some vigour. However, the SFC has recently offered to streamline applications from firms (i) who are, or whose parents are, licensed or registered by the U.S. Securities and Exchange Commission or the U.K. Financial Services Authority, or (ii) who have, or whose parents have, proven track records.

#### Capital Requirements

Under the SFO, a firm licensed for asset management is normally required to have paid-up capital of HK\$5,000,000 and to maintain liquid capital of at least HK\$3,000,000. However, if the firm does not hold client assets, there are no paid-up capital requirements and liquid capital requirements can be reduced to as low as HK\$100,000.

#### Responsible Officers

The most important representatives for a firm will be the responsible officers. Every firm applying to be licensed must have 2 individuals who are approved by the SFC as responsible officers.

At least 1 of these individuals must fully satisfy the SFC that he or she has adequate local regulatory knowledge, industry knowledge, relevant experience and management experience.

Generally, the portfolio manager himself will be a responsible officer.

## Licensing Examination

To satisfy the requirement for local regulatory knowledge, the individual must pass a regulatory examination unless otherwise exempted. Individuals who are, or have previously been, licensed as a responsible officer are normally exempt from the regulatory examination.

Individuals who are, or have previously been, licensed as a responsible officer are normally exempt from the regulatory examination.

Furthermore, individuals may be exempted from the regulatory examination at the discretion of the SFC if:

- the individual is licensed or registered for investment management or advisory business in the U.S. or U.K. or has over 8 years of relevant experience in recognized markets;
- the firm for which the individual will act as responsible officer will only serve professional investors;
- the firm is able to confirm that regulatory and compliance support will be provided to the individual; and
- the individual takes a post-licensing refresher course on local regulations.

## Relevant Experience

To satisfy the requirement for relevant experience, the SFC generally requires a responsible officer to have at least 3 years of experience in the management of public funds (*i.e.* collective investment schemes sold to the public), proprietary trading, alternative investments or investment research.

## Alternative Licensing Approaches

In light of difficulties sometimes encountered in applying for a Type 9 license, a firm may consider avoiding a Type 9 license altogether. Whilst a license from the SFC is still required under these fund structures, the license will be for Type 4 or 5 regulated activity instead. These alternatives may be suitable, for example, for persons who do not have experience considered to be relevant by the SFC.

Broadly, there are 2 alternatives. In one alternative, investment discretion is exercised outside of Hong Kong by an investment manager. The portfolio manager himself remains in Hong Kong as an employee of an adviser to the investment manager. While the recommendations made by the adviser are in theory not binding, they are invariably followed.

In another alternative, investment discretion is exercised by the fund itself. The fund is advised by an investment adviser. The portfolio manager remains in Hong Kong both as an employee of the fund and a sub-adviser. The portfolio manager makes recommendations as an employee of the sub-adviser to the investment adviser and implements those recommendations as an employee of the fund.

## Marketing Arrangements

**I**n broad terms, securities laws of key capital raising jurisdictions generally restrict offers or invitations to the public to acquire shares or other interests in hedge

funds. Specific jurisdictions may establish further restrictions on top of these restrictions. For example, where capital is raised from U.S. pension funds, the assets may be subject to requirements of the Employment Retirement Income Security Act (“ERISA”). Unless appropriate legal measures are taken, the manager of a hedge fund which accepts ERISA assets may become subject to onerous duties under ERISA.

## Authorization

In Hong Kong, offers and invitations to the public to acquire shares or other interests in hedge funds are subject to regulatory authorization requirements unless exempted. Whilst the SFC has established a regulatory framework for the authorization of hedge funds, both in the interest of time and maximizing flexibility in capital raising, investor reporting and investment strategy, portfolio managers tend to prefer to avoid authorization by relying on exemptions. The most commonly used exemptions are set out below.

## Professional Investors

SFC authorization may not be required if the hedge fund is sold only to professional investors (“SFO professional investors”).

SFO professional investors include institutional investors and non-institutional investors. The former include bankers, dealers, insurance companies and certain regulated collective investment schemes. The latter include:

- High net worth individuals, meaning individuals with a portfolio of not less than HK\$8 million;
- Corporations whose sole business is to hold investments and which are wholly-owned by high net worth individuals (as defined above);
- Corporations or partnerships with a portfolio of not less than HK\$8 million or total assets of not less than HK\$40 million;
- Trust corporations registered under the Trustee Ordinance or regulated under the laws of a place outside Hong Kong having total assets under trust of not less than HK\$40 million.

## Sophisticated Investors

Marketing materials for a hedge fund structured as a company may be exempt from the authorization requirements if the shares are offered only to persons whose ordinary business is to buy or sell

shares or debentures, whether as principal or agent.

## Minimum Subscription

Marketing materials of a hedge fund structured as a company may be exempt from the authorization requirement if (i) the materials contain a prescribed warning statement, and (ii) the minimum denomination or the minimum consideration payable by any person for the shares to be subscribed is not less than HK\$500,000. ■

*TIMOTHY LOH, SOLICITORS serves as Hong Kong and International Legal Counsel to financial institutions. Since its establishment in 2004, its clients have included 10 financial institutions ranked in the FT Global 200 and it has been recommended each year by the Asia Pacific Legal 500 for its financial services and regulatory practice.*

© Copyright 2007 Timothy Loh. All rights reserved.

*This article provides general guidance only and should not be relied upon as legal advice. You should seek legal advice specific to your individual circumstances. Timothy Loh disclaims liability to any person relying upon this article as legal advice.*

*To add or remove your name from the distribution list for articles from this firm or to obtain a reprint or soft copies, please send an email to [publications@timothyloh.com](mailto:publications@timothyloh.com).*