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Hong Kong

ALTERNATIVE INVESTMENT FUNDS

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This country-specific Q&A provides an overview of alternative investment funds laws and regulations applicable in Hong Kong.

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HONG KONG
ALTERNATIVE INVESTMENT FUNDS

1. What are the principal legal structures used for Alternative Investment Funds?

Alternative Investment Funds ("AIFs") may be established in Hong Kong in the form of unit trusts, open-ended fund companies ("OFCs") or limited partnership funds ("LPFs").

As there are no requirements for AIFs offered in Hong Kong to be established locally, they are often set up in the form of LPFs in Hong Kong or exempted companies with limited liability or limited partnerships established in the Cayman Islands.

2. Does a structure provide limited liability to the investors? If so, how is this achieved?

Generally, all structures provide limited liability to the investors. The liability of investors of corporate-structured funds are limited to the share capital of their investments and investors of partnership-structured funds are limited to their agreed commitments.

3. Is there a market preference and/or most preferred structure? Does it depend on asset class or investment strategy?

LPFs in Hong Kong and limited partnerships established in the Cayman Islands are generally preferred for closed-end private equity funds. Exempted companies with limited liability incorporated in the Cayman Islands are generally preferred for open-ended hedge funds.

4. Does the regulatory regime distinguish between open-ended and closed-ended Alternative Investment Funds (or otherwise differentiate between different types of funds or strategies (e.g. private equity vs. hedge)) and, if so, how?

In Hong Kong, the legislative regime does not distinguish open-ended or closed-ended AIFs, or otherwise differentiate between different types of funds or strategies. AIFs generally fall within the scope of "collective investment schemes", which are defined as "securities" under the Securities and Futures Ordinance (Cap. 571) ("SFO"), and the management and distribution of "collective investment schemes" are bound by the SFO.

5. Are there any limits on the manager's ability to restrict redemptions? What factors determine the degree of liquidity that a manager offers investor of an Alternative Investment Fund?

For an open-ended AIF, the manager's ability to restrict redemptions would be subject to the fund's constitutive documents and the investment management agreement between the manager and the fund, as well as relevant regulatory codes applicable to the manager. If the manager is a licensed fund manager in Hong Kong, it will be required to comply with the Securities and Futures Commission's ("SFC's") Fund Manager Code of Conduct ("FMCC"). The FMCC requires a manager in managing a fund to consider the appropriateness of liquidity management tools, taking into account the nature of assets held by the fund and its investor base, and that disclosure should be made to all investors in relation to any preferential redemption terms that the fund has granted to its investors.

For AIFs established in Hong Kong such as LPFs or OFCs, there are no statutory requirements on redemptions or liquidity.

Typically, the factors which determine the liquidity tools that a fund should consider would include, without limitation, the nature of investments to be made by the fund (whether they are liquid or illiquid), the likely volume of redemption requests (which risks the liquidity or solvency of the fund) caused by economic downturns, natural disasters, corporate action (e.g. mergers or re-organisations), the departure of key personnel and the number and type of investors.

6. What are potential tools that a manager may use to manage illiquidity risks regarding the portfolio of its Alternative Investment Fund?

There are no legal or regulatory requirements in Hong Kong regarding the tools that a manager may use to manage illiquidity risks in an AIF.

However, typically, tools such as redemption notice periods, early redemption charge, redemption gates, temporary suspension of redemptions, redemptions in-specie and side pockets may be adopted by a fund. Where a side pocket is created, the FMCC requires that managers that are responsible for the overall operation of a fund to disclose certain side pocket terms to fund investors.

7. Are there any restrictions on transfers of investors' interests?

For AIFs established in Hong Kong as LPFs or OCFs, there are no statutory restrictions on the transfer of interests in funds.

However, typically, fund sponsors will contractually impose restrictions on the transfer of fund interests in the constitutive documents of the fund, for example, requiring the transferor and the transferee of interests to satisfy certain legal and compliance requirements and background checks before the fund sponsor granting consent to the transfer.

8. Are there any other limitations on a manager's ability to manage its funds (e.g., diversification requirements)?

Managers of private AIFs are generally restricted to the extent of the limitations in the management agreement, which should clearly outline the investment objectives, strategies, policies and scope, including the different types of investments or products, investment restrictions, diversification requirements, borrowing limits and hedging arrangements. Additionally, as required by the FMCC, fund managers in Hong Kong need to ensure that transactions carried out on behalf of each fund are in accordance with the funds' stated objectives, investment restrictions and guidelines

In addition, the FMCC has been amended in 2022 to require fund managers to take into consideration climate-related risks in their investment and risk management processes.

9. What is the local tax treatment of (a) resident, (b) non-resident, and (c) pension fund investors (or any other common investor type) in Alternative Investment Funds? Does the tax treatment of the target investment dictate the structure of the Alternative Investment Fund?

For individuals, regardless of whether the person is a resident or non-resident, personal investment income and capital gains are generally not subject to tax in Hong Kong unless such income or gain is part of that individual's trade, profession or business.

For corporate investors, regardless of whether the person is a resident or non-resident, profits tax may be payable if the investor carries on a trade, profession or business, and derives profit from such activities, in Hong Kong.

Private AIFs, regardless of domicile, that carry on business in Hong Kong and derives profit from that business in Hong Kong will be subject to profits tax in Hong Kong, but may be exempted under the Unified Funds Exemption if certain requirements are met. The Unified Funds Exemption applies to income arising from "qualifying transactions" and transactions incidental to the carrying out of "qualifying transactions" of up to 5 percent of a fund's total trading receipts. "Qualifying transactions" are investments in specified asset classes, including securities, futures contracts, foreign exchange contracts, bank deposits, exchange-traded commodities, foreign currencies and OTC derivative products.

Investors' preference or tax status and treatment under foreign tax laws may dictate the structure of an AIF. For example, due to US laws and regulations, certain US investors prefer investing through "pass-through" entities (e.g. limited partnerships) while others prefer investing through "blocker" entities (e.g. corporates).

10. What rights do investors typically have with respect to the management or operations of the Alternative Investment Fund?

Typically, investors have the right to participate in the income and profits arising from the AIF; but do not have any rights over the management or operations of the AIF. Subject to the constitutive documents, investors may also have rights to remove the manager or general partner of a fund, but in certain limited circumstances, such as in the event of a material breach of its obligations.

11. Where customization of Alternative Investment Funds is required by investors, what types of legal structures are most commonly used?

If, for whatever reason, a separate vehicle is required to be established to cater for a particular or a particular group of investors' needs, such separate vehicle will usually be structured in the form of a feeder vehicle, a parallel vehicle or an alternative investment vehicle, which can be structured in the form of a separate corporate entity, unit trust or limited partnership depending on the circumstances (such as tax, regulatory, etc).

12. Are managers or advisers to Alternative Investment Funds required to be licensed, authorised or regulated by a regulatory body?

Managers and advisers are required to be licensed by the SFC if they carry on a business, or hold themselves out as carrying on a business, in a regulated activity in Hong Kong. Managers with full discretionary investment authority will typically be required to be licensed for Type 9 regulated activity (asset management), while advisers without discretionary investment authority will typically be required to be licensed for "Type 4 regulated activity (advising on securities).

Additionally, in a circular issued by the SFC on 7 January 2020, the SFC clarified that general partners of private equity funds are generally required to be licensed for Type 9 regulated activity, unless they have fully delegated asset management functions to a Type 9 licensed entity. The SFC further clarified that that offers of co-investment opportunities by private equity firms will likely fall within the scope of "dealing in securities", thereby requiring private equity firms to also be licensed for Type 1 regulated activity.

13. Are Alternative Investment Funds themselves required to be licensed, authorised or regulated by a regulatory body?

Private AIFs are typically offered to professional investors in Hong Kong, or in other manner as exempted from authorisation by the SFC under law (for example, in relation to a corporate AIF, to employees and no more than 50 persons, etc.).

However, in the unlikely event that an AIF is to be marketed or offered to retail investors in Hong Kong or otherwise not within an applicable exemption, the AIF or its marketing materials will be required to be authorized by the SFC in accordance with the requirements set out in the SFC's Code on Unit Trusts and Mutual Funds ("UT Code") or the Code on Open-Ended Fund Companies ("OFC Code"), which may or may not be possible depending on the investment strategy, its service providers and other factors.

14. Does the Alternative Investment Fund require a manager or advisor to be domiciled in the same jurisdiction as the Alternative Investment Fund itself?

For AIFs established in Hong Kong: (i) in relation to LPFs there is such a requirement – the investment manager must be a Hong Kong resident who is at least 18 years old, a Hong Kong company or a foreign company registered as a non-Hong Kong company under the Companies Ordinance (Cap. 622); and (ii) in relation to OFCs, there is a requirement to appoint a Hong Kong manager that is licensed to conduct Type 9 regulated activity (asset management).

15. Are there local residence or other local qualification or substance requirements for the Alternative Investment Fund and/or the manager and/or the advisor to the fund?

For AIFs established in Hong Kong, a local presence is usually required, which may be in the form of a local company, registered office or authorized person.

Managers that operate in Hong Kong are also required to be established in the form of a local company (or, if a foreign company, registered as a branch in Hong Kong) and licensed by the SFC.

16. What service providers are required by applicable law and regulation?

With respect to private AIFs: (i) OFCs are required to appoint an investment manager, a custodian and an independent auditor; (ii) unit trusts are required to appoint a trustee and a management company; and (iii) LPFs are required to appoint an investment manager and an independent auditor; custodians are not mandatory as long as the general partner is able to ensure that there are proper custodial arrangements for the assets of the LPF.

Additional requirements may be required for retail AIFs.

17. Are local resident directors / trustees required?

For private AIFs established in Hong Kong: (i) directors of OFCs do not need to be Hong Kong residents but local process agents must be appointed; (ii) the trustees of unit trusts do not need to be local; and (iii) for LPFs, its general partner needs to be a natural person at least 18 years old, a Hong Kong private limited company, a registered non-Hong Kong company, another LPF or a limited partnership established outside of Hong Kong (but for the latter two categories, a local authorized representative is required).

Additional requirements may be required for retail AIFs.

18. What rules apply to foreign managers or advisers wishing to manage, advise, or otherwise operate funds domiciled in your jurisdiction?

Regardless of whether they are based in Hong Kong or abroad: (i) managers and advisers of all funds domiciled in Hong Kong are bound by the SFO; (ii) managers and advisers of authorized retail unit trusts domiciled in Hong Kong are bound by the UT Code; (iii) managers and trustees of REITs domiciled in Hong Kong are bound by the REIT Code; and (iv) managers of OFCs are bound by the OFC Code.

If foreign managers or advisers are conducting a regulated activity in Hong Kong (see question 12 above), or actively marketing a fund to the public of Hong Kong (see question 27 below), they will be bound by the SFO and likely to be required to be licensed by the SFC. Licensed persons are required to comply with the Code of Conduct for Persons Licensed by or Registered with the SFC ("Code of Conduct") and, in the case of a manager, the FMCC.

19. What are common enforcement risks that managers face with respect to the management of their Alternative Investment Funds?

The SFC is the regulator in Hong Kong which exercises enforcement powers under the SFO. Each year the SFC conducts random audits of licensed entities to ensure its compliance with the SFO and the relevant codes issued by the SFC, including the Code of Conduct. In its 2022-2023 annual report, it was noted that the SFC had conducted 226 on-site inspections during the year and had issued 161 compliance advice letter to address areas of regulator concern, raise standards of conduct and promote compliance. If serious breaches are found, the SFC will also take disciplinary actions, which range from monetary fines, criminal proceedings, disqualification orders and bans from re-entering the industry. In 2022-2023, the SFC had taken disciplinary action against 18 persons and 13 corporations on issues including AML-related breaches, deficient selling practices, regulatory breaches of short selling, insider dealing, market misconduct and internal control deficiencies.

20. What is the typical level of management fee paid? Does it vary by asset type?

Management fee is typically between 1.0% and 2.0% and does range by asset type (e.g. fund-of-funds and funds investing in real estate will be at the lower end). Other varying factors include investment strategy (e.g. fund of funds will also be at the lower end) and the fund size.

21. Is a performance fee typical? If so, does it commonly include a "high water mark", "hurdle", "water-fall" or other condition? If so, please explain.

Yes, typically, the performance-related bonus is around 20%. For hedge funds, performance fees commonly include a "high water mark", which entitles the manager to receive the performance bonus only if the fund exceeds the highest NAV it previously achieved. Some hedge funds may also be subject to a "hurdle rate", i.e. performance fee is payable only if the "hurdle rate" (usually around 6-8%), with reference to the fund's annual rate of return, is exceeded.

In relation to PE funds, proceeds are typically distributed in a "waterfall". Generally speaking, the first level of a waterfall involves a return of the investors' capital contributions, the second level is distributed to investors until they receive the "preferred return" (usually also around 6-8%) on their investment, the third level is distributed to the sponsor until it receives the full amount of its performance bonus on the investor's "preferred return" (i.e. a "catch-up"), and the last level is split of the profit between the sponsor and the investors.

22. Are fee discounts / fee rebates or other economic benefits for initial investors typical in raising assets for new fund launches?

This is a commercial decision between the fund and the investor. Early bird investments may be eligible for better fee discount/rebate and other economic benefits (especially if these investors are considered to be seed investors), but this would depend on the fund raising activity at the time.

23. Are management fee "break-points" offered based on investment size?

This is a commercial decision between the fund and the investor. Investment size is certainly a consideration. Reduced management fee may be also given on the profile of the investor (e.g. strategic alliances) and to early-bird investors.

24. Are first loss programs used as a source of capital (i.e., a managed account into which the manager contributes approximately 10-20% of the account balance and the remainder is furnished by the investor)?

This is sometimes used in hedge funds. Often, an affiliate of the manager will contribute capital as an investor in a separate share class or in side letters. However, whilst the manager's invested class will absorb the fund's losses first, the return of the investors' invested class is also usually capped.

25. What is the typical terms of a seeding / acceleration program?

Typically, investors in seeding and acceleration programs will offer a budget (e.g. interest-free loan) to small or new managers to finance their working capital needs in return for certain equity ownership. These investors will be given investor protection rights and may also be offered additional rights to participate in the management or material decision-making of the managers. The program usually runs for at least 3-5 years. At certain intervals during the program and/or at the end of the program, investors will have the option to withdraw their equity ownership (or alternatively, there is an option to call back the stake from these investors) and/or have capacity rights to make additional investments.

26. What industry trends have recently developed regarding management fees and incentive/performance fees or carried interest? In particular, are there industry norms between primary funds and secondary funds?

Recently, we have seen downward pressure on management fees from the typical 2%. In some cases, coupled with lower management fees, we have also seen a rise in "super carry", which is a higher performance fee or carried interest paid (up to 30% or more) if the return of the fund exceeds certain benchmarks.

27. What restrictions are there on marketing Alternative Investment Funds?

Marketing of AIFs falls within the scope of Type 1 regulated activity (dealing in securities) under the SFO, hence any entity engaged in Hong Kong to conduct marketing activities must hold a Type 1 licence issued by the SFC, unless otherwise exempt. If the marketing activities are conducted from outside of Hong Kong, a licence would be required if a person "actively markets" to the public of Hong Kong. A Type 9 licence holder is however exempt from obtaining a Type 1 licence for marketing a fund that it manages.

Separately, fund marketing materials may also need to be authorized by the SFC, unless an exemption applies. As is typically the case for AIFs, offering to professional investors in Hong Kong is one such exemption and, if the fund is able to operate within this exemption, authorization from the SFC is not normally required. See question 31 below for other exemptions.

28. Is the concept of "pre-marketing" (or equivalent) recognised in your jurisdiction? If so, how has it been defined (by law and/or practice)?

"Pre-marketing" is not defined or recognised as a concept under Hong Kong law. However, for unlicensed persons or entities, to err on the side of caution, such marketing efforts should be based on general branding or investment strategies only, and not reference any specific "securities" or the services that will be provided.

29. Can Alternative Investment Funds be marketed to retail investors?

Yes, if is the AIFs and the marketing materials are authorized by the SFC, which is unusual.

30. Does your jurisdiction have a particular form of Alternative Investment Fund be that can be marketed to retail investors (e.g. a Long-Term Investment Fund or Non-UCITS Retail Scheme)?

In Hong Kong, AIFs must be in the form of a unit trust or mutual fund in order for the SFC to authorise such AIFs and approve the marketing materials for distribution to retail investors.

31. What are the minimum investor qualification requirements for an Alternative Investment Fund? Does this vary by asset class (e.g. hedge vs. private equity)?

Generally, private AIFs are distributed in Hong Kong on the basis that they are exempted from authorization from the SFC or otherwise distributed in a way not to any class of the public in Hong Kong. The exemptions that are commonly relied upon (which depends on the legal structure of the AIF, and does not vary by asset class) include:

- offerings to "professional investors" only, which is defined in the SFO to include recognized exchange companies and clearing houses, regulated investment business professionals, regulated banks, regulated insurers, authorized collective investment schemes, pension schemes, governments (other than municipal government authorities), central banks and multilateral agencies, substantial trusts meeting a HK$40 million minimum asset requirement and high net worth individuals or businesses meeting a HK$8 million minimum investment portfolio or a HK$40 million minimum asset requirement;
- in relation to a corporate AIF, offerings to 50 persons or less, whereby two or more offers in relation to the same class of shares or debentures may be taken as one if (i) the offers were made by the same person and (ii) the offers were made within a 12-month period;
- in relation to a corporate AIF, offerings of which the total consideration payable does not exceed HK$500,000; and
- in relation to a corporate AIF, small offerings, of which the maximum subscription amount must be less than HK$500,000 or that the total maximum offering must be less than HK$5 million.

32. Are there additional restrictions on marketing to government entities or similar investors (e.g. sovereign wealth funds) or pension funds or insurance company investors?

Governments and institutions that perform functions of a central bank, sovereign wealth funds, mandatory provident funds, occupational retirement schemes and insurers would typically fall within the definition of "professional investor" under the SFO. There are no additional restrictions on marketing to such entities but, unless an exemption applies, marketing should be carried out by an SFC licensed person.

33. Are there any restrictions on the use of intermediaries to assist in the fundraising process?

There are no restrictions on the use of intermediaries to assist in the fundraising process but the intermediary should be licensed to conduct Type 1 regulated activity if it intends to conduct the activities in Hong Kong or if it intends to "actively market" to the public of Hong Kong (see question 27 above).

34. Is the use of "side letters" restricted?

Generally, no.

35. Are there any disclosure requirements with respect to side letters?

It is good practice to disclose in the fund's offering documents that side letters may be entered into which may result in preferential treatment for certain investors over others. The SFC also encourages disclosure of material terms to all existing and potential investors and the fact that side letters (where applicable) have been entered into with certain investors.

The FMCC also states that where a fund manager has granted preferential treatment (e.g. terms in a side letter) to certain investors (particularly in relation to preferential redemption provisions), it should disclose such fact and the material terms to all relevant potential and existing fund investors.

36. What are the most common side letter terms? What industry trends have recently developed regarding side letter terms?

The most common side letter terms we have seen include:

- fee-reduction provisions;
- information rights;
- modified confidentiality provisions for fund-of-funds investors;
- Most Favoured Nation provisions;
- preferential redemption rights (for hedge funds);
- excuse rights (for PE funds); and
- transfer rights.

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