

Hong Kong's LPF Regime Assures its Competitiveness as a Private Equity Hub



Hong Kong's new Limited Partnership Fund (LPF) regime is a move to shore up its position as the second-biggest private equity (PE) hub in Asia.¹ But will the new structure live up to its billing?

Hong Kong's much-awaited LPF regime came into effect on August 31, 2020. This will operate separately from the Limited Partnership Ordinance (LPO), which lacked the flexibility modern asset managers needed — and restricted competitiveness with other financial centers.

The government's aim is to cement Hong Kong's position as a go-to international center for PE firms, by providing a regime better-suited to the industry's specific needs. As the newly-formed Greater Bay Area (GBA) of Guangdong-Hong Kong-Macau offers myriad private investment opportunities, and the Cayman Islands face ongoing compliance pressures, it is an opportune moment for LPF to support Hong Kong's ambitions.

¹ As at end of 2019. https://www.legco.gov.hk/yr19-20/english/bills/brief/b202003201_brf.pdf

Addressing shortfalls of an outdated regime

Before the introduction of LPF, funds domiciled in Hong Kong could opt for either a unit trust or open-ended fund company (OFC) structure, which are commonly used by public mutual funds or hedge funds.

Meanwhile PE funds, which favour limited partnership structures, had to work within the legacy LPO regime, a structure that was not originally intended for fund setup, and of limited use as a PE vehicle.

The LPF is critical for enabling PE firms to attract institutional capital, as it addresses important gaps in the LPO structure.

Contrary to the LPO, the partners of an LPF have contractual freedom with respect to the operation of the fund. Importantly, withdrawal of capital contributions and distribution of profits are permitted if the fund remains solvent following such action.

An LPF also creates the possibility of unifying an investment fund's domicile, operations and management team in a sole jurisdiction, which avoids the complexity and expense of appointing additional layers of service providers.

In addition, a fund can register as an LPF with just proprietary capital, giving the general partner (GP) and/or fund managers a two-year period post registration to raise external money.

Another important feature of the LPF is its legal status. As a fund, the LPF is not in itself a legal person, but a registration scheme. The limited partnership agreement (LPA) means each limited partner's liability is limited to their contractual obligation to contribute, unlike the general partner, who has unlimited liability in respect of all debts and obligations of the LPF.

This flexible framework is likely to appeal to a broader spectrum of investment managers, beyond just private equity, including venture capital, buy-out, real estate, and infrastructure, as well as distressed asset and credit funds.

Key features of the LPF



An LPF is not a legal person in itself, it is a registration scheme



At least one general partner, with unlimited legal liability, and one limited partner



Constituted by a written Limited Partnership Agreement



An investment manager (IM) that is a Hong Kong resident or company can be the GP



Must appoint an authorized anti-money laundering/counter-terrorist financing (AML/CTF) person



Must appoint an independent auditor, but not necessarily a custodian, provided there is a proper custody arrangement



A registered office in Hong Kong

Tax incentives could prove decisive

The Hong Kong government plans to introduce new tax incentives to compete with offshore financial centers. For example, no stamp duty is payable when a limited partner contributes to the LPF, transfers its interest or withdraws from the LPF, as long as it meets the definition of a 'fund'.

An issue that must still be resolved, however, is whether carried interest can be treated as a capital gain for tax purposes. Hong Kong does not currently tax capital gains, but performance fees or carried interest allocated to fund managers are treated as profit, which is taxable.

The Hong Kong administration announced in its latest budget speech for 2020/2021² that it plans to provide tax concessions for carried interest in the near future. This is a key incentive for PE managers, and will be important in ensuring LPF's competitiveness with the Cayman Islands' Exempted Limited Partnership Law. If introduced, any tax concession would have retrospective effect as from April 1, 2020, according to the budget.

Prevailing in a competitive landscape

Hong Kong's willingness to provide tax concessions favoured by closed-end fund structures like private equity and venture capital may create an advantage within the region. Some international fund schemes, such as the nascent Asia Region Funds Passport (ARFP) and the older ASEAN Collective Investment Scheme (CIS) have labored under cross-border tax issues that have curtailed take-up rates.

These schemes are predominantly aimed at the long-only mutual fund industry that caters to retail investors, which are covered by the existing OFC structure, allowing the LPF to broaden Hong Kong's appeal as an international financial center to ultra- and high net worth-clients, especially from Mainland China.

Another potential tailwind for Hong Kong is that it is relaxing rules just as other centers face closer scrutiny. The Private Funds Law, 2020 came into force in the Cayman Islands in February, requiring most Cayman-incorporated managers to comply with economic substance requirements — and subjecting them to more stringent regulatory oversight. Further, the rising reputational risk associated with offshore jurisdictions may also lessen their appeal for some international PE funds.

Against this backdrop, Hong Kong — armed with its new LPF regime — will be an attractive prospect as an onshore alternative. Adding the potential tax incentives may prove a winning combination.

The early signs look promising. Applications for the LPF regime started as soon as it was launched, with interest from mainland managers and investors, as well as family offices.

² <https://www.budget.gov.hk/2020/eng/speech.html>

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