

# Structuring a Private Investment Fund and the Latest Development

**Penelope Shen and Maggie Kwok**

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## YOUR Speaker

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Penelope Shen specializes in the establishment and structuring of private investment funds, with a particular emphasis on hedge funds and private equity funds.

She also has in-depth legal experience advising on classified funds, QFII and RQFII funds. Indeed her extensive practice experience in providing legal leadership advice to such clients also extends to advising on legal issues concerning marketing, on-going regulatory, compliance, side letters, ISDA and prime brokerage agreements. As a matter of course, she has advised some of the largest asset managers in Hong Kong, China, Singapore and other jurisdictions on funds formation and restructuring, and on private placement regulation in Hong Kong.

Further, Penelope carries substantial experience from working with top-tier law firms, both onshore and offshore, which has equipped her with first class knowledge in her chosen field.

### Recent Transactions

- Acted for a Chinese asset manager in Hong Kong to establish a classified fund with tiered return arrangement
- Acted for a limited partner to negotiate a limited partnership agreement to invest in a an offshore private equity fund
- Acted for the Hong Kong subsidiary of a PRC trust company to establish various private equity property funds and a fund of funds
- Acted for a Chinese bank in a take-private private equity transaction
- Acted for a Hong Kong fund manager to establish an open-ended fund and assisted with a debt securitization transaction



## THE FIRM

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KYC's root can be traced back more than 20 years ago, to 1994 when the corporate boutique Kwok & Yih was launched and was then widely regarded as a credible alternative to major and international firms in corporate and securities work.

We are a fast growing firm based in Hong Kong with global and regional experience where we combine our legal skills with commercial acumen, bringing desirable results to our clients. We aim to build a champion firm among domestic and international firms in Hong Kong. Partners and lawyers from our different practice groups - Corporate & Securities; Investment Funds; Disputes, Insolvency & Regulatory - are highly regarded in the market and have hands-on experience in a wide range of complex and ground breaking deals.

With a cohesive team of partners and lawyers, we work together seamlessly and intensely focusing on clients' issues that matter.

Our partners have remarkable records in public services and are sitting on various governmental, statutory and other organisations, including the Listing Committee of the Hong Kong Stock Exchange, the Takeovers and Mergers Panel of the Securities and Futures Commission, the Committee on Real Estate Investment Trusts of the Securities and Futures Commission, the Mandatory Provident Fund Schemes Advisory Committee, and various disciplinary tribunals and panels.



## MAGGIE KWOK, Counsel

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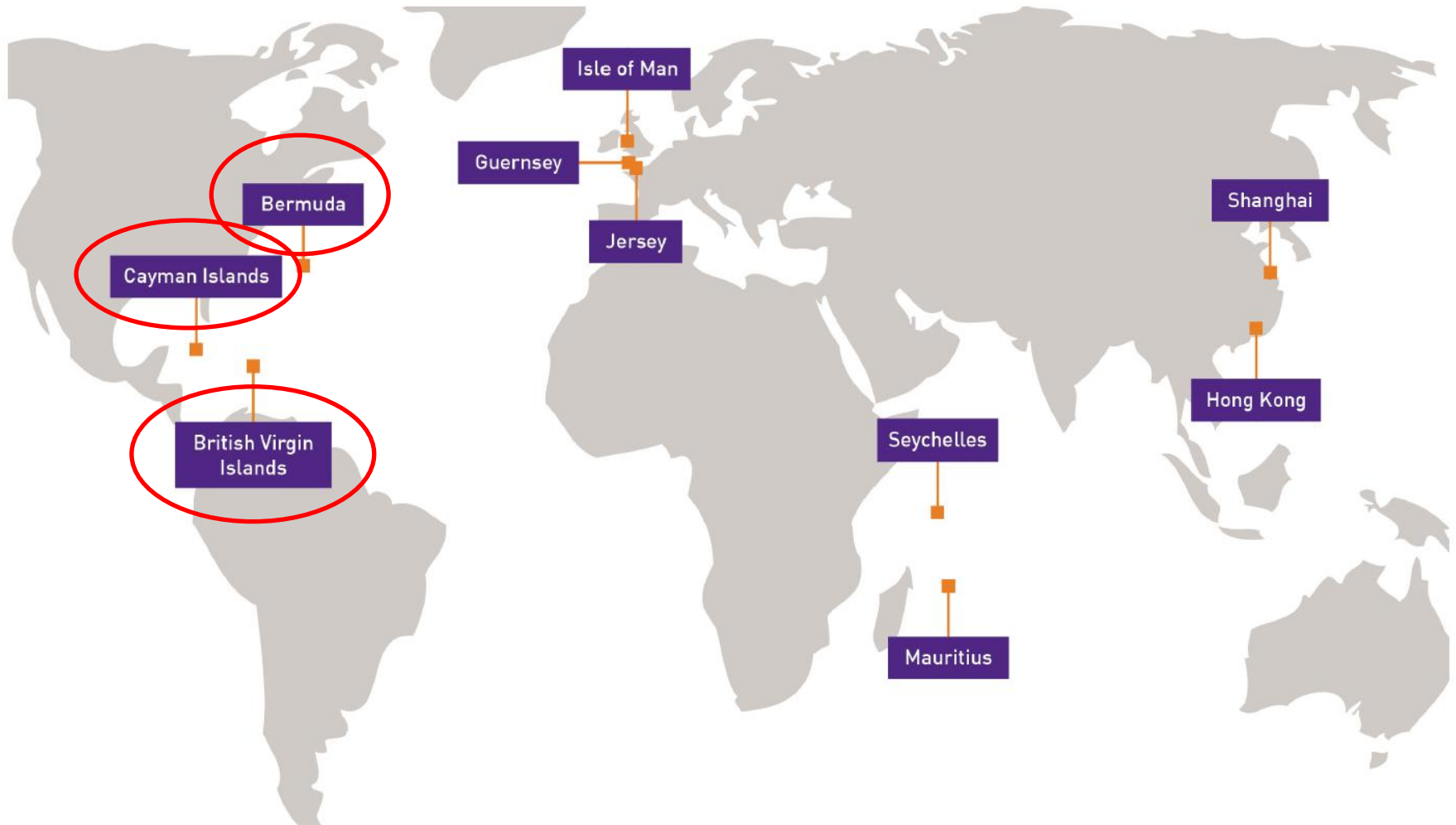
### PROFILE

Maggie Kwok is a Counsel in the Hong Kong office and a member of the Corporate department. She has extensive offshore experience with a particular focus on investment funds. She specialises in the formation, structuring and maintenance of various types of open ended and close ended funds including hedge funds and private equity funds. She works extensively with private equity and hedge fund managers, banks, fund administrators, custodians and investors.

Maggie also has substantial experience in securities transactions, including corporate finance matters, listings, mergers and acquisitions, and corporate restructurings involving parties of multi-jurisdictional backgrounds.

Maggie is recognised in *Asialaw Leading Lawyers*.

## APPLEBY FOOTPRINT



# Introduction

- ▶ What is an investment fund?
- ▶ Why offshore?
- ▶ What is the best structure and how to establish it?
- ▶ Managing an investment fund and how to offer it in Hong Kong?



# What is an Investment Fund?



# Investment Fund - Collective Investment Scheme (CIS)

1) Arrangement  
in respect of  
“property”

2) No day-to-  
day control  
over  
management  
(even if they  
can be  
consulted or  
can give  
directions)

3) Property  
managed as a  
whole;  
contributions,  
profits/income  
are pooled

4) Purpose is to  
receive profits,  
income or  
other returns

## ▲ ELEMENTS OF A CIS (Hong Kong Securities of Futures Ordinance)

- ▶ *\*Property is widely defined and could include, for example, money, goods, choses in action and real estate, whether located in Hong Kong or elsewhere.*





## In other jurisdictions?

**Cayman Islands** - “mutual fund” means a company, unit trust or partnership that issues equity interests, the purpose or effect of which is the pooling of investor funds with the aim of spreading investment risks and enabling investors in the mutual fund to receive profits or gains from the acquisition, holding, management or disposal of investments but does not include a person licensed under the Banks and Trust Companies Law (2013 Revision) or the Insurance Law, 2010, or a person registered under the Building Societies Law (2010 Revision) or the Friendly Societies Law (1998 Revision). (Mutual Funds Law (2015 Revision) of the Cayman Islands)



## Interesting case (1)

- Cheung Kong's sales of Apex Horizon hotel suites

### ▶ *The Pearl Wisdom case*

- ▶ Pearl Wisdom Limited sold hotel rooms at The Apex Horizon development.
- ▶ **SFC** : it was an invitation to acquire an interest or participate in CIS.
- ▶ **Pearl Wisdom Limited and other related parties (all members of Cheung Kong group)** : disagreed, claiming purchaser has day-to-day control of their rooms.
- ▶ Sales were subsequently unwounded.

SFC in August 2016, issued an updated FAQ on Offers of Investments which clarified that “day-to-day control” means management decision about the property, even if investors have the right to be consulted or give direction.

## Interesting case (2)

- ▶ *IPFUND and Ronald Sin case*
- ▶ 31 May 2014, the SFC commenced criminal proceedings against IPFUND Asset Management Limited and its sole director Mr. Ronald Sin for unlicensed dealing of CIS in breach of the SFO.



- ▶ The arrangement was constituted as a CIS by the court. But as the definition of “securities” in the SFO excludes private companies incorporated in HK, there was no unlicensed dealing by IPFUND.
- ▶ The SFC did not appeal the district court decision.

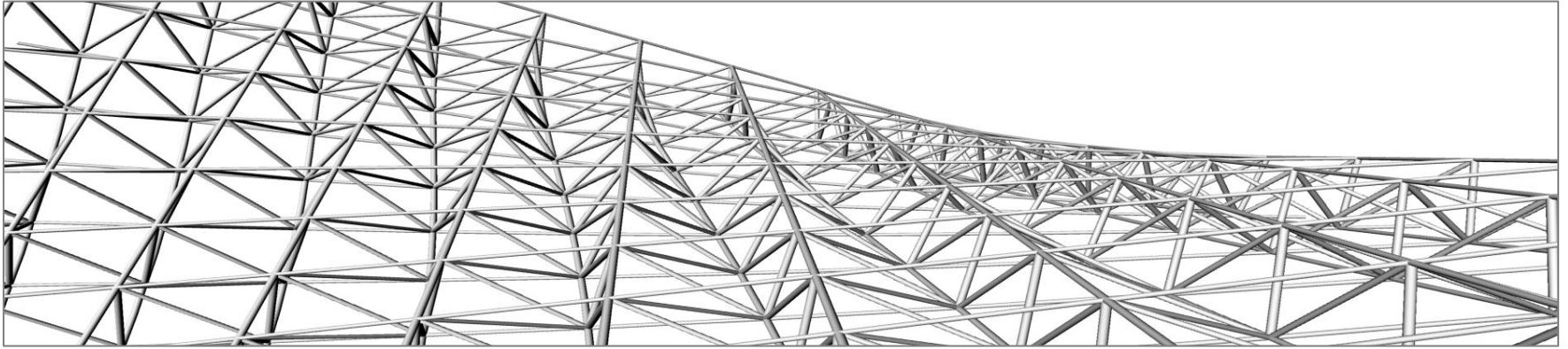


# Why Offshore?



# Why Offshore?

- ▶ Revenue (Profits Tax Exemption for Offshore Funds) Ordinance 2006
  - ▶ A fund may be exempted from profits tax if :
    - ▶ (i) its central management and control is situated outside of Hong Kong, and
    - ▶ (ii) it only enters into “specified transactions” carried out through or arranged by a person licensed with the SFC and transactions incidental thereto.
    - ▶ ‘Deeming Provision’ - Anti-avoidance (HK resident holding 30% or more interest)
  - ▶ 2015 - the profits tax exemption has been extended to private equity funds
- ▶ Hong Kong investment structures
  - ▶ Unit trust
  - ▶ Corporate (restrictions on capital reduction)
  - ▶ Open-ended fund companies (tax consideration for private funds)
- ▶ Other advantages



What is the best structure and how to establish it?

## AGENDA

- Open ended vs. close ended
- Which offshore jurisdiction
- Popular Cayman structure
- Documentation
- Jargons

## OFFSHORE INVESTMENT FUND STRUCTURES

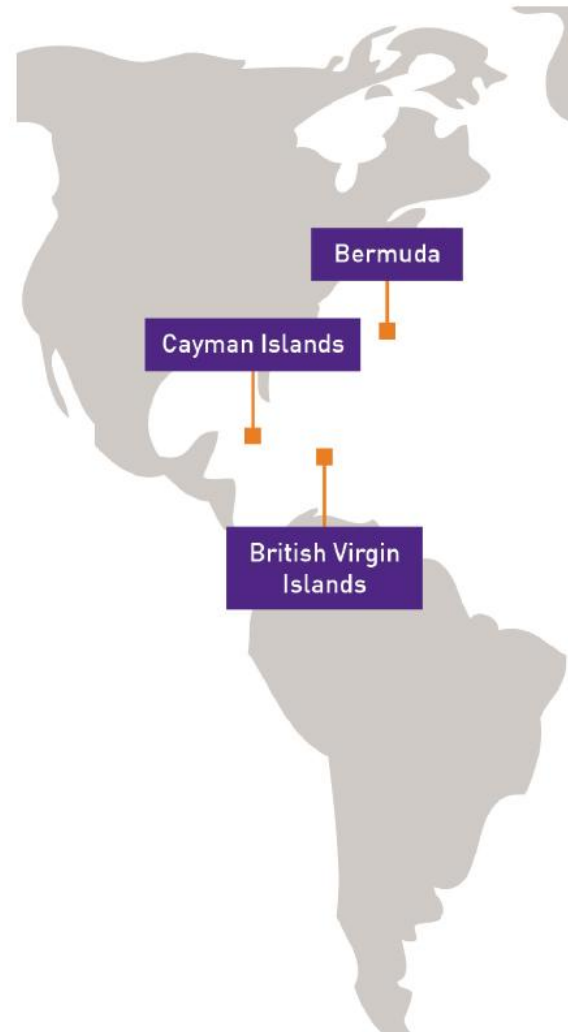
: Pooling of money



## OPEN ENDED VS. CLOSED ENDED

- Key: whether the equity interests are redeemable at the investor's option.
  
- Factors to consider:
  - Investment objectives and strategy (liquid or illiquid?)
  - Appetite of target investors
  - Costs, ease of establishment and timing

## WHICH OFFSHORE JURISDICTION?

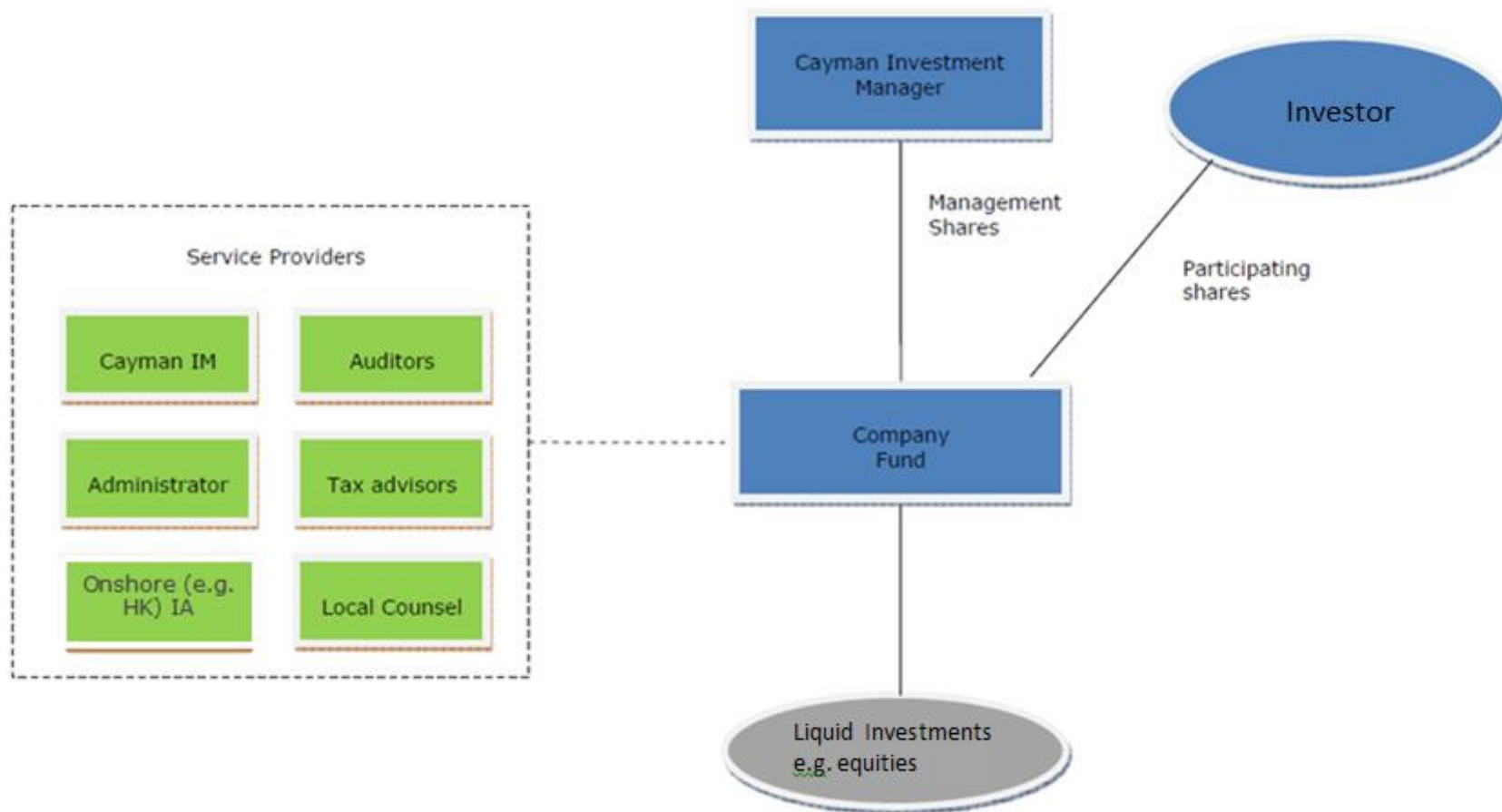


## POPULAR CAYMAN STRUCTURES

- Exempted Company
- Segregated Portfolio Company
- Exempted Limited Partnership

## STRUCTURE: EXEMPTED COMPANY

### Open-ended investment fund – Cayman exempted company



## STRUCTURE: EXEMPTED COMPANY

- CIMA registered
  - Minimum initial investment of US\$100,000 per investor
  - At least 2 directors
  - Offering memorandum
  - CIMA approved auditor
  - Fund administrator

## STRUCTURE: EXEMPTED COMPANY

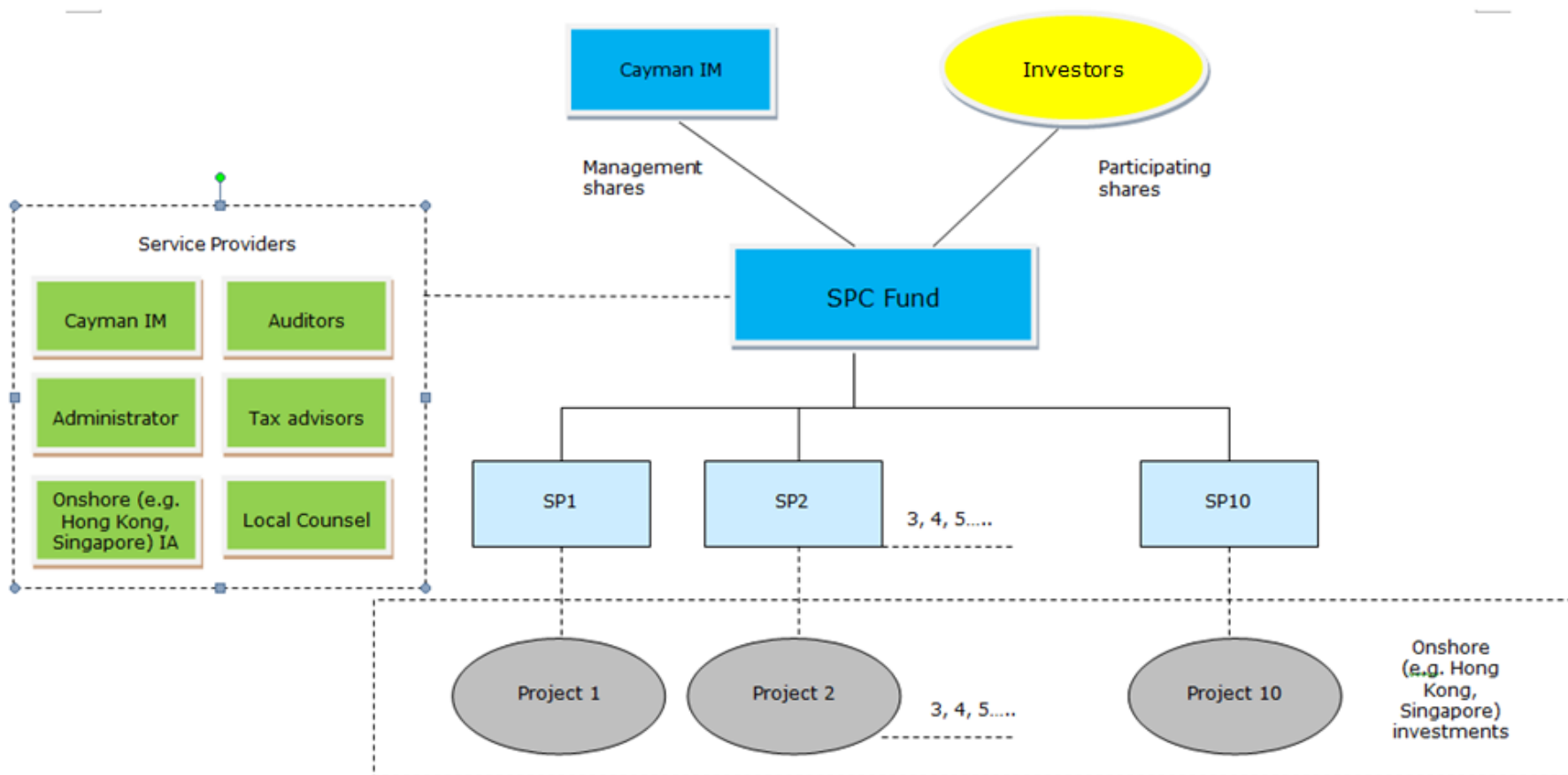
- CIMA exempted
  - not more than 15 investors
  - a majority of the investors in number are given the right to appoint/remove directors

## STRUCTURE: SPC

- Ability to establish internal portfolios
- Statutory segregation of assets and liability (no need for explicit limited recourse language)
- Less expensive and more efficient
- Ideal platform for numerous investment strategies

# STRUCTURE: SPC

## Open-ended investment fund – Cayman SPC



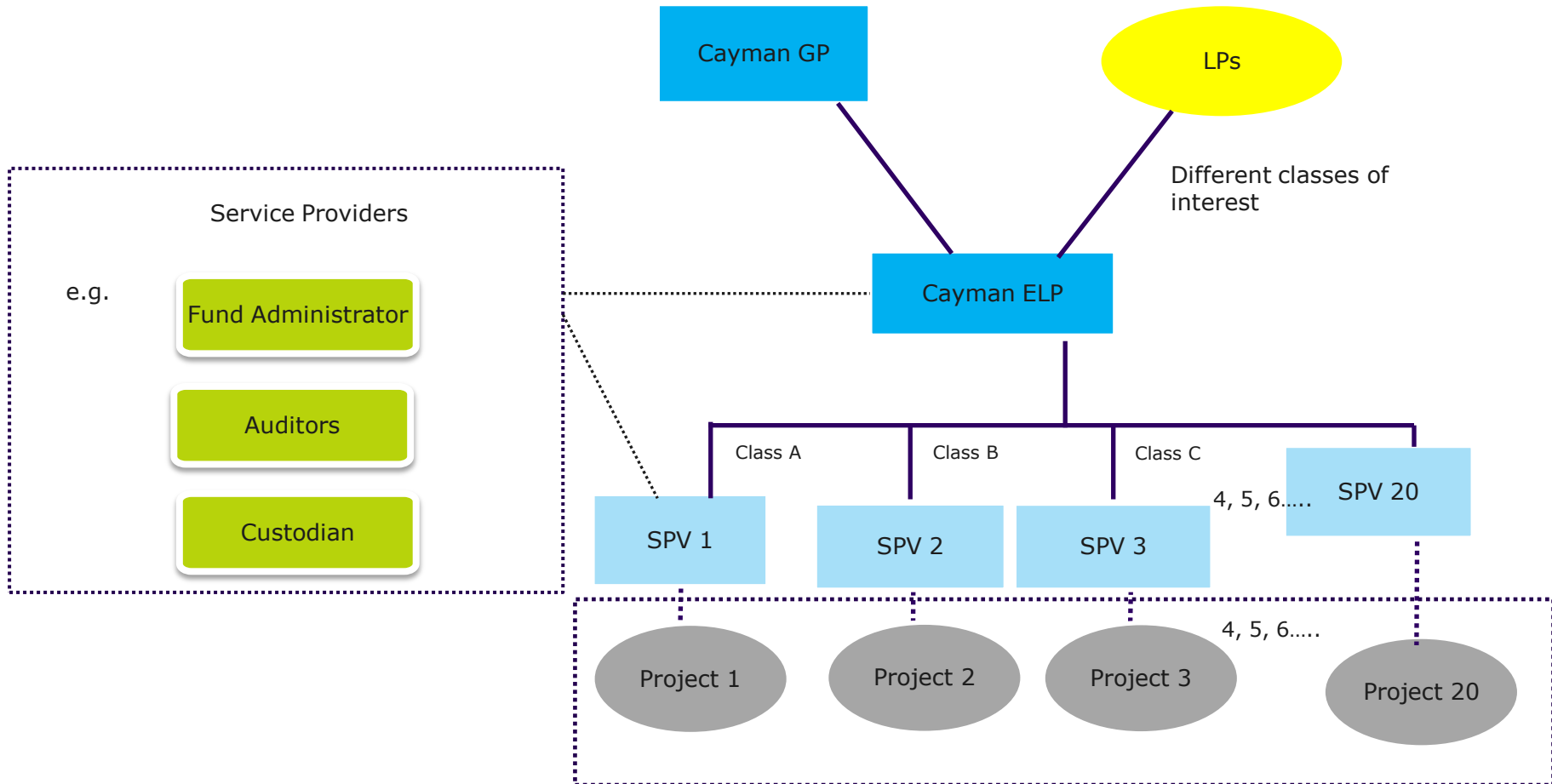
For example: The investor will hold Class A Shares which will participate exclusively in SP1 that invest in Project 1 (ie. each class of share corresponds to a project).

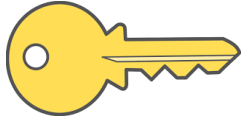


## STRUCTURE: ELP

- A contractual relationship among the partners; does not have separate legal personality
- At least one GP and one LP
- The sole GP or at least one of the GPs must be a Cayman company or partnership (or it could also be Cayman resident or foreign company having a place of business in Cayman)
- GP is liable for the debts and obligations of ELP
- A LP is limited in 2 ways:
  - May not participate in the active conduct of the ELP's business
  - Enjoys limited liability in the event of insolvency

# STRUCTURE: ELP



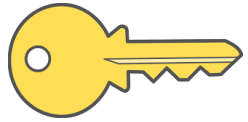


## DOCUMENTATION: COMPANY AND SPC

- M&A
- Offering memorandum / private placement memorandum (PPM)
- Subscription documents and redemption form
- Service provider agreements e.g. IMA
- Launch resolutions
- CIMA required documents (other than PPM)

## JARGONS: COMPANY AND SPC

- Subscriptions
- Redemptions
- NAV
- Side pockets
- Management and Performance fees

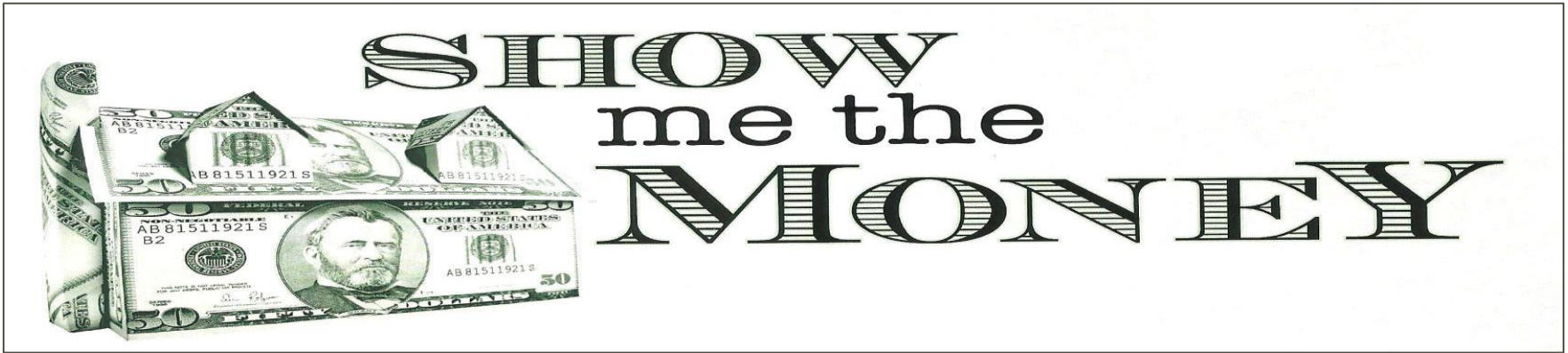


## DOCUMENTATION: ELP

- LPA (as governing document)
- PPM
- Subscription document
- Service providers agreement

## JARGONS: ELP

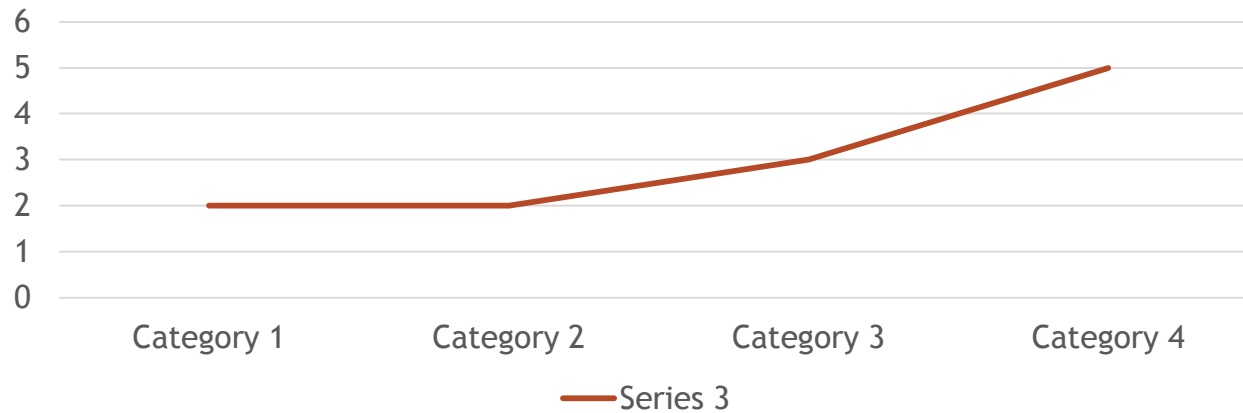
- Commitment
- Capital calls and drawdowns
- Term
- Commitment Period
- Investment Period
- Management fee and carried interest
- Waterfall distributions



## Managing an investment fund and how to offer it in Hong Kong?

- Market trend
- Licensing and regulatory considerations
- Fiduciary duty of Managers
- Private placement regime in Hong Kong

# What has been the market trend?







# Licensing and Regulatory Considerations

- ▶ 10 types of activities regulated by the SFC and fund managers are commonly approved for the following:
  - ▶ Type 1 Dealing in securities
  - ▶ Type 4 Advising on securities
  - ▶ Type 9 Asset management

In the pipeline:

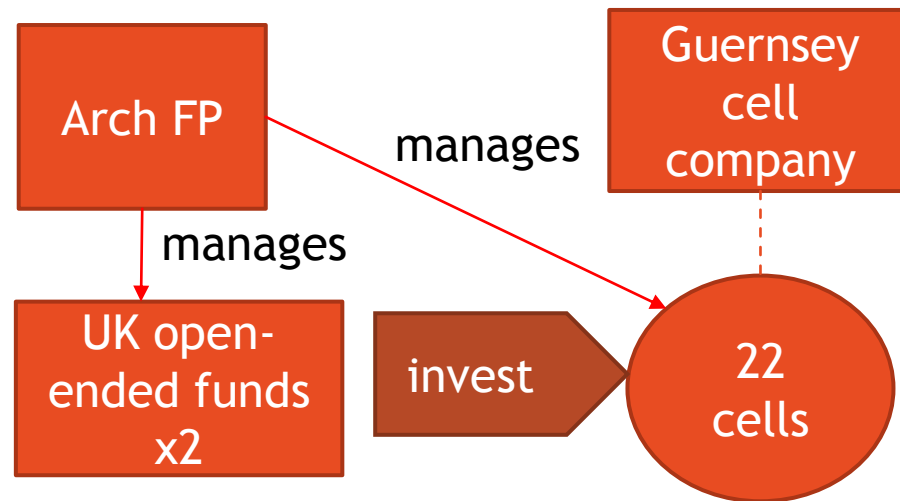
- ▶ Type 11 - Dealing in OTC derivatives products
- ▶ Type 12 RA (providing client clearing services for OTC derivative transactions)

# Fiduciary Duty of Managers

- ▶ Directors of a company owe a fiduciary duty to the company.
- ▶ What about the fund manager of an investment fund?

# Fiduciary Duty of Managers - Interesting Case

- ▶ Arch Financial Products LLP (“Arch FP”) case (UK High Court Case)



# Fiduciary Duty of Managers

Arch FP committed the cells to illiquid investments which was outside the investment scope of the 2 UK open-ended funds

Financial Crisis hit;  
Those assets were written down to zero

insufficient liquid assets to satisfy redemption

It was alleged that Arch FP's decision to invest was driven by its own interest in receiving illegitimate payment of 3 million pounds rather than in the interest of the UK open-ended funds or the cells.

# Fiduciary Duty of Managers

**JUDGMENT** - No reasonable investment manager could have considered that the investment was in the best interest of the cells.

## Principles considered -

1. duty not to exceed investment mandate - if an investment manager exceeds the authority of its investment mandate when making an investment it will be liable to the fund for losses caused;
2. management powers and duties - unless the parties agree a different level of protection an investment manager has a duty to exercise discretionary powers with due skill and care; and
3. duties of loyalty - an investment manager owes fiduciary duties to the funds it manages, which means that it must give preference to the fund's interests above its own interests. This obligation is reinforced by the duties of an investment manager to avoid conflicts of interest with its funds and not to use its position to make a secret profit.

# Fiduciary Duty of Managers

## JUDGMENT (CONT)

- ▶ the court did not accept the defence from Arch FP that the £3m payment was disclosed and consented to by the cells. It is said by the court that the “**disclosure**” **defence** will only succeed only where a fund manager can demonstrate that before entering into a transaction it made full disclosure of material facts and extent of its own interests.
- ▶ The CEO of Arch FP was held also liable for dishonestly assisting Arch Financial to breach its fiduciary duties and inducing Arch Financial’s breach of contract. He was also subject to regulatory sanction from the UK FCA.

# Private Placement Regime in Hong Kong



Who are your target investors?

- General Public
- Professional Investors (PIs) - institutional investors, trust corporations with at least HK\$40 million in assets; individuals, corporations and partnerships with investment portfolios of at least HK\$8 million.

# Private Placement Regime in Hong Kong

- ▶ Professional Investors exception (under the SFO)
- ▶ Private Placement exception (under the Companies (Winding Up and Miscellaneous Provisions) Ordinance)

With prescribed warning:

- ▶ Offer to note more than 50 persons
- ▶ An offer which the total consideration does not exceed HK\$5 million or its equivalent
- ▶ Offer in which the minimum subscription per investor is not less than HK\$500,000



# Private Placement Regime in Hong Kong - Corporate Funds v Non-Corporate Funds

## Non-Corporate Funds

- ▶ professional investors exception
- ▶ industry practice to apply the private placement exception from CO by analogy
- ➔ an offer to an unlimited number of professional investors, plus not more than 50 offerees would not be considered as public offering.

### Additional requirements:

- ▶ each offering document be numbered and individually addressed
- ▶ minimum subscription per investor should be a sizable amount
- ▶ transfer of interests in the fund to another subscriber should be restricted for a minimum period of 6 months following allotment

# Interesting Case - Pacific Sun Advisors Ltd

Court of final appeal case in March 2015

- ▶ Pacific Sun sent an email to various recipients informing them launch of a fund and subsequently published the that in the company's website.
- ▶ It is not clear from the email nor the website that Pacific Sun intended the fund to be solely offered to Pls (and not the general public).
- ▶ SFC took legal action and failed in the initial hearing, but was successful on appeal. Pacific Sun then appealed to the Court of Final Appeal.

# Case study - Pacific Sun Advisors Ltd

- ▶ Court of final appeal found in favour of Pacific Sun and stated:
  - ▶ There is no requirement under the exemption that the advertisements or other materials contain an express statement that the collective investment scheme is intended to be disposed of only to professional investors.
  - ▶ In order for Pacific Sun to rely on the exemption, it needed to show as a matter of fact that the Fund was intended to be disposed of only to professional investors.



**This presentation is intended only as general discussion and should not be regarded as legal advice.**

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