

THE PRIVATE EQUITY
REVIEW

NINTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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REVIEW

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PREFACE

The ninth edition of *The Private Equity Review* follows another extremely active year for dealmakers in 2019. While the number and value of global private equity deals completed declined slightly from 2018, deal activity was still robust, weighted towards the upper end of the market, and included several large take-private transactions. Fundraising activity was also strong with aggregate capital raised just slightly below 2018's record levels, as institutional investors remained extremely interested in private equity as an asset class because of its continued strong performance. That, combined with some caution due to an uncertain market environment, has resulted in private equity funds having significant amounts of available capital, or dry powder. This dry powder, together with competition from non-traditional dealmakers, such as sovereign wealth funds, family offices and pension funds, led to very competitive transactions being completed at increasing purchase price multiples. This has caused private equity firms to become even more creative as they seek opportunities in less competitive markets or in industries where they have unique expertise. Given private equity funds' dry powder and creativity, we expect private equity will continue to play an important role in global financial markets, not only in North America and western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa. In addition, we expect the trend of incumbent private equity firms and new players expanding into new and less established geographical markets to continue.

While there are potential headwinds – including trade tensions, the upcoming US election and an eventual end to one of the longest-running recoveries in US history – on the horizon for 2020 and beyond, we are confident that private equity will continue to play an important role in the global economy, and is likely to further expand its reach and influence.

Private equity professionals need practical and informed guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. *The Private Equity Review* has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 22 different countries, with observations and advice on private equity dealmaking and fundraising in their respective jurisdictions.

As private equity has grown, it has also faced increasing regulatory scrutiny throughout the world. Adding to this complexity, regulation of private equity is not uniform from country to country. As a result, the following chapters also include a brief discussion of these various regulatory regimes.

I want to thank everyone who contributed their time and labour to making this ninth edition of *The Private Equity Review* possible. Each of these contributors is a leader in their respective markets, so I appreciate that they have used their valuable and scarce time to share their expertise.

Stephen L Ritchie

Kirkland & Ellis LLP

Chicago, Illinois

March 2020

Part I

FUNDRAISING

HONG KONG

Lorna Chen, Sean Murphy, Anil Motwani and Iris Wang¹

I GENERAL OVERVIEW

Hong Kong is a leading international financial centre known for its strategic position as a hub and gateway to mainland China, as well as for being one of the world's largest capital markets. Hong Kong is also a principal private equity centre, ranking second in Asia after mainland China for total capital under management by private equity funds (excluding real estate funds), which amounted to US\$159 billion in 2018.² The Hong Kong private equity industry is strengthened by its diversity. Long a preferred destination for global and regional investment fund managers, more than 200 managers were based in Hong Kong in 2018.³ For these reasons, Hong Kong is likewise an important jurisdiction for leading pension funds, insurance companies, sovereign wealth funds, family offices and other investors.

Asset management and fund advisory businesses in Hong Kong amounted to HK\$16,447 billion as at 31 December 2018, resulting in a moderate drop of 6 per cent as compared to 2017. Nonetheless, the private equity industry has continued to see an increase over the past few years in the number of licensed corporations and personnel. From September 2018 to September 2019, the number of corporations licensed in Hong Kong for Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management) regulated activities – the three types of licences most relevant to private equity fund managers – grew by 7 per cent, 12 per cent and 10 per cent, respectively.⁴ Over the same period, the number of licensed representatives in Hong Kong for Types 1, 4 and 9 regulated activities increased respectively by 2 per cent, 8 per cent and 9 per cent.⁵

The continued growth of the private equity sector in Hong Kong also reflects Hong Kong's important role in China's Belt and Road Initiative, one of Chinese President Xi Jinping's signature initiatives for global infrastructure investment. In addition, the rapid development of the Guangdong–Hong Kong–Macao Greater Bay Area has created an additional need for private investment capital by start-ups in the innovation and technology field.

1 Lorna Chen is a partner, Sean Murphy is counsel and Anil Motwani and Iris Wang are associates at Shearman & Sterling.

2 See Asset and Wealth Management Activities Survey 2018, released by the Hong Kong Securities and Futures Commission (SFC) in July 2019, available at www.sfc.hk/web/EN/files/ER/PDF/Asset%20and%20Wealth%20Management%20Activities%20Survey%202018_EN.pdf.

3 See Preqin Special Report: Asian Private Equity & Venture Capital, available at <https://docs.preqin.com/reports/Preqin-Special-Report-Asian-Private-Equity-September-2018.pdf>.

4 See Statistics on Number of Regulated Activities of Licensed Corporations, released by the SFC, available at www.sfc.hk/web/EN/files/SOM/MarketStatistics/2019/c02.pdf.

5 See Statistics on Number of Regulated Activities of Licensed Representatives, released by the SFC, available at www.sfc.hk/web/EN/files/SOM/MarketStatistics/2019/c04.pdf.

Hong Kong is well positioned heading into 2020, thanks in part to tax and legal changes initiated in the past few years by the Hong Kong authorities, including an expansion of the current profit tax exemptions, to encourage the use of vehicles formed locally in Hong Kong; amendments to certain codes of conduct regulating fund managers, to strengthen investor confidence in the Hong Kong private funds market; and tightened regulation over funds investing in virtual assets, to support and promote responsible innovation.

In addition, during 2019, a task force was formed to engage in research and discussions over a proposal for a new limited partnership regime in Hong Kong designed specifically for investment funds. If enacted as expected in 2020, the new regime would replace the existing, century-old statute and attract greater fund formation activity in Hong Kong, thereby strengthening Hong Kong's position as a jurisdiction of choice for fund managers.

II LEGAL FRAMEWORK FOR FUNDRAISING

The Hong Kong Securities and Futures Commission (SFC) is the principal regulator of Hong Kong's securities and futures markets, including with respect to private equity fundraising. As empowered by Hong Kong's primary securities legislation, the Securities and Futures Ordinance (Cap 571) (SFO), the SFC performs a number of key functions central to the private equity industry, including licensing and supervising private equity managers and advisers, and setting and enforcing key regulations covering private equity fund management and the marketing of private equity fund interests in Hong Kong.

i Private placement of private equity fund interests in Hong Kong

Offerings in Hong Kong of interests in private equity funds structured as partnerships or trusts are subject to regulation under the SFO. Offerings in Hong Kong of shares or debentures issued by private investment funds structured as companies are subject to regulation both under the SFO and the Companies Ordinance.

Offering documents relating to securities offered to members of the Hong Kong public, whether offered by a licensed person or not, must be authorised by the SFC unless an exemption applies.

One of the most commonly used exemptions applies to offers made solely to 'professional investors' within the meaning of the SFO and its relevant subsidiary legislation. Professional investors broadly encompasses financial institutions, insurance companies, investment companies, retirement schemes, pension plans, government entities and certain high-net-worth individuals and large entities. If fund interests are marketed in Hong Kong, the relevant investors should be provided with a supplemental Hong Kong investor questionnaire to confirm and document their professional investor status. The admission by a fund of certain types of professional investor, including individuals, may cause such fund to be subject to enhanced compliance and due diligence requirements.

To the extent all Hong Kong offerees cannot meet the professional investor standard, another exemption is available under current market practices for offerings to not more than 50 offerees in Hong Kong. Although the offering documents for the types of private offers listed above are not required to comply with prospectus content requirements, they should include an appropriate securities legend to highlight that the offering documents have not been reviewed by any regulatory authority in Hong Kong and that investors are encouraged to seek independent professional advice.

The common structures for private equity funds with a managerial presence in Hong Kong are (1) fund entities formed as limited partnerships; (2) general partners formed either as limited partnerships or companies; and (3) investment managers or advisers established as companies, typically under the laws of a tax-neutral, offshore jurisdiction such as the Cayman Islands. Typically, a Cayman Islands-domiciled private equity fund with a team of investment professionals based in and working out of Hong Kong would also include a Hong Kong investment manager or adviser entity that employs these professionals and provides investment advice and operational support in respect of the investments that the fund proposes to make. Activities of an investment manager or adviser could, depending on the facts and circumstances, come within various categories of regulated activities under the SFO, including but not limited to selling fund interests to residents in Hong Kong; conducting selling activities in Hong Kong; deal sourcing and execution of transactions; making recommendations and advising with respect to potential deals; and making investment decisions for the investment fund under management. As a result, any such Hong Kong investment manager or adviser entity would likely be required to obtain certain licences from the SFC. The offering of fund interests to investors in Hong Kong must be conducted by an appropriately licensed entity unless marketing takes place entirely outside Hong Kong.

ii SFC licensing regime

General requirements

Any company (or branch office of a foreign company) that carries on a business in a regulated activity in Hong Kong or holds itself out as carrying on a business in a regulated activity in Hong Kong is required to be licensed by the SFC, unless a specific exemption is available.

The SFO prohibits:

- a* a person from carrying out a business in a regulated activity or holding himself or herself out as carrying on a business in a regulated activity without a licence; and
- b* 'active marketing' of any services by any person (including those operating from offshore) to the public, directly or by another person on the person's behalf, if that would constitute a regulated activity if undertaken in Hong Kong, unless the person has obtained a licence.

The SFC guidance suggests that the following factors would be considered in reaching the conclusion that this 'active marketing' threshold has been crossed:

- a* there is a detailed marketing plan to promote the services;
- b* the services are extensively advertised via marketing means such as direct mailing, advertisements in local newspapers, or broadcasting or other 'push' technology over the internet (as opposed to where the services are passively available (e.g., on a take-it-or-leave-it basis));
- c* the related marketing is conducted in a concerted manner and executed in accordance with a plan or a schedule that indicates a continuing service rather than a one-off exercise;
- d* the services are packaged to target the public of Hong Kong (e.g., written in Chinese and denominated in Hong Kong dollars); and
- e* the services are sought out by the customers on their own initiative.⁶

⁶ See 'Actively markets' under Section 115 of the SFO, FAQ released by the SFC, available at www.sfc.hk/web/EN/faqs/intermediaries/licensing/active-marketing-under-section-115-of-the-sfo.html#1.

Regulated activity and relevant exemptions

The SFO stipulates 10 types of regulated activity, the most relevant of which for a private equity fund sponsor are Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management).

Type 1 (dealing in securities) regulated activity includes the making or offering to make an agreement with another person or inducing or attempting to induce another person to enter into an agreement for or with the view to acquiring or disposing of securities. If a company engages in the distribution and sale of securities, such as limited partnership interests or shares in a company, a Type 1 licence would thus be required. In addition, if a company engages in deal sourcing and the execution of private equity transactions, including negotiations with a target company, then this conduct may also constitute Type 1 regulated activity.

Type 4 (advising on securities) regulated activity includes the giving of advice on whether to acquire or dispose of securities. If a company provides investment advice for which remuneration is received, then, unless such advisory activities are wholly incidental to Type 1 regulated activity, the company will need to apply for and obtain a Type 4 licence.

Type 9 (asset management) regulated activity includes the managing of a real estate investment scheme or securities or futures contracts. If a company provides portfolio management services and exercises discretionary investment authority to make investment decisions for its clients, then the company will require a Type 9 licence.

As the profile of each private fund management team or sponsor with a managerial presence in Hong Kong may differ depending on such factors as strategy, personnel, business capabilities and operational models, many firms decide to apply for one or a combination of Type 1, 4 or 9 licences, while some other firms instead seek to rely on an exemption from the licensing requirements. Alternatively, some firms may choose to acquire a corporation that is already licensed and, through the acquisition, conduct the desired type of regulated activity. The SFO sets out various exemptions from the licensing requirements, the most relevant of which are profiled below.

Incidental exemption⁷

A company may not need a licence for certain regulated activities if these activities are performed in a manner that is wholly incidental to the carrying out of another regulated activity for which the company is already licensed. For example, if a company holds a Type 9 licence, then that company may rely on the incidental exemption to carry out related Type 1 and Type 4 regulated activities, provided that the preceding activities are undertaken solely for the purposes of the company's asset management business.

Group company exemption⁸

A company may not need a licence for Type 4 or Type 9 regulated activity if the company provides the relevant advice or services solely to the company's wholly owned subsidiaries, to the company's holding company, which holds all of the company's issued shares, or to other wholly owned subsidiaries of the company's holding company.

7 See SFC Licensing Handbook (February 2019) §1.3.3, §1.3.6.

8 See SFC Licensing Handbook (February 2019) §1.3.13.

Licensing criteria

Licence for the corporation⁹

The core principle behind the Hong Kong licensing regime is that applicants must demonstrate, to the satisfaction of the SFC, fitness and propriety¹⁰ to be licensed. Being fit and proper involves, broadly, being financially sound, competent, honest, reputable and reliable.¹¹

Certain attributes that a corporate applicant would generally have to satisfy to obtain an SFC licence are set out below.

Incorporation

The applicant must be either a company incorporated in Hong Kong or an overseas company registered with the Companies Registry of Hong Kong.

Competence

The applicant must prepare and submit several documents, including a shareholding chart, an organisational chart and operation flowcharts. The SFC revamped its licensing process in 2019 by introducing new licensing forms and mandatory electronic submission of annual returns and notifications. Key changes include introducing questionnaires regarding business profile and internal control summaries and requirements to include continuous professional training compliance confirmations in the annual return forms.

Responsible officers

The applicant must appoint at least two responsible officers (ROs) to be tasked with direct supervision of the conduct of each proposed regulated activity, with at least one RO being available at all times to supervise each of the proposed regulated activities¹² and at least one RO being designated as an executive director.¹³

In addition to ROs, any individual who carries on a regulated activity on behalf of the corporation will similarly be required to obtain a licence as a representative accredited to the corporation. Licensed representatives (LRs) may be accredited to more than one licensed corporation. As with ROs, LR applicants must satisfy the SFC that the LR has fulfilled the fit-and-proper requirement. All LR applicants must pass the competence test for a licensed representative.

In addition, all executive directors of the applicant must become ROs accredited to that applicant, and must seek and obtain the SFC's prior approval to do so.

9 Authorised financial institutions, such as banks, are required to be registered instead of licensed. This chapter is focused on issues relating to fully licensed corporations.

10 See SFO §129.

11 See SFC Licensing Handbook (February 2019), Fit and Proper Guidelines (October 2013), Guidelines on Competence (March 2003) and Guidelines on Continuous Professional Training (March 2003), issued by the SFC.

12 The same individual may be appointed to be an RO for more than one regulated activity, provided that this individual is fit and proper to be so appointed and there is no conflict in the roles assumed.

13 'Executive director' means a director of the corporation who (1) actively participates in or (2) is responsible for directly supervising, the business of a regulated activity for which the corporation is licensed.

Among other requirements, each RO applicant has to satisfy the SFC that the applicant has fulfilled the fit-and-proper requirements and has sufficient authority to supervise the business of regulated activity within the licensed corporation to which the RO applicant will be accredited.

Senior management

The senior management of the applicant must remain primarily responsible for ensuring the company's maintenance of appropriate standards of conduct and the company's adherence to procedures that facilitate compliance with those standards of conduct.

Substantial shareholders, officers and other related persons to be fit and proper

The applicant must ensure that all substantial shareholders,¹⁴ officers¹⁵ and any other person who is or is to be employed by, or associated with, the corporate applicant for the purposes of the regulated activity for which the application is made shall, likewise, be fit and proper.

Financial resources

The applicant must at all times maintain specified amounts of paid-up share capital and liquid capital in accordance with SFO requirements that depend on the licence type.

Insurance

If the applicant is a stock exchange participant seeking a Type 1 licence, the applicant must specify to the SFC that the applicant will take out and maintain insurance policies protecting against specific risks for specified amounts based on the SFC's approval of a master insurance policy applicable to the applicant.

Ongoing obligations

Licensed corporations, ROs and LRs must remain fit and proper at all times and comply with both the SFO and any other codes and guidelines issued by the SFC. Key ongoing obligations include:

- a* display of licence or certificate of registration;
- b* availability of ROs;
- c* notification requirements;
- d* submission of audited accounts;
- e* payment of certain annual fees; and
- f* continuous professional training.

14 'Substantial shareholder' means a person who, either alone or with his or her associates, (1) has an interest in shares of the corporation with a nominal value of 10 per cent or more of the issued share capital or that entitles the person to exercise more than 10 per cent of the voting power at general meetings of the corporation, or (2) holds shares in any other corporation that entitles him or her to exercise 35 per cent or more of the voting power at the general meetings of the other corporation, or of a further corporation that is itself entitled to exercise more than 10 per cent of the voting power at the general meeting of the corporation.

15 'Officer' means a member of the senior management (including directors, ROs and 'managers-in-charge of core functions'), manager or secretary, or any other person involved in the management, of the corporation.

iii Codes of conduct

In addition to the SFO, the SFC has issued other codes and guidelines that regulate licensed or registered persons, including the Code of Conduct for Persons Licensed by or Registered with the Securities and Futures Commission (the Code) and the Fund Manager Code of Conduct (FMCC).

The Code applies to all licensed or registered persons in the course of their performance of the regulated activities for which they are licensed or registered. The Code sets out in detail certain fit-and-proper requirements that such persons must uphold to remain registered, including showing honesty and fairness, conducting and enabling due diligence, making proper disclosures and proper handling of conflicts of interest and client assets. Failure to comply with the Code would not directly and necessarily cause the relevant persons to become subject to legal action. However, the SFC will consider whether any such non-compliance would adversely affect the persons' status as being fit and proper to remain licensed or registered and, if so, may initiate an investigation using authority granted under the SFO.

The FMCC sets out further conduct and disclosure requirements for persons licensed by or registered with the SFC whose business involves the management of (1) authorised collective investment schemes, (2) unauthorised collective investment schemes, or (3) discretionary accounts. The FMCC, in this manner, supplements other codes and guidelines applicable to licensed or registered persons, including the Code, and emphasises and elaborates on certain existing requirements. Similarly to a breach of the Code, a breach of the FMCC would reflect negatively on a person's status as being fit and proper, and may create a basis for disciplinary action.

iv Taxation

Sponsors in Hong Kong prefer to set up private funds in certain offshore jurisdictions to enjoy tax neutrality or the otherwise preferential tax rates and treaty benefits that these jurisdictions may offer. Funds that are domiciled outside of Hong Kong may be exempted from the Hong Kong profits tax if certain conditions under the Inland Revenue Ordinance (Cap 112) are met. The profit tax implications may vary for the asset-based management fees and variable performance fees that are often payable to fund managers.

Although a Hong Kong-based investment manager or adviser may advise on the operation of the fund, a portion of profits and income may remain with a separate Cayman-based fund manager or adviser, pursuant to appropriate commercial arrangements. In recent years, taxation of fund managers and advisers in Hong Kong has drawn closer scrutiny by the Inland Revenue Department (IRD) in terms of both the nature and source of income derived and also the sufficiency of amounts received by the Hong Kong-based investment manager or adviser.

In the current market, sponsors of private equity funds would be advised to carefully review the service agreements among managerial entities, alongside the underlying compensation arrangements, to anticipate and defend against any challenges from the IRD.

III REGULATORY DEVELOPMENTS

i Hong Kong limited partnership regime

During 2019, a task force was formed to develop a proposal for a modern limited partnership regime in Hong Kong. Benefiting from research into Hong Kong's market landscape as well as international trends, the proposal should be better suited to the current needs and desires

of market participants in Hong Kong's private equity fund industry than the existing regime, which was last amended in 1924. If the updated regime is enacted in 2020, as projected, then funds in the Cayman Islands or elsewhere being operationally managed from Hong Kong may re-domicile to Hong Kong (and, correspondingly, successor vintages of such funds may be formed in Hong Kong), thereby aligning legal structures with business activities, and contributing to Hong Kong's ongoing growth as a global financial centre.

ii Regulatory approach for cryptocurrency assets and complex products

In light of the growing investor interest in virtual assets (including exposure to such assets through private equity funds) and the growth in unlicensed trading platform operators in Hong Kong, the SFC, on 1 November 2018, announced a new regulatory framework for the governance of virtual assets.¹⁶ Among other things, the SFC announced that terms and conditions will be imposed on licensed corporations that manage or plan to manage portfolios with a stated investment objective to invest in virtual assets or an intention to invest 10 per cent or more of the gross asset value of the portfolio in virtual assets (collectively, virtual asset fund managers).

On 4 October 2019, the SFC published the proforma 'Terms and Conditions for Licensed Corporations which Manage Portfolios that Invest in Virtual Assets',¹⁷ which further sets out the terms and conditions that will be imposed on all virtual asset fund managers, subject to minor variations and elaborations depending on the individual virtual asset fund manager's business model and circumstances. These terms and conditions are mostly principle-based and will be imposed on virtual asset fund managers by way of a licensing condition. Failure to observe such licensing condition may be considered as misconduct under the SFO and may adversely affect the fitness and properness of a virtual asset fund manager and even result in disciplinary action by the SFC.

The SFC issued a circular on 13 June 2019 on the implementation of regulatory requirements for the online and offline sale of complex products. A complex product is 'an investment product whose terms, features and risks are not reasonably likely to be understood by a retail investor because of its complex structure'. Factors to determine whether an investment product is complex or not are further set out in the Guidelines on Online Distribution and Advisory Platforms and the Code, and include, but are not limited to:

- a* whether a secondary market is available for the investment product at publicly available prices;
- b* whether there is adequate and transparent information about the investment product available to retail investors; and
- c* whether any features or terms of the investment product might render the investment illiquid or difficult to value.¹⁸

16 See Statement on Regulatory Framework for Virtual Asset Portfolios Managers, Fund Distributors and Trading Platform Operators, issued by the SFC, available at www.sfc.hk/web/EN/news-and-announcements/policy-statements-and-announcements/reg-framework-virtual-asset-portfolios-managers-fund-distributors-trading-platform-operators.html.

17 Available at www.sfc.hk/edistributionWeb/gateway/EN/circular/intermediaries/supervision/doc?refNo=19EC62.

18 See Guidelines on Online Distribution and Advisory Platforms, Section 6.1.

Thus, a private fund is likely to be considered a complex product that is subject to enhanced requirements relating to suitability, the provision of information and warning statements.

iii SFC licensing guidance for private equity firms and family offices

On 7 January 2020, the SFC issued guidance on the licensing obligations of private equity firms and family offices that conduct business in Hong Kong. In a circular to private equity firms seeking to be licensed,¹⁹ the SFC clarifies certain existing licensing requirements, such as those applicable to general partners and investment committee members offering co-investment opportunities and fund marketing activities. The circular also clarifies how the SFC assesses private equity firms' discretionary investment authority and investments in securities of private companies, as well as the industry experience requirement for their responsible officers. A separate circular²⁰ provides general guidance for family offices intending to carry out asset management or other services in Hong Kong and explains the potential implications for both single and multi-family offices. Licensing exemptions, or carve-outs, may be available depending on how a family office operates.

IV OUTLOOK

Hong Kong, as Asia's leading financial centre and a major gateway to China, has attracted the interest of both domestic and international investors. The private equity industry in Hong Kong has experienced tremendous growth in the past decade. Faced with a growing number of participants and capital under management, on the one hand, and transforming technology and evolving global financial conditions on the other hand, Hong Kong is widely expected to develop and tighten regulations aimed at mitigating financial risks and keeping pace with regulatory developments in comparable international markets.

Recent years have seen the SFC increasing its efforts to fight irregularities in the private equity market and strengthen its scrutiny over fund managers on various aspects of their businesses, including the licensing requirement and approval process, the role of transfer pricing in a firm's managerial structure and the appropriate regulatory approach to investments in new industries. While Hong Kong is expected to maintain its historically competitive edge in terms of free trade, low tax and freedom of capital mobility, it will likewise continue to closely monitor and regulate the conduct of the private equity industry in a way that embraces and benefits from China's economic boom, the new global economy and growing financial integration.

19 See Circular to private equity firms seeking to be licensed, available at www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=20EC2.

20 See Circular on the licensing obligations of family offices, available at www.sfc.hk/edistributionWeb/gateway/EN/circular/doc?refNo=20EC1.

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