

THE PRIVATE EQUITY
REVIEW

EIGHTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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REVIEW

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This article was first published in June 2019
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Published in the United Kingdom
by Law Business Research Ltd, London
87 Lancaster Road, London, W11 1QQ, UK
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ISBN 978-1-83862-013-4

Printed in Great Britain by
Encompass Print Solutions, Derbyshire
Tel: 0844 2480 112

ACKNOWLEDGEMENTS

The publisher acknowledges and thanks the following for their assistance throughout the preparation of this book:

A&L GOODBODY

ALLEN & OVERY

BAHR

CAMPOS MELLO ADVOGADOS
IN COOPERATION WITH DLA PIPER

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PREFACE

The eighth edition of *The Private Equity Review* follows an extremely active 2018. While the number of global private equity deals completed declined from 2017, the total value of such deals was the highest since 2007, and the third-highest of all time. Deal activity was weighted towards the upper end of the market, and included several large take-private transactions. Fundraising activity was also strong, as institutional investors remained extremely interested in private equity as an asset class because of its strong performance relative to public markets. As a result, private equity funds have significant amounts of available capital, leading 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 all of this, 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, a slowing Chinese economy, Brexit and an eventual end to one of the longest-running recoveries in US history – on the horizon for 2019 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. This review has been prepared with this need in mind. It contains contributions from leading private equity practitioners in 25 different countries, with observations and advice on private equity deal-making 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 eighth 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

April 2019

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 an international hub and gateway to China, as well as 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 currently amounts to US\$141 billion.² The Hong Kong private equity industry is strengthened by its diversity. Long a preferred destination for global and regional private equity sponsors, 36 of the top Asia-focused funds based on size have a managerial presence in Hong Kong.³ Hong Kong is an important jurisdiction for leading pension funds, insurance companies, sovereign wealth funds and other limited partners. Consistent with its position as a leading private wealth management hub, asset managers and family offices also play a prominent role in Hong Kong's private equity sector.

Asset management and fund advisory businesses in Hong Kong grew by 23 per cent to HK\$17,511 billion in 2017 amid a global economic upswing. In addition to this remarkable growth in managed capital, the private equity industry also saw an increase over the past few years in the number of licensed corporations and personnel. From September 2017 to September 2018, 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 that private equity fund managers are most likely to hold – grew by 8 per cent, 12 per cent and 12 per cent respectively.⁴ Over the same period, the number of individuals licensed in Hong Kong for Type 1, 4 and 9 regulated activities similarly increased by 2 per cent, 9 per cent and 9 per cent respectively.⁵

In addition to benefiting from strong economic tailwinds for much of 2018, the growth of the private equity sector in Hong Kong also reflects Hong Kong's important role in China's

1 Lorna Chen is a partner, Sean Murphy is counsel, Anil Motwani is an associate and Iris Wang is a registered foreign lawyer at Shearman & Sterling.

2 See Asset and Wealth Management Activities Survey 2017, released by the SFC (as defined below) in July 2018, available at https://www.sfc.hk/web/EN/files/ER/PDF/2017%20Asset%20and%20Wealth%20Management%20Activities%20Survey_e.pdf.

3 See Overview of Hong Kong Financial Services Industry, released by the Hong Kong Financial Services Development Council, available at http://www.fsdc.org.hk/sites/default/files/Overview%20of%20HK%20Financial%20Services%20Industry_E.pdf.

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

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

Belt and Road Initiative (BRI), one of Chinese President Xi Jinping's signature initiatives, focused on infrastructure and investment across the globe, and the continued development of the Guangdong–Hong Kong–Macao Greater Bay Area. A number of private funds focused on the BRI and the Greater Bay Area were launched successfully in 2018, and this activity is likely to continue in 2019 in support of these critical initiatives.

Heading into 2019, Hong Kong will be well positioned to face any headwinds thanks to numerous tax and legal changes initiated in 2018 by the Hong Kong authorities, including: a proposed 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 and comfort in the Hong Kong private funds market; and tightened regulation over funds investing in virtual assets, to support and promote responsible innovation.

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 encompass 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 required to complete a supplemental Hong Kong investor questionnaire to ensure their professional investor status. In addition, certain categories of professional investors, including individuals, are subject to enhanced compliance and due diligence requirements.

To the extent that 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 the 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 private equity fund structure most commonly offered in Hong Kong comprises a fund organised as a limited partnership, with a general partner organised either as a limited partnership or as a company, and an investment manager organised as a company, often under the laws of the Cayman Islands or other offshore jurisdiction. 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 adviser entity that employs the professionals and generates investment advice and operational support in respect of the investments that the fund proposes to make. Activities of an investment adviser could, depending on the facts and circumstances, come within various categories of regulated activity 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 it manages. As a result, any such Hong Kong investment adviser entity would probably 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 active-marketing test corresponds to the concept of 'solicitation' commonly used in other regulatory regimes. The SFC places emphasis on whether:

- 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 <https://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. As a result, if a company is considering engaging in the distribution and sales of securities such as limited partnership interests, where marketing is involved, a Type 1 licence would be required. In addition, engaging in deal sourcing and the execution of private equity transactions (including participation in negotiations with a target company) may also fall into the category of Type 1 regulated activity.

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

Type 9 (asset management) regulated activity includes the managing of real estate investment scheme or securities or futures contracts. If a company wishes to provide portfolio management services, then the company will require a Type 9 licence.

As the profile of each private equity firm with a managerial presence in Hong Kong may differ depending on such factors as strategy, business capabilities, operational model and personnel, many firms decide to apply for one or a combination of the Type 1, 4 or 9 licences, while some other firms instead seek to rely on an exemption from the licensing requirements.⁷ The SFO sets out various exemptions from the licensing requirements, the most relevant of which we discuss below.

Incidental exemption⁸

A company may not require a licence for certain regulated activities if the 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, that company may rely on the incidental exemption to carry out Type 1 and Type 4 regulated activities provided that these activities are undertaken solely for the purposes of the company's asset management business.

Dealing with professional investors exemption⁹

A company may not require a licence for futures or securities dealing activity if the company acts as principal and only deals with certain professional investors.¹⁰

7 Some firms that might otherwise decide to apply for a licence might instead choose to acquire a corporation that is already licensed, and in this way conduct the desired type of regulated activity.

8 See SFC Licensing Handbook (April 2017) §2.3.4, §2.3.6.

9 See id. §2.3.12.

10 In applying this exemption, the definition of professional investor from Part 1 of Schedule 1 to the SFO is used (instead of the other similar but separate definition thereof from the Securities and Futures (Professional Investor) Rules).

*Group company exemption*¹¹

A company may not require 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, the company's holding company, which holds all the company's issued shares, or to other wholly owned subsidiaries of the company's holding company.

Licensing criteria

*Licence for the corporation*¹²

The core principle behind the Hong Kong licensing regime is that the applicants must demonstrate to the satisfaction of the SFC that they are fit and proper¹³ to be licensed. Being fit and proper involves, broadly, being financially sound, competent, honest, reputable and reliable.¹⁴

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 detailed business plan, compliance manuals and operation flowcharts, as well as any other documents demonstrating that the corporate applicant has a proper business structure, good internal control systems and qualified personnel to ensure the proper management of risks that the company will encounter in operating the business set out in the business plan.

Responsible officers

The applicant must appoint at least two responsible officers (ROs) to be tasked with directly supervising the conduct of each proposed regulated activity, with at least one RO available at all times to supervise each proposed regulated activity,¹⁵ and at least one RO designated as an executive director.¹⁶

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

11 See SFC Licensing Handbook (April 2017) §2.3.13.

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

13 See SFO §129.

14 See SFC Licensing Handbook (April 2017), Fit and Proper Guidelines (October 2013), Guidelines on Competence (March 2003), and Guidelines on Continuous Professional Training (March 2003), issued by the SFC.

15 The same individual may be appointed to be a responsible officer 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.

16 '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.

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.

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,¹⁷ officers¹⁸ 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;

17 '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.

18 'Officer' means a member of the senior management (including directors, responsible officers and Managers-In-Charge of Core Functions), manager or secretary of, or any other person involved in the management of, the corporation.

- c* notification requirements;
- d* submission of audited accounts;
- e* payment of certain annual fees; and
- f* continuous professional training.

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

Private equity funds offered in Hong Kong tend to be domiciled in tax-neutral, offshore jurisdictions such as the Cayman Islands. This is driven in part by tax considerations. Funds that are domiciled outside Hong Kong may be exempted from Hong Kong profit tax if certain conditions under the Inland Revenue Ordinance (Cap. 112) are met. The profit tax implications may vary for fund managers, which are commonly entitled to receive asset-based management fees and variable performance fees. Although a Hong Kong-based investment adviser often manages the operation of the fund, profits and income are often kept by the Cayman-based fund manager through contractual arrangements to control the extent of Hong Kong tax. In recent years, taxation of fund managers and advisers in Hong Kong has drawn tighter 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 adviser under a transfer pricing analysis. In the current market, sponsors of private equity funds must carefully review the service agreements among managerial entities alongside the underlying compensation arrangements to anticipate any challenges from the IRD.

v Recent developments

FMCC amendments

On 17 November 2018, an amended version of the FMCC came into effect.¹⁹ The SFC explained that the amendments to the FMCC are meant to implement financial policy reforms in the wake of the global financial crisis, and that the reforms are influenced by work undertaken by international bodies, including the International Organization of Securities Commissions, the Financial Stability Board and other regulatory bodies. The FMCC's objective, as amended, is to help ensure that Hong Kong's regulatory regime is adequately robust and in line with recent, international regulatory developments.

Although the amended FMCC applies to all SFC licensed or registered persons with a business involving the management of collective investment schemes or discretionary accounts, certain critical requirements apply only to a fund manager that is 'responsible for the overall operation of the fund' (ROOF). While the facts and circumstances must be examined to determine whether a particular manager is a ROOF, the SFC's apparent intention is to capture a fund manager that is responsible for day-to-day fund management operation. The SFC has offered, by way of example, that if the representatives of a fund manager or its subsidiaries constitute a majority of a fund board, then the fund manager may be considered a ROOF.

The amended FMCC enhances certain obligations and imposes new requirements, covering areas such as securities lending and repurchase agreements, the safe custody of fund assets, proper liquidity risk management and the disclosure of leverage.

New regulatory approach for cryptocurrency assets

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.²⁰

A virtual asset, in brief, is a digital representation of value and is referred to commonly using such terms as cryptocurrency, crypto-asset or digital token. Many virtual assets do not squarely fit within the definition of securities or futures contracts and thus would arguably fall outside the SFC's regulatory jurisdiction. On this basis, the management of funds investing solely in virtual assets and the operation of platforms that solely provide trading services for virtual assets might appear not to constitute a regulated activity as specified under the SFO. However, if firms are engaged in the distribution of funds that invest thereafter in virtual assets, then, irrespective of whether the assets constitute securities or futures contracts, these firms would be required to be licensed by or registered with the SFC. This is because the interests in such funds would be securities and the distribution of such fund interests would be a Type 1 regulated activity.

19 See Consultation Conclusions on Proposals to Enhance Asset Management Regulation and Point-of-sale Transparency and Further Consultation on Proposed Disclosure Requirements Applicable to Discretionary Accounts, issued by the SFC, available at <https://www.sfc.hk/edistributionWeb/gateway/EN/consultation/conclusion?refNo=16CP5>.

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

To improve investor protection, the SFC has developed a set of terms and conditions to better address the risks posed by virtual assets. These terms and conditions will be imposed as licensing conditions on virtual asset portfolio managers that have a stated investment objective to invest in virtual assets or that intend to invest or have invested more than 10 per cent of the gross asset value of their managed capital in virtual assets. Such portfolio managers are, furthermore, required to inform the SFC of such intentions or of any existing management.

In addition, the SFC proposes to explore how to regulate virtual asset trading platforms in a more tailored manner by working with certain virtual asset trading platform operators that have demonstrated a commitment to high standards of conduct.

Profits tax exemption expansion

On 7 December 2018, the Hong Kong government gazetted the Inland Revenue (Profits Tax Exemption for Funds) (Amendment) Bill 2018 (the Bill) to introduce changes to the existing profits tax exemption for privately offered funds. The Bill was subsequently introduced into Hong Kong's Legislative Council on 12 December 2018 and is expected to come into effect on 1 April 2019.

The purpose of the Bill is to address the concerns of the Council of the European Union over the ring-fencing features of Hong Kong tax regimes for privately offered offshore funds, and to enhance the competitiveness of Hong Kong tax regimes by creating a level playing field for all funds operating in Hong Kong. To achieve this objective, the Bill unifies the profits tax exemptions for privately offered funds so that all funds in Hong Kong, regardless of structure, location of central management and control, size or purpose, can enjoy the profits tax exemption for their transactions in specified assets, subject to certain conditions. A fund can also enjoy the profits tax exemption from investment in both offshore and local private companies. Moreover, to counteract tax evasion, the Bill also introduces certain anti-abuse measures.²¹

III 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, Hong Kong

21 See press release by the IRD, available at <https://www.ird.gov.hk/eng/ppr/archives/18120701.htm>.

will likewise continue to closely monitor and regulate the conduct of the private equity industry in a way that embraces and benefit from China's economic boom, the new global economy and growing financial integration.

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ISBN 978-1-83862-013-4