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# Investment Funds 2022

Hong Kong: Law & Practice  
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Shearman & Sterling

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# HONG KONG

## Law and Practice

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## CONTENTS

<b>1. Market Overview</b>	<b>p.3</b>
1.1 State of the Market	p.3
<b>2. Alternative Investment Funds</b>	<b>p.4</b>
2.1 Fund Formation	p.4
2.2 Fund Investment	p.4
2.3 Regulatory Environment	p.5
2.4 Operational Requirements	p.9
2.5 Fund Finance	p.9
2.6 Tax Regime	p.10
<b>3. Retail Funds</b>	<b>p.10</b>
3.1 Fund Formation	p.10
3.2 Fund Investment	p.10
3.3 Regulatory Environment	p.10
3.4 Operational Requirements	p.11
3.5 Fund Finance	p.11
3.6 Tax Regime	p.11
<b>4. Legal, Regulatory or Tax Changes</b>	<b>p.11</b>
4.1 Recent Developments and Proposals for Reform	p.11

## 1. MARKET OVERVIEW

### 1.1 State of the Market

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 centre for alternative investments, ranking second in Asia after Mainland China for total capital under management by private equity funds (excluding real estate funds), which amounted to USD164 billion in 2020. The Hong Kong industry for alternative asset management is strengthened by its diversity. Long a preferred destination for global and regional investment fund managers, 287 private equity and venture capital fund managers were headquartered in Hong Kong in 2020. For these reasons, Hong Kong is likewise an important jurisdiction for leading pension funds, insurance companies, sovereign wealth funds, family offices and other investors.

Hong Kong's asset and wealth management business posted strong growth in 2020 despite the challenges facing global markets. For example, the asset management and fund advisory businesses in Hong Kong amounted to HKD24,038 billion as at 31 December 2020, representing a significant increase of 20% as compared to 2019. Furthermore, from September 2020 to September 2021, 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 alternative asset managers – grew by 1%, 6% and 4%, respectively. Over the same period, the number of licensed representatives in Hong Kong for Type 1 and 4 regulated activities slightly dropped by 2%, while such number for Type 9 regulated activities increased by 2%.

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

Hong Kong is well positioned heading into 2022, thanks in part to legal and tax changes initiated this past year by the Hong Kong authorities, including:

- a new re-domiciliation mechanism that enables foreign funds to relocate to Hong Kong and, in connection therewith, to be registered as open-end fund companies (OFCs) or limited partnership funds (LPFs); and
- a special concession for carried interest distributable by private equity funds operating in Hong Kong not to be subject to taxation.

These changes have helped to promote and support industry adoption of the LPF form, pursuant to the Limited Partnership Fund Ordinance (LPFO) that had taken effect on 31 August 2020. With the passage of time and the benefit of these governmental initiatives, the LPFO is coming closer towards realising its objectives of bringing Hong Kong's limited partnership form in line with global standards and encouraging the use of vehicles formed locally in Hong Kong.

## 2. ALTERNATIVE INVESTMENT FUNDS

### 2.1 Fund Formation

#### 2.1.1 Fund Structures

With the enactment of the LPFO, the authors expect Hong Kong to be used more often by advisers and managers for the formation of fund entities. By the end of 2021, there were 410 limited partnership funds (LPFs) registered with the Hong Kong Company Registry.

#### 2.1.2 Common Process for Setting Up Investment Funds

The common structure of a private fund that has a managerial or advisory presence in Hong Kong consists of:

- a fund entity formed as an LPF in Hong Kong;
- a general partner (GP) formed as a limited partnership or as a company; and
- an investment manager or adviser licensed by the Hong Kong Securities and Futures Commission (SFC).

Core fund documents include a limited partnership agreement, subscription documents, a private placement memorandum (where applicable), side letters entered into with investors (where applicable), an investment management agreement and/or an investment advisory agreement.

#### 2.1.3 Limited Liability

Persons investing in private funds set up in Hong Kong generally will not be deemed to be taking part in the management of the business of these funds (and will therefore benefit from the safeguard of limited liability) so long as these persons act as passive, economic investors in connection with the investment.

As in other leading funds jurisdictions, the LPFO sets out a non-exhaustive list of safe harbour

activities that are not to be regarded as taking part in the LPF's management, including serving on a board or committee of the LPF or the GP, acting as an agent of the LPF or the GP, advising the GP in relation to the LPF's business, voting on any of the LPF's proposed transactions, and taking part in certain decisions, such as the admission or removal of partners, the extension or end of the LPF's term, the incurrance of indebtedness by the LPF, a change in the LPF's investment scope and the exercise of the LPF's rights in respect of an investment.

#### 2.1.4 Disclosure Requirements

The SFC is the primary regulator of private funds and fund managers and advisers in Hong Kong. Hong Kong-based investment managers and advisers with SFC licences are subject to regulation under certain codes of conduct, 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), which prescribe a set of matters that are required to be disclosed to investors. The FMCC, for example, requires disclosure of cross trades, leverage arrangements, securities lending, repo and reverse repo transactions, risk management policies, custody arrangements and so forth, which are usually contained in marketing documents, such as a term sheet or private placement memorandum.

## 2.2 Fund Investment

### 2.2.1 Types of Investors in Alternative Funds

Hong Kong is an international market with many of the same key investor types that operate in other important jurisdictions, including pension funds, insurance companies, private banks, wealth management firms, funds of funds, high net worth individuals and family offices. Some of these institutional investors are branch offices of Mainland China-based operations.

## 2.2.2 Legal Structures Used by Fund Managers

With the enactment of the LPFO, the authors expect Hong Kong to be used more often by advisers and managers for the formation of fund entities.

As described in **2.1.2 Common Process for Setting Up Investment Funds**, the common structure of a private fund that has a managerial or advisory presence in Hong Kong would consist of:

- a fund entity structured as an LPF in Hong Kong;
- a general partner structured as a limited partnership or as a company; and
- an investment manager or adviser licensed by the SFC.

## 2.2.3 Restrictions on Investors

Due to the periodic tightening of RMB capital outflows by the monetary regulators in Mainland China, investors that have to source capital from their Mainland China affiliate(s) may encounter difficulty in funding capital calls on a timely basis. In recent years, regulators in Mainland China have revisited and tightened control on inbound and outbound investments. Prior to making a private fund investment, investors would be advised to carefully review and understand the impact of these rules, updates thereto and relevant law enforcement actions. Certain investors are subject to special regulations based on their investor type.

## 2.3 Regulatory Environment

### 2.3.1 Regulatory Regime

Private funds set up in Hong Kong that have a Hong Kong-based team of investment professionals would typically retain, directly or indirectly, a Hong Kong investment manager or adviser.

The primary securities legislation in Hong Kong is the Securities and Futures Ordinance (SFO). 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:

- 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.

A Hong Kong investment manager or adviser entity, therefore, will usually be licensed under the SFC for conducting regulated activities in Hong Kong. The three types of licences that such manager or adviser is most likely to hold are Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management). Moreover, a manager registered in a jurisdiction other than Hong Kong that intends to conduct a regulated activity in Hong Kong, such as offering private fund interests to residents in Hong Kong or providing fund management or advisory services, must still comply with the private placement rule as detailed in **2.3.6 Marketing of Alternative Funds** and the SFC licensing regime as detailed in **2.3 Regulatory Environment**, as applicable.

The core principle behind the Hong Kong licensing regime is that applicants must demonstrate, to the satisfaction of the SFC, that these applicants are fit and proper (SFO, Section 129) to be licensed. Being fit and proper involves, broadly, being financially sound, competent, honest, reputable and reliable. To obtain an SFC licence, an applicant would need to satisfy standards relating to the competence of responsible officers and other senior management and relating also to the adequacy of financial resources.

With regard to responsible officers (ROs), an applicant must appoint at least two such 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 activities and at least one RO being designated as an executive director.

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 (LRs) accredited to such corporation. As with ROs, LR applicants must satisfy the SFC that such LR has fulfilled the fit and proper requirement and must pass a related competency test.

### 2.3.2 Requirements for Non-local Service Providers

To register a fund as an LPF, the proposed GP must arrange for a local Hong Kong law firm or solicitor to submit an application to the Hong Kong Company Registry. In addition, the GP must appoint an independent and local auditor to perform an audit of the LPF's annual financial statements.

Non-local service providers operating in Hong Kong are not, where permitted, subject to an additional legal registration requirement solely on account of being non-local.

### 2.3.3 Local Regulatory Requirements for Non-local Managers

As indicated in **2.3.1 Regulatory Regime**, if a non-local manager engages in a regulated activity from outside Hong Kong (eg, by actively marketing its services or products to the public, whether by itself or through another person on its behalf), and such activity, if undertaken in Hong Kong, would constitute the carrying on of a business in regulated activity under the SFO, then such non-local manager should adhere to the Hong Kong licensing regime as discussed herein.

### 2.3.4 Regulatory Approval Process

As indicated in **2.3.1 Regulatory Regime**, the SFO prohibits undertaking an activity (eg, the "active marketing" of a service to the public, including through persons operating outside Hong Kong) if it would constitute a regulated activity if undertaken in Hong Kong, unless such person has obtained an appropriate licence.

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

- there is a detailed marketing plan to promote the relevant services;
- the services are extensively advertised via marketing means such as direct mail, advertisements in local newspapers, the use of broadcasts or other "push" technology over the internet (as compared with situations where such services are only passively available; eg, on a "take it or leave it" basis);
- the related marketing is conducted in a concerted manner and executed in accordance with a plan or schedule that indicates a continuing service rather than a one-off exercise;
- the services are packaged to target the public of Hong Kong; eg, written in Chinese and denominated in Hong Kong dollars; and
- the services are not sought out by the customers on such customers' own initiative.

### 2.3.5 Rules Concerning Marketing of Alternative Funds

The SFO stipulates ten types of regulated activities, 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 regulated activity includes the making of, 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 regulated activity includes the giving of advice on whether to acquire or dispose of securities. If a company provides investment advice, 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 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 need a Type 9 licence.

As the profile of each private fund management team or sponsor with a managerial or advisory presence in Hong Kong may differ depending on factors such as strategy, personnel, business capabilities and operational models, 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. 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.

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.

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;
- the company's holding company that holds all of the company's issued shares; or
- other wholly owned subsidiaries of the company's holding company.

### 2.3.6 Marketing of Alternative Funds

Offerings in Hong Kong of interests in private funds structured as partnerships or trusts (in the case of closed-end funds) are subject to regulation under the SFO. Offerings in Hong Kong of shares or debentures issued by private investment funds structured as companies (in the case of open-end funds, such as hedge funds) 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 insti-

tutions, 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. It should be noted, however, that the admission by a fund of certain types of professional investors, 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.

### 2.3.7 Investor Protection Rules

As mentioned in **2.3.6 Marketing of Alternative Funds**, one exemption commonly relied upon by a private fund to facilitate private placement in Hong Kong is an offering limited to “professional investors”. The term “professional investor”, for this purpose, is defined in the SFO and its relevant subsidiary legislation, and is broadly split into three categories:

- institutional professional investors;
- individual professional investors; and
- corporate professional investors.

Institutional professional investors generally includes authorised or regulated entities, such

as recognised exchange companies, recognised clearing houses, recognised exchange controllers, recognised investor compensation companies, authorised financial institutions and authorised collective investment schemes. Individual professional investors and corporate professional investors are usually determined on the basis of their asset value or portfolio size, including:

- a trust corporation having been entrusted under one or more trusts of which it acts as a trustee with total assets of not less than HKD40 million;
- an individual, either alone or with any of their associates on a joint account, having a portfolio of not less than HKD8 million;
- a corporation or partnership having a portfolio of not less than HKD8 million or total assets of not less than HKD40 million; and
- a corporation whose principal business is to hold investments and that is wholly owned by a professional investor under the three points above.

### 2.3.8 Approach of the Regulator

The SFC is the main regulator of funds and fund managers and advisers in Hong Kong. The SFC derives its investigative, remedial and disciplinary powers from the SFO and subsidiary legislation. The SFO has empowered the SFC with multiple roles. The SFC’s principal responsibilities include maintaining and promoting the fairness, efficiency, competitiveness, transparency and orderliness of the securities and futures industry. The SFC’s scope of work includes licensing and supervising persons that conduct activities under the SFC’s regulatory purview.

The SFC often publishes guidance on regulatory matters and is timely to act when dealing with pressing concerns. The SFC often consults the industry and public at large prior to enacting significant changes in regulation. In recent years, the SFC has focused on addressing irregularities

in the market, developing regulatory approaches towards new, emerging asset classes such as virtual assets, strengthening oversight of fund managers and advisers, and taking account of the multi-jurisdictional nature of private equity.

The SFC, where applicable, initiates disciplinary actions against fund managers and advisers for misconduct. For example, the SFC recently reprimanded and fined an asset management company HKD6.4 million for control failures in solicitation and recommendation of investment products to clients. The SFC posts notices of enforcement actions on its website as a way of offering and providing insight into its regulatory approach and priorities. The SFC has also tightened its regulation on virtual assets and complex products in recent years, as detailed in **4.1 Recent Developments and Proposals for Reform**.

## 2.4 Operational Requirements

Fund managers in Hong Kong have certain reporting obligations under the SFO, the Code, the FMCC and other applicable codes and guidelines. For example, licensed or registered persons are required by the SFC, on an ongoing basis, to submit records of audited accounts. Pursuant to the FMCC, fund managers may also be requested by the SFC on an ongoing basis to provide additional information to help enable the SFC to monitor systemic risk. Such information may cover matters such as fund-level leverage, the terms of securities lending and the substance and balance of other assets and liabilities. In addition, the Code requires licensed or registered persons to report to the SFC immediately following certain specified events, such as compliance breaches and the initiation of legal proceedings.

The FMCC, in particular, requires a fund manager that is responsible for overall fund operations to disclose to investors the expected maximum level of leverage that may be employed on

behalf of such fund and the basis for calculating this leverage, which should be reasonable and prudent. Moreover, the FMCC provides that a fund manager should not borrow funds from a connected person on behalf of a fund, unless interest charged and fees levied in connection with the relevant loan are no higher than the prevailing commercial rate for a similar loan.

Although a breach of the Code or the FMCC should not directly cause the relevant licensed or registered persons to become subject to legal action, such a breach could reflect negatively on the fitness and propriety of the sanctioned persons and may thus create a basis for disciplinary action.

## 2.5 Fund Finance

Asian private equity or venture capital funds have traditionally sought financing to bridge a funding gap, either by way of a capital call or subscription credit facility. Such facilities are useful to private equity and venture capital funds as they could access funds quickly to capitalise on investment opportunities, while waiting for capital calls from limited partners to arrive. Drawdown under a capital call facility could be arranged within as little as one business day, whereas a capital call could take ten business days or more. This firm has also seen capital call facilities being utilised to bridge the funding gap between the time in which an acquisition is completed and drawdown under a permanent asset-level financing.

If seeking to incur financing or leverage, these funds are most likely to do so by entering into capital call and subscription credit facilities from banks, including international banks with a Hong Kong presence. Capital call and subscription facilities are structured as a revolving facility with the private equity or venture capital fund as borrower. The facilities are secured by an assignment of capital call rights under the limited partnership agreement and unfunded

commitments of the limited partners, together with a charge over the accounts to which capital calls are to be deposited. The facilities are not usually secured by any of the fund's underlying investment assets.

## **2.6 Tax Regime**

Under the LPFO, the LPF is eligible for an exemption from Hong Kong profits tax on qualifying income. Relatedly, cash contributions and distributions to and from an LPF will not incur Hong Kong stamp duty.

Management fees, if not sourced in Hong Kong, are generally not subject to Hong Kong profits tax. Carried interest received on or after 1 April 2020 is generally exempt from Hong Kong profits tax and salaries tax (and excluded from employment income for purposes of calculating salaries tax) pursuant to the Inland Revenue (Amendment) (Tax Concessions for Carried Interest) Ordinance 2021. To qualify for the exemption under this ordinance, eligible carried interest must relate to the provision of investment management services to certified investment funds. A certified investment fund means a fund within the meaning of Section 20AM of the Inland Revenue Ordinance (IRO) that is certified by the Hong Kong Monetary Authority (HKMA) to be in compliance with the criteria for certification published by the HKMA. On 16 July 2021, the HKMA issued a guideline setting out the criteria for certification of funds in relation to the tax concessions for carried interest.

## **3. RETAIL FUNDS**

### **3.1 Fund Formation**

#### **3.1.1 Fund Structures**

This topic is outside the coverage scope for this chapter.

#### **3.1.2 Common Process for Setting Up Investment Funds**

This topic is outside the coverage scope for this chapter.

#### **3.1.3 Limited Liability**

This topic is outside the coverage scope for this chapter.

#### **3.1.4 Disclosure Requirements**

This topic is outside the coverage scope for this chapter.

### **3.2 Fund Investment**

#### **3.2.1 Types of Investors in Retail Funds**

This topic is outside the coverage scope for this chapter.

#### **3.2.2 Legal Structures Used by Fund Managers**

This topic is outside the coverage scope for this chapter.

#### **3.2.3 Restrictions on Investors**

This topic is outside the coverage scope for this chapter.

### **3.3 Regulatory Environment**

#### **3.3.1 Regulatory Regime**

This topic is outside the coverage scope for this chapter.

#### **3.3.2 Requirements for Non-local Service Providers**

This topic is outside the coverage scope for this chapter.

#### **3.3.3 Local Regulatory Requirements for Non-local Managers**

This topic is outside the coverage scope for this chapter.

### 3.3.4 Regulatory Approval Process

This topic is outside the coverage scope for this chapter.

### 3.3.5 Rules Concerning Marketing of Retail Funds

This topic is outside the coverage scope for this chapter.

### 3.3.6 Marketing of Retail Funds

This topic is outside the coverage scope for this chapter.

### 3.3.7 Investor Protection Rules

This topic is outside the coverage scope for this chapter.

### 3.3.8 Approach of the Regulator

This topic is outside the coverage scope for this chapter.

## 3.4 Operational Requirements

This topic is outside the coverage scope for this chapter.

## 3.5 Fund Finance

This topic is outside the coverage scope for this chapter.

## 3.6 Tax Regime

This topic is outside the coverage scope for this chapter.

## 4. LEGAL, REGULATORY OR TAX CHANGES

### 4.1 Recent Developments and Proposals for Reform

The LPFO took effect on 31 August 2020. With the advent of the LPF, fund sponsors have the ability to form a streamlined fund structure with legal domicile, business operations and management personnel all in the single jurisdiction

of Hong Kong, with resulting cost and other efficiency benefits.

Relatedly, in recognition of that many private funds set up in foreign jurisdictions may wish to re-domicile to Hong Kong during their term of operation, a new fund re-domiciliation mechanism came into effect on 1 November 2021. This new set of ordinances allows, via submission of a relatively straightforward application, a foreign fund to relocate to Hong Kong and be registered as an OFC or LPF, as applicable. Investors' rights and liabilities in a converted vehicle would not be adversely affected by such conversion, and no additional stamp duty would be incurred.

With respect to climate change, much industry attention was drawn from the SFC's issuance on 20 August 2021 of Consultation Conclusions on the Management and Disclosure of Climate-related Risks by Fund Managers. Pursuant to these conclusions, fund managers are required to address, and make appropriate investor disclosures with respect to, climate change. This new requirement for fund managers reflects industry demand for asset managers to be mindful of their climate risk exposures, as well as the SFC's efforts to keep ahead of global regulatory developments in this space.

The authors are optimistic that the combination of Hong Kong's favourable global position, expanding treaty network, tax concessions and well-designed LPF Ordinance may cause many fund sponsors to look to Hong Kong for their next generation of private funds.

**Shearman & Sterling** has over 850 lawyers around the world, nearly half of whom practise outside the USA, speaking more than 60 languages and practising US, English, French, German, Italian, Hong Kong, OHADA and Saudi law. The full-service Investment Funds team is led by lawyers based in Hong Kong, London, New York and Tokyo, with support from the firm's global network of offices, advising clients across the full spectrum of investment funds, including private equity, hedge, real estate, in-

frastructure, growth and venture capital, credit and special situations, registered mutual (both open-end and closed-end) and UCITS funds. In addition to a deep bench and broad coverage across strategies, the firm has expertise in launching complex policy funds, leading sovereign wealth fund investments and providing advice to ambitious, growing PRC and Hong Kong-based asset managers, as well as advising on funds in other parts of Asia, including Japan, India and Singapore.

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