

THE PRIVATE EQUITY
REVIEW

TWELFTH EDITION

Editor
Stephen L Ritchie

THE LAWREVIEWS

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REVIEW

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PREFACE

The 12th edition of *The Private Equity Review* comes in the wake of a successful – but bumpy – year for dealmakers, which came on the heels of 2021’s record-breaking level of activity. While private equity dealmakers remained active in 2022, with merger and acquisition (M&A) activity at the second-highest level on record (and well above 2020 and pre-pandemic levels), that activity was largely a continuation of 2021’s unprecedented momentum carrying into the first half of 2022 before dropping sharply in the latter part of the year. That drop was due to a confluence of factors, including rising borrowing costs, challenged debt markets, high inflation, fears of a potential recession and declining boardroom confidence. The net result was an overall reduction in deal activity of roughly 40 per cent by value and 15 per cent by deal count from 2021. Large deals were up slightly as a percentage of overall M&A value but down in absolute numbers from 2021 levels, driven by the steep drop in mega-deals in the second half of 2022. Private equity exit activity decreased substantially in 2022, with value down 63 per cent and count down 28 per cent. Consistent with these trends, initial public offering and M&A by special purpose acquisition corporations (SPACs) – one of the biggest drivers of 2021’s record-breaking deal volume – came to a screeching halt in 2022. The number of liquidated SPACs, with SPAC funds being returned to investors without a deal being done, shot up in the fourth quarter of 2022, with more expected as additional SPACs face upcoming expirations. Although 2022 did see a steady increase in announced de-SPAC M&A activity, likely due in part to SPAC sponsors seeking a deal ahead of the significant number of SPACs approaching their expiry dates, these deals were done at much smaller average sizes than peak 2021 levels and amid an overall background of increasing numbers of terminated de-SPAC transactions.

That said, more than US\$1 trillion of global activity in 2022 was attributed to private equity sponsors – at roughly 33 per cent of global deal value, exceeding the prior all-time-high metric set in 2021. Private equity sponsors continued to seek out larger public targets in record number, with overall take-private activity and value surpassing recent levels – the average take-private deal size was US\$3.5 billion in 2022, up significantly from US\$2.6 billion in 2021. With continued confidence in the performance of private equity as an asset class, fundraising activity remained strong as well, with private equity funds raising aggregate capital of over US\$1.2 trillion and continued record amounts of available capital, or dry powder, at, by one estimate, over US\$1.4 trillion.

The year 2022 again demonstrated private equity’s enormous impact and the continuing creativity of private equity dealmakers. Given private equity funds’ success, creativity and available capital, private equity will continue to play a major role in the global economy, not

only in North America and Western Europe, but also in developing and emerging markets in Asia, South America, the Middle East and Africa, notwithstanding ongoing and potential additional political, regulatory and economic challenges.

Private equity professionals need practical and informed guidance from local practitioners about how to raise money and close deals in multiple jurisdictions. We intend for *The Private Equity Review* to help address this need. It contains contributions from leading private equity practitioners in 14 different countries, with observations and advice on private equity dealmaking and fundraising in their respective jurisdictions.

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

I want to thank everyone who contributed their time and labour to making this 12th 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 2023

Part I

FUNDRAISING

HONG KONG

*Lorna Xin Chen, Anil Motwani, Ji Zhang and Nannan Gao*¹

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\$182 billion in 2021.² The Hong Kong private equity industry is strengthened by its diversity. Hong Kong has long been a preferred destination for global and regional investment fund managers, and 287 private equity and venture capital fund managers were headquartered in Hong Kong in 2020.³ For these reasons, Hong Kong is likewise an important jurisdiction for leading pension funds, insurance companies, sovereign wealth funds, family offices and other investors.

Hong Kong's asset and wealth management business remained resilient in 2021 despite the challenges facing global markets. For example, the asset management and fund advisory businesses in Hong Kong amounted to HK\$25,888 billion as at 31 December 2021, representing an increase of 8 per cent compared with 2020. Furthermore, from September 2021 to September 2022, 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 2 per cent, 6 per cent and 6 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 by 1 per cent, 6 per cent and 3 per cent, respectively.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.

1 Lorna Xin Chen is Asia regional managing partner, Anil Motwani is a counsel, and Ji Zhang and Nannan Gao are associates at Shearman & Sterling.

2 See *Asset and Wealth Management Activities Survey 2021*, released by the Hong Kong Securities and Futures Commission (SFC) in July 2022, available at <https://www.sfc.hk/en/Published-resources/Reports-and-surveys/Periodic-reports-and-surveys>.

3 See *Preqin Alternative Assets in Asia-Pacific: Greater China*, available at <https://www.preqin.com/insights/research/reports/preqin-alternative-assets-in-asia-pacific-greater-china>.

4 See Table C2 Statistics on Number of Regulated Activities of Licensed Corporations, released by the SFC, available at <https://www.sfc.hk/en/Published-resources/Statistics>.

5 See Table C4 Statistics on Number of Regulated Activities of Licensed Representatives, released by the SFC, available at <https://www.sfc.hk/en/Published-resources/Statistics>.

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.

Hong Kong is well positioned heading into 2023, thanks in part to legal and tax changes initiated in recent years 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-ended 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), which took 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 the global standard and encouraging the use of vehicles formed locally in Hong Kong.

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 in respect of 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 under both the SFO and the Companies Ordinance.

Offering documents relating to securities offered to members of the Hong Kong public, whether or not offered by a licensed person, 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 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 a fund to be 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 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 LPFs in Hong Kong, (2) general partners formed as either limited partnerships or companies, and (3) investment managers or advisers established as companies in Hong Kong. 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, (1) selling fund interests to residents in Hong Kong, (2) conducting selling activities in Hong Kong, (3) deal sourcing and execution of transactions, (4) making recommendations and advising in respect of potential deals, and (5) 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 (1) 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 (2) 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, 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 need 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, whereas 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 (January 2022) §1.3.3, §1.3.6.

8 See SFC Licensing Handbook (January 2022) §1.3.13.

Licensing criteria

*Licence for the corporation*⁹

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 flow charts. 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 (January 2022), Fit and Proper Guidelines (January 2022), Guidelines on Competence (January 2022) and Guidelines on Continuous Professional Training (January 2022), 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 they 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

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 the Ordinance, eligible carried interest must relate to the provision of investment management services to certified investment funds.¹⁶

16 As defined in Paragraph 2 of Schedule 16D to the Inland Revenue Ordinance (IRO), a 'certified investment fund' means a fund within the meaning of Section 20AM of the 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.

III REGULATORY DEVELOPMENTS

The LPFO took effect on 31 August 2020. With the enactment of the LPFO, 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 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 an LPE, 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.

The SFC published a consultation paper on 10 June 2022 proposing amendments to certain enforcement-related provisions of the SFO, including the professional investors exemption as referenced above under Section II.i. Pursuant to the proposed amendments, advertisements of offerings that are intended to be sold only to professional investors may, in fact, be issued only to professional investors that have been pre-identified as such by an intermediary through its client identification and related procedures. The consultation period expired on 12 August 2022 and it is not yet clear when or whether the SFC's proposed amendments will be adopted.

In respect of climate change, much industry attention was drawn to 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 the Conclusions, fund managers are required to address and make appropriate investor disclosures in respect of climate change. These requirements have been introduced via amendments to the Fund Manager Code of Conduct, with the transition period for compliance having come to an end. These new requirements for fund managers reflect 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.

Going forward, we expect Hong Kong to be used more often by advisers and managers for the formation of fund entities. As at July 2022, over 510 LPFs were registered with the Hong Kong Company Registry.¹⁷

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.

¹⁷ See Financial Services and the Treasury Bureau of the Government of the HKSAR – Secretary's Blog, available at <https://www.fstb.gov.hk/en/blog/blog080922.htm>.

Recent years have seen the SFC increasing its efforts in fighting irregularities in the private equity market and strengthen its scrutiny of 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. Although 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.

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