**A New Approach To The Licensing Of Private Equity Sponsors?**

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On January 7, 2020, the Securities and Futures Commission (SFC) issued its “Circular to private equity firms seeking to be licensed” (PE Circular) setting out its view on the licensing obligations of private equity firms. The PE Circular suggests that a number of activities frequently undertaken by private equity firms may trigger licensing obligations and as a result, private equity firms operating in Hong Kong without a licence will need to consider their scope of activities and whether or not they do, in fact, wish to run the risk of operating without a licence. The PE Circular appears to confirm that the SFC’s historically relaxed approach to the licensing of private equity firms has now possibly changed.

Prior to 2019, the SFC had taken what appeared to have been a relaxed approach to the licensing of private equity firms.  Though many private equity firms operated in Hong Kong without a licence, the SFC had not taken any enforcement action against them.

Then, in October 2019, the SFC appeared to signal a possible change in approach for the first time. That month, the SFC took disciplinary action against an SFC licensed private equity firm, fining it HK$1 million on the basis that it had allowed its director and an investment manager, both of whom were not licensed by the SFC, to perform regulated functions by introducing clients to invest in funds managed by the firm and arranging for subscriptions into those funds.  This decision suggests that the SFC takes the view that private equity firms in Hong Kong raising capital are engaged in a regulated activity.

**Applicable Law**

Under the Securities and Futures Ordinance (**SFO**), unless exempted, any person who carries on a business in a regulated activity must be licensed or registered.  In this context, there are 3 relevant regulated activities, namely Type 1 (dealing in securities), Type 4 (advising on securities) and Type 9 (asset management).

Under the SFO:

“Dealing in securities” means, subject to exemptions, making or offering to make an agreement with another person, or inducing or attempting to induce another person to enter into, or to offer to enter into an agreement (i) for or with a view to acquiring, disposing of, subscribing for or underwriting securities, or (ii) the purpose or pretended purpose of which is to secure a profit to any of the parties from the yield of securities or by reference to fluctuations in the value of securities.  In the context of private equity, it is possible that the intermediation role played by a private equity firm between the fund and a prospective target company or between the fund and a prospective investor into the fund could be regarded as “dealing in securities” on the basis that in such a role, the firm induces a person (whether the fund or the investor) to enter into an agreement to acquire securities.

“Advising on securities” includes, subject to exemptions, giving advice on whether, which, the time at which, or the terms or conditions on which, securities should be acquired or disposed of.  In the context of private equity, it is possible that a private equity firm which advises a fund or the general partner of the fund on a possible investment into a prospective target company could be regarded as “advising on securities”.

“Asset management” means, subject to exemptions (i) a real estate investment scheme management, or (ii) securities or futures contracts management.  The latter means, subject to exemptions, providing a service of managing a portfolio of securities or futures contracts for another person.  In the context of fund management, where a person exercises investment discretion on behalf of another person in respect of securities, it is likely that the first person is managing a portfolio of securities for the second person.

“Securities” excludes shares or debentures of a private company within the meaning of the Companies Ordinance.

Many private equity firms took the view that because they were investing in unlisted private companies, they were not dealing in or advising on “securities” or managing a portfolio of “securities”.  This view was overly aggressive as, under the Companies Ordinance, a “private company” is, by definition, limited solely to a company incorporated in Hong Kong.

The SFC’s own Licensing Handbook also clarifies that “*where a firm deals in, advises on or manages shares or debentures of private offshore companies that fall outside the definition of ‘private company’ under the Companies Ordinance, it is likely that the firm in question will be required to be licensed*”.

**PE Circular**

The PE Circular identifies a number of common activities undertaken by private equity firms and sets out the SFC’s view on those activities.

**General Partners**

The PE Circular states that, as a general partner of a limited partnership commonly assumes responsibility for the management and control of a fund, it is generally required to be licensed for Type 9 (asset management) regulated activity “*if it conducts fund management business in Hong Kong*”.  This statement is surprisingly bold given that the general partner is the controlling mind of a limited partnership and holds the assets of the partnership on trust for the limited partners.  In these circumstances, it may be suggested that the general partner is not managing a portfolio on behalf of “another person” (i.e*.* the limited partners) as required under the SFO definition of Type 9 regulated activity, but is instead managing the portfolio for itself and as trustee.  As a trustee, the general partner would be investing in its own name and not as agent for another person.

In any event, assuming the PE Circular correctly sets out the position, the key question is whether the general partner conducts its business in Hong Kong.  This reflects the broader statutory requirement for a sufficient territorial nexus to Hong Kong in order for licensing requirements to apply.  In this regard, it is often wrongly assumed that because a general partner is incorporated outside of Hong Kong, it follows that it does not carry on business in Hong Kong or is otherwise insufficiently connected to Hong Kong to fall within the territorial scope of the licensing provisions of the SFO. For example, it is possible that a general partner incorporated outside of Hong Kong with directors or members of its investment committee based in Hong Kong may have a sufficient territorial nexus arising to trigger licensing requirements.

**Local Investment Committees**

The PE Circular suggests that where PE firms licensed for Type 9 (asset management) establish investment committees “*in Hong Kong*” and members of the investment committee “*play a dominant role in making investment decisions*”, those members are required to be licensed.  The PE Circular goes on to state that where members of an investment committee of such PE firms merely provide input from a legal, compliance or internal control perspective, they will generally not need to be licensed.

**Private Companies**

The PE Circular specifically attacks the use of special purpose vehicles (**SPVs**) incorporated as private companies in Hong Kong to hold underlying investments in companies which are incorporated outside of Hong Kong. The PE Circular states that “*If underlying investments held through SPVs fall within the definition of ‘securities’ (even if the SPVs are carved out) or the SPVs themselves fall within the definition of ‘securities’, the SFC will regard the management of the portfolio as ‘asset management’ and the PE firm would be required to be licensed*”.

It is not clear whether the SFC position accords with the statutory position as, in theory, if the directors of the SPV were to make an investment decision without reference to the private equity firm, there may be difficulties as a matter of law to suggest that the private equity firm itself was managing the assets held by the SPV.  Invariably, though, the position would be clouded by various considerations, including the fact that the directors of the SPV would likely be drawn mostly (if not exclusively) from the ranks of the officers of the private equity firm itself.

**Co-Investment Opportunities**

The PE Circular provides that where a private equity firm offers co-investment opportunities to other persons, the firm is generally required to be licensed for Type 1 (dealing in securities).    The PE Circular justifies this position on the basis that “*the act of offering the co-investment opportunities will likely be regarded as inducing other persons to enter into securities transactions*”.

However, the position on the ground may be more nuanced than the PE Circular suggests.  For example, investors in a private equity fund may be entitled, under the terms of the limited partnership agreement, to co-invest alongside the fund and in this case, it is not clear whether the private equity firm would be regarded as “inducing” the investor to co-invest.

**Capital Raising**

Consistent with the October 2019 enforcement action, the PE Circular confirms that fund marketing activities, including raising capital, will generally constitute Type 1 (dealing in securities) regulated activity.

**Outstanding Issues**

*Advisory Firms*

In a common private equity structure, the private equity sponsor acts as a non-discretionary adviser in Hong Kong with the general partner taking advice from the sponsor and then exercising investment discretion.  The PE Circular is silent on the licensing position of such a sponsor, leaving open the difficult question of whether such a sponsor may need a licence for Type 1 (dealing in securities) in the context of intermediating investments to be made by the limited partnership into a target portfolio company or a Type 4 (advising on securities) licence in the context of its provision of advice to the general partner.

*Type of Licence*

Equally, the PE Circular is silent on the type of licence which the SFC may consider to be appropriate for a private equity firm.  The PE Circular makes frequent reference to Type 9 (asset management) regulated activity but a review of the licensing status of a range of private equity firms suggests that some firms are licensed for Type 1 (dealing in securities) regulated activity, some for Type 4 (advising on securities) regulated activity, and some for Type 9 (asset management) regulated activity.  Under the SFO, the specific type of licence will depend on the private equity firm’s specific contemplated activities in Hong Kong.