

Investment Management Alert

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SFC Issues Guidance to Private Equity Firms and Family Offices on Licensing Issues

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In recent years, the Hong Kong Securities and Futures Commission (SFC) has increasingly focused on private equity funds' obligation to be licensed under the Securities and Futures Ordinance (SFO). In February 2019, the SFC's Licensing Handbook was updated to specifically note that private equity and venture capital firms may, depending on the nature of their business activities, be required to obtain a Type 1, Type 4 or Type 9 license. The latest pronouncements from the SFC contained in its circular dated January 7, 2020, titled "Circular to Private Equity Firms seeking to be Licensed," seeks to further clarify the circumstances in which it would expect private equity firms and its personnel to be licensed under the SFO, as summarized below.

Licensing triggers depend on a private equity firm's activities in Hong Kong and discretionary investment authority

Where a private equity firm is granted full discretionary investment authority with respect to the funds under its management, it would generally be expected to obtain a Type 9 license. In determining whether "full discretionary investment authority" has been granted, the SFC will consider facts such as the firm's proposed investment decision-making process, roles of the proposed licensed individuals and their involvement in such process and the documenting of investment authority delegation.

Additionally, underlying investments falling within the meaning of "securities" or "futures contracts" under the SFO, which are held in special purpose vehicles and are managed by the private equity firm, will similarly trigger a Type 9 licensing requirement for such firm (notwithstanding that the interest in the special purpose vehicle is itself carved out from the scope of asset management under the SFO).

Where a private equity firm may offer co-investment opportunities to investors, market funds to investors and/or negotiate terms to secure a transaction, it will generally be expected to obtain a Type 1 licence (unless the activity clearly falls within the Type 9 incidental exemption).

General Partners

A general partner is generally expected to be licensed for Type 9 regulated activity if it undertakes fund management activities in Hong Kong with respect to a private equity

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fund, unless (i) the general partner has fully delegated such fund management activities to another entity or (ii) the fund management activities fall outside the definition of “asset management” under the SFO (for example, if it involves assets that are not “securities” or “futures contracts” under the SFO, such as physical real estate).

Investment Committee Members

Investment committee members who (either individually or jointly) play a dominant role in investment decision making (as opposed to providing legal, compliance or internal control advice) in respect of private equity firms licensed for Type 9 activity would also similarly be expected to obtain a Type 9 licence as either licensed representatives or responsible officers.

Pragmatic approach to the licensing of private equity individuals

Responsible officers are generally required to possess three years of relevant industry experience over the six years immediately preceding the date of the individual’s application. The SFC has stated that it will adopt a pragmatic approach (similar to the approach adopted for overseas fund managers in the SFC’s June 2007 circular) in considering this requirement in relation to individuals seeking to be licensed and accredited to a private equity firm. That is, the SFC is prepared to also consider wider industry experience of the individual in the private equity context in satisfaction of the related requirement, such as experience in structuring management buyouts and privatizations and managing and monitoring a private equity fund’s underlying investments.

Family Offices

In a separate circular also issued on January 7, 2020, the SFC clarified that licensing obligations of family offices are to be determined by the structure and activities of the family office rather than the general type of family office (e.g., single vs. multifamily office).

Unless a specific exemption applies, family offices would generally be expected by the SFC to obtain a Type 9 licence in order to exercise full discretionary investment authority over a portfolio of securities and/or futures contracts. The most relevant exemptions from this licensing requirement would be if (i) the family office does not manage third party assets (i.e., it acts on behalf of the trustee only to manage assets under the trust) or (ii) the family office is a wholly owned by the trustee/entity which holds the family assets such that the intra-group exemption may be relied upon.

Other specific licenses such as for Type 1, Type 2, Type 4 or Type 5 regulated activity may also be required depending on the exact nature of the family office’s activities.

Conclusion

While the SFC has previously updated the Licensing Handbook to refer specifically to private equity and venture capital activities in February 2019 and the most recent guidance is also helpful for private equity fund managers to determine whether their activities trigger a licensing requirement, it would be most helpful if the SFC could also provide guidance on some of the practical difficulties that private equity fund managers may experience when seeking to comply with certain provisions of the SFC’s Fund Manager of Code of Conduct (FMCC) if such manager is to be licensed for Type 9 regulated activity.

The FMCC contains various compliance requirements for fund managers to comply with regarding, amongst other things, portfolio valuation policies and custody requirements. Some of these requirements are far more easily complied with by funds that hold liquid underlying investments, rather than private equity fund investments. For example, the FMCC expects certain generally accepted accounting valuation principles to be reflected in the valuation policies of the investment manager. However, not all such principles would be relevant in a private equity context (such as those relating to listed securities) and the valuation of different types of private equity fund assets are also not envisaged by such valuation principles.

The SFC also routinely imposes a licensing condition on Type 9 managers to restrict them from holding client assets in return for permitting them to maintain a lower liquid capital requirement of HK\$100,000 with no minimum paid-up share capital requirement (as opposed to a minimum liquid capital requirement of HK\$3,000,000 and a minimum paid-up share capital requirement of HK\$5,000,000 if such licensing condition is not agreed on). The term “hold” is defined in the SFO to mean (i) being in possession of property, (ii) being registered or recorded as having title to the property or being entitled to receive the property and (iii) in the case of a person carrying on business, the person being in a position to transfer the property to himself or otherwise receive the benefit of the property (where another person has a legal or equitable interest in the property and there is a connection between the property and the business carried on). In practice, it can be difficult to convince a custodian to assume responsibility for holding private equity type assets because typical private equity fund assets (e.g., physical share certificates, title documents, etc.) involve significant risk that custodians do not typically assume when acting on behalf of funds that invest in liquid strategies. If a private equity fund manager is forced to self-custody, this may be in breach of its licensing condition requiring it not to hold client assets.

In light of the recent SFC circulars, private equity firms and family offices should review their operations to ascertain whether a licence may need to be obtained from the SFC. It would also be most welcome for the SFC to provide more guidance on how private equity fund managers should approach the obligations which are more difficult to comply with under the FMCC and the usual condition on such managers’ licenses which will prevent them from “holding” client assets.

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