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Overruling the *IPFUND* case – no more "private company" exclusion for collective investment schemes?

In the recent decision of *Department of Justice v IPFUND Asset Management Limited & Anor* [2023] HKCA 925, the Hong Kong Court of Appeal overturned the District Court's ruling[1] which previously set the grounds for excluding collective investment schemes in the form of Hong Kong private companies from falling within the ambit of "securities" under the Securities and Futures Ordinance (Cap. 571) (the "**SFO**"). After the ruling, it has become less clear whether the "private company" exclusion still applies as a matter of law.

Background

In 2011, Sin Chung Yin, Ronald ("**Ronald**"), through IPFUND Asset Management Limited ("**IPFUND**"), arranged with multiple parties to invest in 16 commercial property projects.

[1] *HKSAR v IPFUND Asset Management Limited and Sin Chung Yin, Ronald* DCCC 23/2015 (Chinese only)

Ronald was responsible for sourcing properties and negotiating with the sellers, and for incorporating Hong Kong private companies, as shell companies, to acquire the properties. Upon signing a provisional sale and purchase agreement, IPFUND would notify potential investors of the property details. Each potential investor may then indicate their interest to invest, after which Ronald would decide how the indirect interest in the property was split between the investors. The investors would then pay their respective sums to fund the acquisition of the properties by the shell company.

Ronald would then sell the properties by way of confirmor sale, which obviates the need for a bank mortgage. Where a confirmor sale is successful, the shell company will pay net profits by way of a cheque to investors, and subsequently be deregistered. Where the property cannot be sold by confirmor sale (and thus requires a bank mortgage), the nominal shareholder of the shell company that holds the underlying asset will sign a declaration of trust and a shareholders agreement with the investors, with each investor being allocated his or her proportionate number of shares of the shell company based on their respective size of investment in the property.

Where this case is concerned, throughout the process, the investors were not involved in the operation of IPFUND, nor did they have day-to-day control over the management of the properties.

Based on the above facts, IPFUND and Ronald were charged with the offences of carrying on (or holding out as carrying on) a business in a regulated activity, being "dealing in securities", without a licence.

District Court

The District Court held that the investment arrangements constituted "collective investment schemes" under the SFO, meaning that IPFUND and Ronald were operating such a scheme at the relevant time.

However, the Court ruled IPFUND and Ronald not guilty of carrying on a business in the regulated activity of "dealing in securities" without a licence, on the grounds that the investors were in essence acquiring shares in the shell companies under the investment arrangements, and such shares do not constitute "securities" since the definition of "securities" expressly excludes shares of a private company within the meaning of the Companies Ordinance (Cap. 622).

As part of the reasoning in support of the "private company" exclusion, the judge agreed with the defendants' submission that in the absence of such exclusion, any dealing in shares of a property-holding private company would be considered as operating a collective investment scheme. It would then imply that any dealing in the shares of such a company, unless licensed, would result in a violation of section 114 of the SFO, and this could not have been the purpose and intention of the SFO and the regulatory regime.

Court of Appeal

Upon review of the facts, the Court of Appeal disagreed with the lower court's analysis and concluded that the investors were in fact acquiring interests in collective investment schemes, instead of acquiring shares in the shell companies. In other words, the investors were acquiring a chose in action (i.e. a right) to participate in the profits, income or other return arising from acquisition, holding, management or disposal of the properties. As such, the "private company" exclusion under the definition of "securities" in the SFO could not have come into play, and both IPFUND and Ronald were therefore guilty of the offences.

In coming to their conclusion, the Court considered the facts that:

- the shares of the shell companies were only allocated to the investors on occasions where the properties could not be sold by way of confirmor sale and required a mortgage from the bank, and it was undisputed that investors were allocated shares in respect of only some but not all of the shell companies in relation to the 16 investment projects; and

- throughout the investment arrangements, IPFUND and the investors always referred to the percentage interest in the properties and the profits arising from the sale of such properties, but not their shareholding in the shell companies.

Notwithstanding the above findings, IPFUND and Ronald remain acquitted since the Department of Justice only sought to obtain clarification on legal points and did not seek to reverse the verdict.

Discussion

Since the District Court ruling in 2016, market participants have generally taken comfort from the fact that operating a collective investment scheme in the form of a Hong Kong private company would not amount to "dealing in securities", which would otherwise require a licence if conducted in Hong Kong.

Such a view must now be taken with caution following the Court of Appeal's judgment. Since this point was not determinative of the case, the Court did not decide on whether collective investment schemes in the form of Hong Kong private companies are excluded from the definition of "securities" upon proper construction of the SFO. However, the Court expressly disagreed with the lower court's view that any dealing in shares of any private company holding properties would be considered as operating a collective investment scheme, and pointed out by way of example that pure holding companies not operated by way of business will not constitute collective investment schemes.[2]

Going forward, it is expected that any reliance on the District Court judgment in favour of the "private company" exclusion will be scrutinised by the courts. The courts are likely to further explore issues such as the finer differences between a chose in action and actually investing in the shares of a shell company to determine if one was in fact investing in a collective investment scheme.

Managers may wish to take the opportunity to review its existing investment structures if they involve any use of Hong Kong private companies as investment vehicles. Detailed analysis should be made to ensure that it does not amount to unlicensed regulated activity when dealing in the shares of such companies.

That said, the Court of Appeal did not outright reject the possibility that collective investment schemes operated in the form of Hong Kong private companies remain excluded from the definition of "securities". Through careful structuring, Hong Kong private companies can remain as useful vehicles in certain scenarios involving a limited number of investors.

Our team is experienced in advising clients on investment structures and regulatory issues in relation to asset management. Please get in touch if you are interested in discussing any of the above.

[2] Pursuant to Schedule 1 of the SFO, the definition of "collective investment scheme" does not include "arrangements operated by a person otherwise than by way of business".

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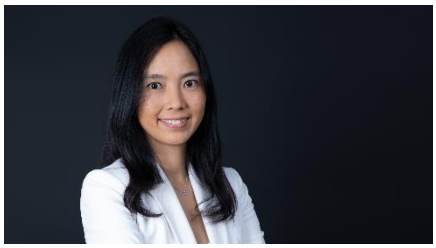

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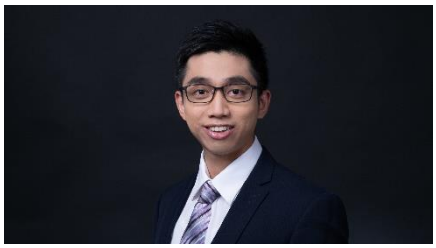

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