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Hong Kong regulatory considerations for fund managers involved in SPAC transactions

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This client update reviews Hong Kong regulatory requirements applicable to SFC-licensed fund managers and individuals that sponsor or promote SPACs and analyzes the relationship, transactions and potential conflicts of interest between funds they manage and these SPACs. We discuss in particular (a) allocation of investment opportunities, (b) participation by client funds in SPAC transactions, and (c) the impact of licensed individuals' dual roles on their fitness and properness.

Over the past several years, special purpose acquisition companies (SPACs) have attracted much attention across global markets, including Hong Kong. Many Hong Kong-based private equity fund managers have participated as sponsors (also known as promoters) in SPAC deals in the United States. In January 2022, with the adoption by the Hong Kong Stock Exchange (HKEX) of the new Chapter 18B of the Listing Rules, the Hong Kong securities market is now open to SPACs. Among other things, the rules require that at least one of the SPAC promoters[1] holding no less than 10% of promoter shares must be a corporation, or controlled by a corporation, with a Type 6 (advising on corporate finance) or Type 9 (asset management) license granted by the Securities and Futures Commission (the SFC). Thus, fund managers with Type 9 SFC licenses play a prominent role in this new regime.

This client update reviews Hong Kong regulatory requirements applicable to SFC-licensed fund managers ("fund managers") and the related licensed individuals ("licensed individuals") in the SPAC context. We focus on fund managers that sponsor or promote SPACs and analyze the relationship, transactions and potential conflicts of interest between funds that they manage ("client funds") and such SPACs. Specifically, we discuss: (a) allocation of investment opportunities, (b) participation by client funds in SPAC transactions, and (c) the impact of licensed individuals' dual roles on their fitness and properness.

Regulatory requirements overview

Hong Kong licensed fund managers are subject to the Securities and Futures Ordinance (the SFO), the Code of Conduct for Persons Licensed by or Registered with the SFC (the "Code of Conduct"), the Fund Manager Code of Conduct (the FMCC), and relevant SFC guidance and FAQs.

Fund managers must manage conflicts of interest and act in the best interest of the fund clients. As a fundamental matter, the fund manager must be satisfied that when it selects or recommends certain investments to its fund clients, such investments must be identified as the best available investments for the fund clients after appropriate consideration and due diligence. If a fund manager has identified two or more investment opportunities which appear to be equally in the best interests of its fund clients, the investment which does not involve a material interest on the part of the fund manager should be selected.

When a fund manager has a material interest in a transaction or when an actual or potential conflict arises, if it determines that proceeding with the transaction is in the best interest of its fund clients, the fund manager must ensure

that (a) it should act in good faith, (b) the transaction must be in arm's length, (c) the transaction must be on normal commercial terms, (d) the transaction must follow best execution standards, i.e., the fund client's orders should be executed on the best available terms, (e) actual or potential conflicts must be properly disclosed to the client fund and the fund investors, and (f) conflicts must be managed and minimized to ensure fair treatment of the fund investors.

A distinction should be made among the "client" funds, fund investors as a whole, and fund investors individually. Under the FMCC, "client" refers to the fund (i.e., the collective investment scheme) itself, while "fund investors" refer to "investors as a whole of a collective investment scheme…managed by" the fund manager. The relationship among the fund manager, the client fund and the fund investors (i.e., the limited partners of the client fund) both as a whole and individually is governed by the organizational documents (e.g., the limited partnership agreement, or the LPA) and the laws of the place of incorporation of the fund, which may impose additional requirements, restrict scope of transactions, or provide for procedures of disclosure and consent.

When a fund manager sponsors or promotes a SPAC, a separate set of obligations and requirements intended to protect the interests of the SPAC's other shareholders, instead of the client fund and fund investors, are applicable to the fund manager. In this respect, the fund managers, acting as promoters, are additionally subject to the organizational documents (e.g., the articles of association of the SPAC, or "SPAC Articles") and the laws of the place of incorporation of the SPAC. Listing of SPACs is also subject to the securities laws of the listing venue such as, for Hong Kong listed SPACs, Chapter 18B of the Listing Rules.

The two sets of obligations – those applicable to fund managers and to promoters – may not necessarily coincide. As a result, a fund manager must consider and balance between its duties towards its client funds and the SPAC it sponsors or promotes and consider the impact of the dual roles on its fitness and properness, as explained in detail below.

SPAC transaction

A SPAC transaction typically has two main steps: (a) formation and IPO of the SPAC, and (b) the de-SPAC transaction.

In the first step, one or more SPAC promoters invest a certain amount of their own money in the form of "at risk" capital to purchase certain promoter shares and warrants (if applicable) from the SPAC in a private placement. Typically, such shares and warrants are structured to incentivize the promoters with the prospect of substantial appreciation after a successful de-SPAC transaction. The SPAC then conducts an IPO where investors subscribe for SPAC units consisting of SPAC shares and warrants (if applicable), with proceeds placed in an insulated trust or escrow account.

In the second step, the SPAC identifies and acquires a potential target in the de-SPAC transaction. If the SPAC successfully completes the de-SPAC transaction, its promoters may obtain returns since the promoter shares and warrants were purchased at a nominal consideration far below the issue price and the value of such promoter shares and warrants increase post-business combination in a successful de-SPAC. If the de-SPAC transaction does not occur within a prescribed period of time, proceeds from the SPAC's IPO will be returned from the designated account to the IPO investors. In general, the initial capital provided by the promoters would be used to pay transactional expenses and will be (in part at least) lost if de-SPAC is not completed. During the de-SPAC process, equity and debt investors may be introduced to provide additional acquisition financing.

Fund managers, and their client funds, could potentially participate in the SPAC and its transactions at multiple stages and in multiple roles as analyzed below.

Investment opportunity allocation

Licensed individuals of the fund manager could act as directors or officers of the SPAC and, as such, owe a fiduciary duty to the SPAC to act in the best interest of the SPAC shareholders. Where such director is a licensed person accredited to the fund manager, both the individual director and the fund manager must also act in the best interest of their client funds. If the acquisition strategy of the SPAC overlaps with the client funds' investment mandate, potential conflicts may arise if and when investment opportunities are allocated between the SPAC and the funds.

Such potential conflict is typically addressed at the formation stage of the SPAC. The SPAC Articles may be designed to differentiate the industry focus or acquisition strategy of the SPAC from the fund's investment mandate. Regulators may, and have, inquired the fund managers regarding potential conflicts with SPAC and a clear distinction between the mandates of the SPAC and the client funds is an important factor to demonstrate the efforts of the fund manager to proactively manage conflicts. Further, fiduciary duties towards SPAC shareholders are typically restricted, through the SPAC Articles, by allowing the fund manager and licensed individuals to bring an investment opportunity to the client fund ahead of the SPAC. Related disclosure, including in the offer documents of the SPAC IPO and disclosure to fund investors, should be made in advance. In a typical SPAC IPO, risk factors are generally included in the listing documents to discuss the conflict of interest arising from the management members' responsibilities to the promoters or its affiliate entities (including funds), and the fact that the promoters or its affiliated entities may have similar investment objectives which may deprive the SPAC of suitable investment opportunities.

When an investment opportunity does arise, the fund manager must allocate it between the SPAC and the client funds. In doing so, the fund manager should address any potential conflicts and treat the clients fairly. An analysis will necessarily require the consideration of the specific structure of the SPAC and the fund, their constitutional documents (we assume that proactive steps discussed above have already been taken), the nature and terms of the potential acquisition transaction, existing disclosure, and prior representations to regulators (if any). The allocation decision should be made, and documented, by reference to the different investment objectives, strategies, guidelines, restrictions, risk tolerances, tax status, and other criteria consistent with the constitutional documents of the SPAC and the client fund as well as any relevant prior disclosure. Records for the allocation decision may include, for example, investment committee materials and minutes and other documents and supporting files required by the relevant internal policies.

Participation by client fund in SPAC transactions

A client fund may participate, using fund investors' money, in transactions involving the SPAC promoted by the fund manager at different stages, subject to the client fund's investment mandate and the applicable rules and waivers of the relevant stock exchange. The client fund could potentially invest into the SPAC IPO as an investor or participate in the equity or debt financing in support of the de-SPAC transaction. Equity investment could take place at the time of de-SPAC in the form of a PIPE (private investment in public equity) investment. In the U.S., it could also be made at the time of the SPAC IPO in the form of a "forward purchase" arrangement, where an investor commits to subscribe, and the SPAC commits to issue, equity in connection with a de-SPAC transaction[2]. The SPAC may also acquire a portfolio company of the client fund. In all these situations, because the client fund and the SPAC are both connected with the same fund manager, the fund manager must address potential or actual conflicts of interest and act in the best interest of its client funds. Additional procedural requirements and conditions under the applicable listing rules, for example, those in relation to connected transactions, should also be observed.

1. General considerations

In general, a fund manager may consider the following factors from the client fund's perspective when it assesses

proposed transactions with a SPAC it has promoted:

- **Fund procedures**. A decision of the client fund to participate in the relevant transactions typically requires approval, at the minimum, by the investment committee of the fund (IC). Depending on the client fund's organizational documents, a transaction involving the SPAC promoted by the fund manager likely will constitute an affiliated transaction that requires approval by the limited partners advisory committee (LPAC) and may, potentially, require approval by limited partners through voting or individual consent. To the extent applicable, such procedures should be followed. During this process, potential conflict should be clearly identified and disclosed to disinterested decision makers, including members of the IC without an interest in the SPAC, the LPAC, and (if applicable) the limited partners.
- **Professional advice**. Where necessary, advice should be sought and obtained from the client fund's external counsel as to the requirements under the SPAC Articles (e.g., fiduciary duty) and the LPA (e.g., procedures required for limited partners' consent), as well as potential conflicts of interest (both as a matter of Hong Kong law and the laws and regulations of other relevant jurisdictions).
- **Good faith**. Licensed persons must act in good faith. The fund manager and licensed individuals must honestly believe that the particular transaction is in the best interest of the client fund.
- **Arm's length**. The transaction should be on arm's length and on normal commercial terms. Good practices may include (a) the client fund receives the same terms and is treated the same as other independent parties participating in the transaction, and (b) the terms of the transaction (e.g., structure of shares and warrants in a SPAC IPO) follow customary market practice.
- **Best interest**. The fund manager should be prepared to demonstrate that the transaction, with respect to the client fund, is on the best available terms. It is generally desirable if the transaction is attractive to independent investors. For example, where a SPAC IPO is oversubscribed - i.e., viewed by public investors as a good investment opportunity - the argument that the terms are the best available is stronger. In relation to de-SPAC, indicators that the terms are the best available include sufficient financing for the acquisition, interest indicated by independent investors, result of shareholder votes, and share price movement of the SPAC around the time of the de-SPAC transaction.
- **Disclosure and consent**. Adequate disclosure must be made to limited partners under FMCC Paragraph 1.5 to address conflicts of interest. While consent by individual limited partners is not explicitly required by virtue of this paragraph or FMCC Paragraph 3.9.2, as discussed below, approval procedures under the LPA should be followed, which may additionally require consent by limited partners as a group or individually.
- **Fund mandate**. The client fund's participation in SPAC transactions makes the SPAC, or the successor company that becomes listed, a portfolio company of the fund. It is necessary to analyze the fund documents to determine whether the investment is consistent with the fund's mandate, pursuant to FMCC Paragraph 3.1. There is a risk for the transaction to be inconsistent with the client fund's mandate because, as analyzed above, some differentiation between the investment mandate of the SPAC and the client fund may have been built into the SPAC structure. If necessary, procedures under the client fund's LPA to ratify the mandate should be followed.
- **Structural assurance**. The fund manager may adopt mechanisms to ensure, structurally, that the fund manager or licensed individuals would obtain substantially similar economic payouts from either the SPAC or the client fund irrespective of the allocation or investment decision. Such assurance, if applicable, could potentially neutralize a conflict of interest concern. For example, funds may build in mechanisms to avoid "double dipping", i.e., carried interests for the fund may be adjusted based on realized gains from the SPAC investment to avoid paying the fund manager twice on the same investment. Incentives for licensed individuals may also be aligned between an investment realized through a de-SPAC transaction and other traditional exit routes of the client funds for its portfolio companies.

As could be seen from the above, consideration of these factors is fact-intensive and depends on the market condition

and the terms and structure of the specific transaction.

2. Hong Kong-listed SPACs

Additional requirements apply to the participation by a client fund in transactions involving Hong Kong-listed SPACs promoted by its fund manager.

Section J of the HKEX Guidance Letter HKEX-GL113-22 provides that a SPAC promoter may participate in the SPAC IPO or financing for the de-SPAC if (a) it is a professional investor, (b) the SPAC complies with the open market requirements[3], and (c) the price and terms of the subscription are substantially the same as other investors. Investment by the promoter into the SPAC IPO would require a waiver from the HKEX, and the promoter will have to be prepared to hold the investment until de-SPAC under Listing Rules 18B.15.[4]

While Section K of the HKEX Guidance Letter HKEX-GL113-22 provides that PIPE investment or forward purchase agreement by a client fund into a related SPAC constitute a "connected transaction" from the SPAC's perspective and require the SPAC's shareholder approval, and that waivers in relation to forward purchase agreement prior to the SPAC IPO could be sought from the HKEX for the purpose of entering into such forward purchase agreement, the Hong Kong regulators had indicated that they will not, in general, grant advanced waivers for forward purchase agreements.

In relation to a connected de-SPAC target, the SPAC must (a) demonstrate minimal conflicts of interest, (b) support, with adequate reasons, that the transaction would be in arm's length, and (c) provide independent valuation in the listing document for the de-SPAC transaction. Although the client fund may not be a controlling shareholder of the de-SPAC target, it may still be a connected person of the SPAC and hence should not receive cash consideration from its sale of shares in a de-SPAC target as part of the de-SPAC transaction, and any share consideration should be subject to a 12-month lockup, pursuant to Rule 18B.56 of the Listing Rules. These mandatory requirements for Hong Kong-listed SPACs, together with other provisions that apply more generally to these transactions,[5] may alleviate conflict concerns by ensuring arm's length of the transactions and a fair market price or valuation.

In our experience, the HKEX has placed particular focus on the conflicts of interest in Hong Kong-listed SPACs, and requires the SPAC to have concrete internal controls and policies to address potential conflicts of interest and provide robust disclosure. It is common for the HKEX to seek information from fund manager promoters regarding why they do not believe there would be material conflicts of interest if the affiliated funds have similar investment objectives. The HKEX may also require fund manager promoters to mitigate potential conflict in relation to investment opportunities or where a fund manager promotes multiple SPACs.

We note that these provisions and requirements are primarily designed to protect public investors of the SPAC instead of the interests of client funds and their investors. Therefore, the fund manager should still assess the general considerations outlined above to ensure that client funds are not disadvantaged, especially in adverse market conditions.

3. Principal trade

On or prior to the SPAC IPO, the SPAC is owned by the promoters, and may be considered a house account if the fund manager, as promoter, can exercise control and influence over the SPAC. Subscription by a client fund in the SPAC IPO, from the fund manager's perspective, thus falls under Paragraph 3.9.2 of FMCC and requires prior written consent of the fund. Procedures and requirements under the LPA for such consent should be followed.

Further, a licensed individual affiliated with the fund manager promoter could act as an individual promoter to Hong

Kong-listed SPACs, together with the fund manager entity.[6] For SPACs listed outside Hong Kong, depending on the rules of the listing venue, individuals affiliated with the fund manager may also act as sponsors or promoters. In relation to these individual promoters, a similar question is whether IPO subscription by the client fund would be prohibited as a transaction between staff personal accounts and client accounts. An argument could be made, assuming and on the basis that the SPAC's board of directors include directors other than the individual promoter and/or that the individual promoter is not the sole or controlling shareholder of the SPAC, that the SPAC entity is not considered a personal account of the individual promoter. Although promoters may be allowed to participate in the SPAC IPO or financing for the de-SPAC in general, subject the conditions under Section J of the HKEX Guidance Letter HKEX-GL113-22 as mentioned under paragraph 2 above, Hong Kong's regulatory position is unclear as to whether a SPAC would be regarded as personal account of an individual promoter of such SPAC, and accordingly, whether in this case, the client funds of an individual promoter would be prohibited to participate in such SPAC's IPO or the financing for its de-SPAC.

4. Investment by fund manager

On the flip side, if a fund manager does not use client funds but instead uses its own funds to invest in the SPAC either in its IPO or the de-SPAC transaction, there is no conflict between a client fund and the SPAC. But an issue may arise as to whether the fund manager should instead bring the opportunity to invest in the SPAC to any client fund or otherwise refrain from making the investment even if the investment is outside the mandate of the client fund or if the client fund is not allocated the opportunity due to concerns of conflicts with the SPAC (see Section III). The fund manager must follow the client fund's constitutional documents, such as the LPA, when it pursues its own investment in the SPAC.

Fitness and properness of licensed persons

When a fund manager promotes a SPAC, certain licensed individuals will have dual roles at the SPAC and at the fund manager. Dual roles include not only directorship or employment, but also "providing consultancy services or having an ownership or beneficial interest" according to the SFC's FAQ.[7] Notification must be provided to the SFC in relation to such external interest in the SPAC.

Irrespective of any participation by client funds in SPAC transactions, when a licensed person has dual capacities, a question of fitness and properness arises. A role at a SPAC could conceivably prejudice the interests of the client fund and its investors due to conflicts of interest, confidentiality concerns, allocation of resources, etc. Under the SFC's FAQ, in relation to outside directorships and business interests, the SFC is "unlikely to be satisfied that an individual is fit and proper to be licensed or to remain licensed" if the dual role "will likely prejudice the interests of investors" due to these factors. The FAQ provides, as example, that the SFC "will likely have concern if a licensed individual is also an executive director of a listed company [e.g., the SPAC] which is not of the same group of companies as his principal [e.g., the fund manager]."

Given the above, licensed persons must satisfy themselves as to fitness and properness, following a factor-based exercise, as outlined in the FAQ. Relevant factors to consider include (a) business nature, (b) the roles and duties, as well as reporting lines, of the persons having dual roles, (c) measures to manage potential or actual conflicts of interest, (d) basis on which the firms (i.e., the SPAC and the fund manager) take the view that there will not be conflicts of interest arising from the dual capacities. In addition, the licensed persons must ensure proper treatment of confidential information and allocation of sufficient time and resources to the regulated activities (i.e., services as fund manager for the client funds vis-à-vis the SPAC). These factors are non-exhaustive and, according to the FAQ, "[e]ach case will be considered having regard to its particular circumstances." Because this is a fact-specific balancing test, as we have seen in cases, licensed individuals of a fund manager promoting a SPAC are not automatically prohibited from acting, and may act, as directors of that SPAC, even if the SPAC does not belong to the same group of companies of the fund

manager.

1. Internal controls and procedures

With potential transactions in mind, a fund manager must review and ensure that it has appropriate procedures and internal controls to deal with conflicts. Such controls should include policies and procedures to consider and decide on the allocation of investment opportunities (and documentation of basis for the allocation), procedures for licensed employees to disclose potential conflicts, procedures for making investment decisions including composition of, disclosure to and approvals by IC, LPAC, or limited partners on affiliated transactions, effective information barriers, etc. When potential conflicts arise in the context of a major transaction, a fund manager should consider seeking and obtaining external and independent legal and financial advice where necessary. Any conflict must be dealt with by proper disclosure, in the best interests of the client fund, and in compliance with the constitutive documents, including the LPA, and applicable laws and regulations (such as laws of the place of organization of the funds or the listing venue). Finally, both the SPAC and the client fund should also consent to the dual capacities.

2. Confidential information

Licensed persons with dual roles may come across confidential information in the course of services being provided to the client funds, which could benefit the SPAC, and vice versa. Such confidential information may be related to publicly listed companies or investment targets in which either the SPAC or the client funds have invested or may explore investing. Here, the FAQ recognize that "Confidentiality concerns may arise as a result of the individual's possible access to non-public or sensitive information in light of his roles with his principal and/or the Company." Both the client funds and the SPAC must consider potential scenarios and establish proper control. Under the FAQ, "any measures imposed by the Firms to effectively address confidentiality concerns arising from his possible access to non-public or sensitive information in light of his roles and duties" goes to fitness and properness.

Typically, a fund enters into non-disclosure agreements (NDAs) before receiving confidential information. Dual-role licensed individuals may be required to refrain from using such confidential information for the purposes of the SPAC. The SPAC Articles should anticipate this, and permit the licensed individual to not disclose such confidential information to the SPAC. The relevant NDA should be drafted to allow the licensed person to act in his or her SPAC role while being aware of confidential information. Conversely, a situation may also arise if the licensed person becomes aware of confidential information as a result of participating in the activities of the SPAC. For example, opportunities for potential targets may be brought to the SPAC's attention beyond the control of the dual-role licensed individuals. Such confidential information from the SPAC may preclude the client funds from making certain investments, for example in public companies associated with the potential targets due to insider trading concerns. It is therefore important for the fund manager to establish and enforce effective information barriers to insulate such information to allow client funds (or other affiliated funds) to continue to function.

3. Resource allocation

Under the FAQ, time allocation "in performing his roles and duties in [the SPAC and the fund manager], and whether he can properly manage his time in carrying on (and, where applicable, supervising) the regulated activity for [the fund manager]" is one of the factors considered by the SFC for fitness and properness. A dual-role licensed person must, therefore, devote sufficient time to the business of managing the client funds. Fund managers should also observe the requirements of any resource allocation clauses in LPAs.

If you have any questions regarding the matters covered in this publication, please reach out to any of the lawyers listed below or your usual Davis Polk contact.

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[1] In this client update, we refer to SPAC sponsors or promoters as "promoters" following the Hong Kong terminology. Similarly, "promoter" shares and warrants also refer to founder shares and warrants.

[2] In Hong Kong, such forward purchase agreements require waivers from the HKEX. See subsection 2 below.

[3] Under the "open market requirements," at least 75% of the SPAC securities must be distributed to institutional professional investors, at least 75 professional investors, including at least 20 institutional professional investors, must participate in the IPO, not more than 50% of the SPAC securities in public hands may be beneficially owned by the three largest public shareholders, and 25% of SPAC securities must be held by the public at all times.

[4] SPAC promoters and their close associates are prohibited from dealing in the SPAC's listed securities prior to the completion of the de-SPAC transaction.

[5] For example, independent PIPE investors, including key investors, are required for PIPE investments.

[6] For a Hong Kong-listed SPAC, Rule 18B.10(1) provides that at least one of the promoters holding no less than 10% of promoter shares is a licensed corporation or controlled by a licensed corporation. A licensed individual alone cannot satisfy this requirement. See SPAC Consultation Conclusions, paragraph 121, and Listing Rule 18B.10. But it is not prohibited for individuals with license to become a promoter of Hong Kong SPACs, along with a licensed corporation as described above, and we have seen such precedents. In other jurisdictions, licensed individuals could act as SPAC sponsors without the involvement of a licensed entity.

[7] See https://www.sfc.hk/en/faqs/intermediaries/licensing/Outside-directorships-and-business-interests.