

Legal Commentary

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Rules Issued on Asset Product Investments in Two Fund Types

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On October 25, 2019, the National Development and Reform Commission (the “**NDRC**”) promulgated the *Circular on Matters Concerning Further Clarifying the Regulation of Investment of Financial Institution Asset Management Products in Venture Capital Funds and Government-funded Industry Funds* (the “**Rules**”), jointly with the People’s Bank of China, the Ministry of Finance, the China Banking and Insurance Regulatory Commission, the China Securities Regulatory Commission, and the State Administration of Foreign Exchange. The Rules are a regulatory supplement to Article 2 of the *Guiding Opinions on Regulating the Asset Management Business of Financial Institutions* (the “**Guiding Opinions**”), which provide that “the provisions with regard to venture capital funds and government-funded industry funds shall be developed separately.” We briefly summarize and analyze the key provisions of the Rules for your reference in combination with the *Press Conference Q&A Regarding Circular on Matters Concerning Further Clarifying the Regulation of Investment of Financial Institution Asset Management Products in Venture Capital Funds and Government-funded Industry Funds* (the “**Q&A**”).

Applicable scope of the Rules

The Rules mainly apply to investments made by financial institution asset management products in venture capital funds (“**VC Funds**”) and government-funded industry investment funds (“**Government Industry Funds**”; collectively, the “**two fund types**”), which is consistent with the logic of the Guiding Opinions¹. In addition, the exemptions for “nesting restrictions” equally apply to investments in the two fund types by financial institution asset management products and ordinary private equity funds. “Financial institution asset management products” refer to asset management products issued by financial institutions such as a banking, trust, securities, funds, futures, or insurance asset management institutions, or financial asset investment companies, as provided in the Guiding Opinions.

¹ Please refer to Han Kun’s Legal Review, entitled *Han Kun Series—Analyzing the Guiding Opinions on Regulating the Asset Management Business of Financial Institutions—for Private Equity Funds*, dated of April 28, 2018 (Chinese). <http://www.pbc.gov.cn/en/3688253/3689009/3788480/3778722/index.html>

Conditions for the two fund types to enjoy “support policies”

What are the two fund types? Under the Rules, the definitions of the funds do not see significant changes compared to previous documents. Specifically, the definition of “VC Funds” is essentially the same as that provided in the *Interim Measures for Administration of Venture Capital Investment Enterprises*² issued by the NDRC et al. in 2005, and the definition of “Government Industry Funds” is essentially the same as provided in *Interim Measures for Administration of Government-funded Industry Investment Funds*³ issued by the NDRC at the end of 2016. However, not all of the two types of funds are eligible for support policies under the Rules. Funds must satisfy conditions stipulated in either Article 1 or Article 2 of the Rules to be eligible for the support policies.

The conditions for VC Funds include:

1. Conformity with the relevant provisions for VC Funds as stipulated in the Interim Measures for Administration of Venture Capital Investment Enterprises or the Interim Measures for Supervision and Administration of Private Investment Funds, and completion of the record-filing procedures as required;
2. The fund’s investments conform to national macro management policies such as industrial policies and investment policies;
3. The investment scope of the fund is limited to unlisted enterprises, except for shares which are not transferred or allotted as held by the fund after the listing of the investee;
4. The operation of the fund does not involve debt financing, except for the issuance of bonds for purposes of improving investment capacity in accordance with law;
5. The duration of the fund is no shorter than seven years; structured arrangements are not allowed for fund shares, with the exception of preferred share classes for government-established and -funded venture capital guidance funds;
6. The name of the fund contains the words “venture capital”, or the fund contract and prospectus describe a “venture capital” strategy.

Item (5) requires special attention among the six conditions above, that is, “[t]he duration of the fund is no shorter than seven years; structured arrangements are not allowed for fund shares, with the exception of

² According to Article 2 of *Interim Measures for Administration of Venture Capital Investment Enterprises*, the term “venture capital investment enterprise” as used in these Measures refers to an enterprise incorporated within the territory of the People’s Republic of China mainly engaged in venture capital investment. The term “venture capital investment” as used in the previous paragraph refers to a method of investment whereby equity investments are made in start-up enterprises in the hope of reaping capital gains mainly through equity transfers after the invested start-up matures or is relatively mature. The term “start-up enterprises” as used in the previous paragraph refers to growth enterprises being set up or re-established, which are registered and established within the territory of the People’s Republic of China, excluding those already listed.

³ According to Article 2 of *Interim Measures for the Administration of Government-funded Industry Investment Funds*, for the purpose of the Measures, the term “government-funded industry investment funds” refers to equity investment funds and venture capital funds which are sponsored by the government and are mainly used to invest in enterprises’ non-publicly traded equity.

preferred share classes for government-established and -funded venture capital guidance funds”. The Rules encourage VC Funds to make long-term investments by stipulating a duration of seven years or more for VC Funds. Based upon our past experiences, most VC Funds we have encountered are of a duration of seven years or more, but there are also certain VC Funds (particularly special funds) whose duration is less than seven years. In addition, VC Funds with structured share classes will also face certain obstacles to become eligible for the support policies. In practice, preferred share classes are not only given to government-established and -funded venture capital guidance funds, but also may be extended to financial institution asset management products, depending on the business arrangements of relevant parties.

Government Industry Funds need to satisfy the following conditions:

1. Approval obtained from the people’s government at the central or provincial levels, or municipalities with independent planning status (including a department thereof or institution directly thereunder) and the government capital commitments are clearly specified in the approval document or other documents; the proportion of government capital commitments shall not be less than 10% of the total fund size, where the establishment of the fund is approved by the CPC Central Committee and State Council, the proportion of government capital commitment shall not be less than 5% of the total fund size;
2. Conformity with relevant provisions of *the Interim Measures for the Administration of Government-funded Industry Investment Funds and the Interim Measures for the Administration of Government Investment Funds*;
3. The fund’s investment scope conforms with national macro administrative policies, such as industrial policies and investment policies;
4. The operation of the fund does not incur implicit debts for local governments.

The above conditions clearly exclude application of the Rules to Government Industry Funds set up by governments below the provincial, autonomous district, and municipality levels (except for municipalities with independent planning status)⁴. Therefore, Government Industry Funds that are established by governments of municipalities directly under the central government or governments of prefecture-level municipalities are not included in the applicable scope which, however, account for a considerable portion of Government Industry Funds that are currently mature and active in the market. Government Industry Funds ineligible for preferential treatment for Government Industry Funds under the Rules may consider whether they satisfy conditions for VC Funds.

Based upon the definitions provided in the Rules, it appears that the scopes of the two fund types are limited to direct investment private equity investment funds that invest directly in unlisted companies. So, does this mean government industry parent funds and venture capital parent funds are exempted from the Rules? According to the Q&A, “some of the two fund types are ‘parent funds’ that directly serve the real

⁴ As of the date of this Article, there were five municipalities with independent planning status, including Dalian, Qingdao, Ningbo, Xiamen, and Shenzhen.

economy. They do not violate restrictions of the Guiding Opinions that prohibit asset management products from ‘leaving the real economy for the virtual economy’ and ‘circulating within the financial system’.” According to the NDRC’s explanations, we understand that the two fund types referenced in the Rules should also include “parent funds” that primarily invest in the equities or shares of other private equity funds, the details of which await to be further clarified and explained by the NDRC in practice.

Exemptions for nesting restrictions

According to the Guiding Opinions, “[a]n asset management product may further invest in a layer of asset management product, but the latter may not further invest in an asset management product other than a publicly offered securities investment fund”, and “[p]rivate investment funds shall be governed by the special laws and administrative regulations on private investment funds, or, in the absence of explicit provisions in such laws and administrative regulations, by these [Guiding Opinions], and the provisions with regard to venture capital funds and government-funded industry investment funds shall be developed separately.” Before the promulgation of the Rules, it had not been clarified in any laws or by any regulatory authority whether a general private equity investment fund established by a non-financial institution constituted “a layer of asset management product” in counting investment layers. In practice, many financial institutions may feel uncertain about complying with the nesting restrictions when investing in ordinary private equity funds. The Rules put an end to this uncertainty by clarifying the relevant issues in a formal written document jointly issued by the six ministries and commissions.

The Rules clearly specify that VC Funds and Government Industry Funds which meet the conditions are not considered a layer of asset management product when they receive investments from financial institution asset management products and private equity funds—such investments will not be considered nesting investments. The Q&A further explains the inherent logic of the exceptions made for the two fund types: the nesting restrictions for asset management product investments as stipulated in the Guiding Opinions are primarily intended to reduce the flow of funds within financial institutions; that is, to prevent asset management products from “leaving the real economy for the virtual economy” and “circulating within the financial system”. The two fund types should not be considered as nesting layers because they directly serve the real economy. In this respect, the Rules basically resolve the concerns regarding the application of nesting restrictions on financial institution asset management products when investing in ordinary private equity funds. After the promulgation of the Rules, we expect that financial institution asset management products, Government Industry Funds, or market-oriented parent funds will prefer investees that meet the conditions stipulated in the Rules in order to reduce their own nesting compliance risk.

Effectiveness of existing products

Financial institutions may have already made investments into the two fund types prior to the issuance of the Guiding Opinions. However, those investments may be at risk of violating the restrictions as stipulated in the Guiding Opinions on asset management business carried out by financial institutions, thus making it difficult for financial institutions to determine the effectiveness of such investments.

According to the Rules, subscription agreements signed by and between financial institutions and VC

Funds and Government Industry Funds that meet the conditions before the issuance of the Guiding Opinions will continue to be effective. During the transition period, financial institutions can make investments by issuing existing products (subject to fewer restrictions compared to new products as stipulated in the Guiding Opinions), but must gradually and orderly reduce the scale of the existing products on yearly basis. If the existing products issued by financial institutions have not yet expired at the end of the transition period, the Rules provide that these existing products will be “handled appropriately according to a plan approved by the financial regulatory department”. Therefore, we understand that unexpired products after the transition period will be handled on case-by-case basis before obtaining further instructions from the relevant authorities.

In principle, the VC Funds and Government Industry Funds are governed by the Guiding Opinions in all aspects, other than matters subject to “separate provisions” or for which “exceptions” have been provided in the Rules. In our view, on the whole, the Rules benefit VC Funds and Government Industry Funds and, to some extent, relax investment restrictions on investments in these two fund types by financial institution asset management products. This will attract more capital flows into early investments, long-term investments, and investments in line with industrial policies and will bring vitality to the private equity investment market. We will continue to monitor issues that may arise during the implementation of the Rules and share and discuss our opinions with you in a timely manner.

Important Announcement

This Legal Commentary has been prepared for clients and professional associates of Han Kun Law Offices. Whilst every effort has been made to ensure accuracy, no responsibility can be accepted for errors and omissions, however caused. The information contained in this publication should not be relied on as legal advice and should not be regarded as a substitute for detailed advice in individual cases.

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