Tianjin pinches its PE rules

As one of China's preeminent fund formation hub cities, Tianjin is regarded by many industry participants as an influential barometer for other jurisdictions' private equity-related regulation. The city recently released new measures that enforce stricter supervision on a wide spectrum of fund formation, administrative and operation matters

Since the introduction of the term "PE" into China from abroad around 2007, Rmb-denominated private equity funds (PEFs) have mushroomed in China and so have a number of cities that compete to attract such funds to their jurisdiction. Among the various PEF formation hub cities that have emerged, Tianjin stands out as one of the leading fund formation cities because of its advantage as a State Council-designated pilot city for financial innovation and its relatively flexible and efficient fund formation environment. At the same time, however, there have been a few high-profile illegal fund-raising and financial fraud cases involving PEFs formed in Tianjin in recent years.

In order to manage financial risks and combat illegal financial activities such as illegal fund-raising, further regulate PEFs and their management companies (PEMCs) and promote the healthy development of the PE industry in Tianjin, against the backdrop of the issuance of the *Notice of the General Office of the National Development and Reform Commission on Further Regulating the Development Equity Investment Enterprises in Pilot Regions and the Relevant Record-Filing Administration* (Fa Gai Ban Cai Jin [2011] No. 253) (国家发展改革委办公厅关于进一步规范试点地区股权投资企业发展和备案管理工作的通知) (发改办财经[2011]253号) (Circular 253) requiring the mandatory record filing of PEFs of Rmb500 million or above formed in designated pilot areas with the National Development and Reform Commission (NDRC), Tianjin has recently revamped its filing regulation on PEFs and PEMCs. The old Tianjin filing regulation, the *Trial Measures for the Administration of Registration and Filing of Equity Investment Funds and Equity Investment Fund Management Companies (Enterprises) in Tianjin* (Jin Fa Gai Cai Jin [2008] No. 813) (天津股权投资基金和股权投资基金管理公司（企业）登记备案管理试行办法) (津发改财金[2008]813号), (the Old Measures), issued on November 10 2008, were superseded by the *Measures for the Administration of Equity Investment Enterprises and Equity Investment Management Institutions in Tianjin* (Jin Fa Gai Cai Jin [2011] No. 675) (天津股权投资企业和股权投资管理机构管理办法) (津发改财金[2011]675号)) (the New Measures) promulgated on July 11 2011 with an effective date of September 2011.

In this context and for the purposes described above, the New Measures prescribe more comprehensive and stringent regulation than the Old Measures on the record filing, bank custody, registration requirements, supervision of fund

Tightened measures: increased thresholds for capital raising, more stringent record-filing procedures, and heightened supervision

formation jurisdictions, intermediary agencies and other aspects of the formation and operation of PEFs and PEMCs. The advent of the New Measures signals a new phase of stricter regulation on PEFs and PEMCs in Tianjin. Compared to the Old Measures, significant changes mandated by the New Measures include the following:

Increased threshold for establishment and capital raising of PEFs

Under the Old Measures, PEFs in corporate form and PEMCs in the form of a limited liability company (LLC) are required to have a minimum registered capital of Rmb10 million and Rmb1 million (Rmb 5 million for PEMCs in the form of a company limited by shares (CLS)), respectively, of which no less than Rmb10 million and Rmb1 million shall be contributed at the time of formation, respectively. The New Measures increased the minimum capital requirements.

Pursuant to the New Measures, PEFs in corporate form are required to have a minimum registered capital of Rmb100 million (up from Rmb10 million), of which no less than Rmb 20 million shall be contributed as the first installment. PEMCs in LLC form are implicitly required to have a minimum capital of Rmb2 million, of which the greater of Rmb2 million (compared to Rmb1 million under the Old Measures) and 20% of the registered capital as required by the *PRC Company Law* (中华人民共和国公司法) shall be contributed as the first installment. For PEMCs in CLS form, while the New Measures no longer have an explicit requirement of Rmb5 million minimum capital in the Old Measures, they impose the same increased minimum first installment payment as that for PEMCs in the LLC form described above.

New Measures prescribe more comprehensive and stringent regulation than the Old Measures on the record filing, bank custody, registration requirements, supervision of fund formation jurisdictions, intermediary agencies and other aspects of the formation and operation of PEFs [private equity funds] and PEMCs [private equity management companies]

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One major loophole in the Old Measures that received a lot of criticism in the wake of several fraud cases involving PEFs formed in Tianjin was the lack of requirements on any capital contribution to PEFs in partnership form. To close the loophole, in addition to imposing the same Rmb100 million minimum capital requirement on PEFs in partnership form as PEFs in corporate form, the New Measures explicitly require PEFs in partnership form to pay up at least Rmb10 million at the time of formation. Such initial capital contribution needs to be verified with contribution verification reports from accounting firms as well as bank statements/certificates.

In order to combat illegal fundraising activities, the New Measures impose more stringent requirements on PEF investor eligibility: (i) each entity investor and each individual investor in a PEF are required to subscribe for a minimum of Rmb10 million and Rmb2 million, respectively, up from Rmb1 million for any entity or individual investor as previously required under the Old Measures; (ii) each individual investor in a PEF is required to provide a certificate issued by a financial institution evidencing his or her ownership of financial assets of at least Rmb2 million; (iii) the investor(s) in a PEMC shall have never been subject to any material administrative or judicial sanction and; (iv) the investor in a PEF or a PEMC shall make capital contributions with her own capital, and the PEF may not accept any entrusted capital subscription by any investor on behalf of other investors. While the last eligibility requirement may be understood to be primarily for the purpose of preventing nominee arrangements, it is causing a lot of confusion about whether any collective trust plan is eligible to invest in a PEF, and if so, whether the beneficiaries behind the trust plan should count toward the 50-investor cap for PEFs in partnership or limited liability company form. At the ime of writing, it appears that the New Measures will be interpreted to require the look-through of any collective trust plan in any PEF of at least Rmb500 million in counting the 50-investor cap. This will largely prevent the use of such trust plans in any PEF of significant size and seems to be an overkill.

More stringent record-filing procedures for PEFs and PEMCs

Record filing at the national or local level is in some sense a double-edged sword for PEFs and PEMCs: On one hand, it has previously been the case (for example, under the Old Measures) that only PEFs of Rmb100 million or above that also satisfy certain other requirements (such as a minimum single investor's investment of no less than Rmb1 million and a specified minimum number of qualified senior investment management professionals) are eligible to conduct record filing, and record filing appears to provide a level of government endorsement and legitimacy of the PEFs in their fundraising games and treatment of certain local preferential policies (record filing with the central NDRC is even more sought after by major PEFs because such record filing is a pre-condition for soliciting investments from China's national pension fund, one of the limited institutional investors for large PEFs in China at this time). On the other hand, however, PEFs and PEMCs that so file subject themselves to a heightened level of regulation, including various reporting and disclosure requirements, and also incur additional compliance costs.

The eligibility requirements for record filing under the Old Measures, such as a minimum amount of registered (subscribed) capital of no less than Rmb100 million for PEFs and a minimum

of three senior investment management professionals with over two years of relevant experience, at least one of whom has had experience in equity investment or economic management for over five years, for PEMCs now became threshold requirements for the establishment of PEFs and PEMCs in the first place.

Under the New Measures, all PEFs formed in Binhai New District, the pilot district in Tianjin, with a registered (subscribed) capital of at least Rmb500 million (or its foreign currency equivalent) are required to file indirectly with the NDRC at the central level through the Tianjin Filing Office led by the Tianjin NDRC. All the PEFs formed in Tianjin (for example, those falling between no less than Rmb100 million and less than Rmb500 million or their respective foreign currency equivalent) are now required to file with the Tianjin Filing Office within 60 days after formation, and the related PEMCs are required to make ancillary filings as well. The New Measures also require PEFs formed before the promulgation of the New Measures to be regulated and uniformly supervised step-by-step.

The promulgation of the New Measures is significant in the sense that it not only will have a significant impact on PEFs and PEMCs formed in Tianjin or that are considering Tianjin as a potential jurisdiction of organisation, but may also influence the regulatory thinking of other major PE hub cities in China

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Increased regulation on custodian banks

Circular 253 only requires that the assets of a PEF whose management company is a wholly foreign-owned enterprise or Sino-foreign joint venture shall be placed in custody with a custodian institution with legal person status. The New Measures expanded the scope of PEFs requiring custody by providing that all PEFs formed in Tianjin shall enter into custody agreements with custodian banks and place their assets with such custodian banks. Further, the New Measures increased the banks' custody responsibilities by requiring that the custodian bank itself apply for record filing, monitor the use of assets under management of PEMCs and submit annual asset custody reports to the Tianjin Filing Office.

Increased Supervisory Responsibilities of Government Departments in the Registration Location

The New Measures require PEFs and PEMCs in Tianjin to be formed in its Binhai New District in principle. Other districts and counties that satisfy certain requirements may apply to the Tianjin Filing Office to become a recognized jurisdiction for the formation of PEFs and PEMCs. Such requirements include the existence of dedicated working groups, management systems and departments, staff familiar with relevant laws and regulations governing the capital raising and operation of PEFs and the experience of handling a relatively large number of PEF registrations in the past. Such qualified jurisdictions and their relevant staff are subject to regular inspection and training by the Tianjin Filing Office, and failure to do so may result in the loss of their qualification.

Regulation of intermediaries

Another new requirement under the New Measures is that accounting firms and law firms with PEF clients formed in Tianjin are now required to submit certain information regarding such firms to the Tianjin Filing Office for record, including the basic information regarding such firm, its business, persons in charge, personnel involved in servicing PEF clients and experience with similar representations. PEFs and PEMCs that have completed the record-filing are encouraged to apply to become members of the Tianjin Equity Investment Funds Association voluntarily and subject themselves to its supervision.

The New Measures signal the continued rapid evolvement of PRC regulation on the nascent private equity industry. The promulgation of the New Measures is significant in the sense that it not only will have a significant impact on PEFs and PEMCs formed in Tianjin or that are considering Tianjin as a potential jurisdiction of organisation, but may also influence the regulatory thinking of other major PE hub cities in China. It remains to be seen how the tightened Tianjin regulation will be implemented and whether its brethren provinces will follow suit.

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